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**THE TAXABILITY OF INCOME DERIVED FROM ILLEGAL
ACTIVITIES IN TERMS OF THE INCOME TAX ACT 58 of
1962**

By

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DECLARATION

I, Ntuthuko Hugo Khumalo, hereby declare that the work on which this dissertation is based on is my original 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 hereby presented in partial fulfilment of the requirements for the award of the Degree of Master of Laws in Business Law.

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Signature

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Date

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ABSTRACT

This dissertation is a comparative analysis of the taxation of income derived from illegal activities in South Africa and the United States of America, with specific reference to the South Africa Income Tax Act 58 of 1962. The issue of whether or not income which has been received by a taxpayer in the furtherance of illegal activities should be viewed as being received by the taxpayer for purposes of assessing such a person's gross income has been a topic of debate, both in South Africa and abroad. However, it is submitted that taxation of income from illegal activities is now a well-established tax principle both in South Africa and in the United States of America, notwithstanding the fact that it is tainted with illegality. It has been established that in both jurisdictions income is taxed irrespective of the legality of the source, in other words 'income is taxed from whatever source derived'.

It is submitted that the proper and exact meaning should be attributed to the phrase 'received by' as provided for in the definition of 'gross income' in terms of Income Tax Act. This is important as the proper definition of the phrase is a useful vehicle in terms of which a decision can be made to determine whether or not to tax income derived from illegal activities. A novel approach to the interpretation of the term 'received by' emerged after the *MP Finance Group CC (In Liquidation) v Commissioner for South African Revenue Service* 2007 (5) SA 521 (SCA) case, with its interpreting of the phrase 'received by' being made with reference to the subjective intention of the taxpayer. The Supreme Court of Appeal in the *MP Finance* case resolved that the critical element of a receipt is the intention of the taxpayer to retain an amount with the objective of deriving a benefit for himself. That is to say, a person receives an amount if he claims a right to it, regardless of whether he or she is entitled to it or not. On the other hand the United States follows an 'economic benefits approach', which poses the question as to whether the taxpayer 'has such control over ill-gotten gains that, as a practical matter, he derives readily realisable economic value from it'. Thus for an amount to be taxed the taxpayer must derive an economic benefit from such income.

In its closing the dissertation will look at the issue of deductibility of expenses incurred in the production income from illegal activities. Due to fact that The South African Income Tax Act

58 of 1962 offer very little clarity on the deductibility of such expenses, the dissertation will look to The United States Internal Revenue Code which, a richer source of information in this regard. Tax law in the United States allows taxpayers to deduct most business expenses.

TABLE OF CONTENTS

DECLARATION	i
ACKNOWLEDGEMENTS	ii
ABSTRACT	iii
CHAPTER ONE	1
1. Introduction	1
1.2. Background	2
1.3. Statement of Purpose.....	4
1.4. Rationale of the Study	4
1.5. Main Research Questions.....	5
1.6. Research Sub Questions	5
1.7. Methodology	6
1.8. Limitations of the Study.....	6
1.9. Overview of the chapters.....	7
CHAPTER TWO	8
2. The Taxing of income derived from illegal activities in terms of the South African Law	8
2.1. Introduction	8
2.1.1. Is income derived from unlawful activity taxable?.....	8
2.2. Should income derived from illegal activities be taxed?	11
2.3. Can income derived from illegal activities constitute taxable income?.....	13
2.3.1. The definition of gross income	13
2.3.2. The meaning of the phrase ‘received by’	14
2.3.3. Criticisms of <i>Commissioner of Taxes v G</i>	17
2.5. <i>MP Finance Group v Commissioner, SARS</i>	20
2.5.1. The Facts	20
2.5.2. Decision of the Court a quo	21
2.5.3. The Legal Question and the Taxpayer’s Arguments	21
2.6. The Intention of the Taxpayer as a Test for ‘receipt’	22
2.7. Deductions.....	24
2.8. Conclusion.....	27
CHAPTER THREE	29

3. Taxation of income derived from illegal activities in the United States of America	29
3.1. Background	29
3.2. Introduction	29
3.3. Is income derived from illegal activities taxable in the United States?	30
3.4. Should illegally derived income be taxed in terms of American Law?	33
3.5. Deductions.....	34
3.6. Conclusion.....	36
CHAPTER FOUR.....	37
4. Conclusion	37
4.1. Is income derived from illegal activities taxable?.....	37
4.2. Should the government subject income from illegal activities to taxation	38
4.3. Intention of the taxpayer	39
4.4. Deductions.....	39
4.5. Conclusion.....	Error! Bookmark not defined.
Bibliography	42
Primary Sources.....	42
United States of America Case Law	42
Table of Statutes	43
South African Case Law	43
Table of Statutes	44
Secondary Sources	45
Books.....	45
Journal Articles	45
Theses.....	46

‘Nothing can be said to be certain, except death and taxes.’¹

CHAPTER ONE

1. Introduction

The issue of whether or not income which is received by a taxpayer in the course of carrying on illegal activities should be regarded as being received by such a taxpayer for purposes of assessing such person’s gross income has been a subject of debate, both in South Africa² and abroad.³ Different jurisdictions have arrived at different decisions in regard to the above issue, for example a Zimbabwean case of *Commissioner of Taxes v G*,⁴ held that, ‘stolen money cannot constitute gross income in the hands of the thief, because of the fact that the money never became the property of the thief, despite his own intentions.’⁵ The basis of this decision was that ‘a thief ‘takes’ rather than ‘receives’ the money within the meaning of the Zimbabwean tax legislation,⁶ thus the stolen money was not deemed to have been received by the thief.’

However the above Zimbabwean court decision is now in direct contrast with the recent South African Supreme Court of Appeal judgment in the case of *MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service*,⁷ (hereafter *MP Finance*) as it no longer reflects the current position under South African income tax law. It is trite that South African courts have been inconsistent and have highlighted the uncertain treatment of income derived from illegal activities which is received by a taxpayer for income tax purposes⁸ until the case of *MP Finance*.⁹

¹ 'Letter from Benjamin Franklin to Jean Baptiste Le Roy' (Nov. 13, 1789), reprinted in A Smyth (ed) *The Writings of Benjamin Franklin 1789-1790* (1907) at 69.

² G Goldswain 'Illegal activities – Taxability of its proceeds' (2008) 22 *Tax Planning* 143. In South Africa (RSA) the courts 'have been grappling for a long time with the question of whether income from illegal activities should be included in 'gross income' for purposes of taxation. See '*Geldenhuis v Commissioner for Inland Revenue* 1947 (3) SA 256 (C); *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A); *Secretary for Inland Revenue v Smart* 1973 (1) SA 754 (A); *MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service* 2007 (5) SA 521 (SCA)'.

³ E Muller 'The taxation of illegal receipts. A pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)' (2007) 28(1) *Obiter* at 166. See *Commissioner of Taxes v G* 1981 (4) SA 167 (ZA).

⁴ *Commissioner of Taxes v G* 1981 (4) SA 167 (ZA).

⁵ *Ibid* at 377.

⁶ Income Tax Act [Chapter 23:06], Zimbabwe.

⁷ *MP Finance Group CC (in liquidation) v CSARS* 2007 (5) SA 521 (SCA).

⁸ E Muller (see note 3 above) at 166.

⁹ *MP Finance Group CC* (see note 7 above).

1.2. Background

The definition of gross income as provided for in section 1 of the Income Tax Act¹⁰ (hereafter the Act) is the basis on which to determine a taxpayer's taxable income. Gross income in relation to any year or period of assessment, means¹¹

- i. in the case of any resident, the total amount, in cash or otherwise, received by....such resident; or
- ii. in the case of any person other than a resident, the total amount, in cash or otherwise, received by...such person from a source within the Republic.

It is important to note that only those amounts that are 'received by' or 'accrued to' the taxpayers are subject to taxation for the purpose of income tax.

The phrase 'received by' plays a pivotal role in determining whether an amount falls within the definition of gross income or not. The correct interpretation of the above term is very important for the purposes of determining the taxability of income derived from illegal activities received by a taxpayer. There have been some debates as to how the term 'received by' should be interpreted. This is so because the term 'received by' is not defined or interpreted by the Act and has only been the subject of judicial interpretation by the South African courts. In the case of *Geldenhuis v CIR*,¹² it was held that the meaning of 'receive' for purposes of the definition of gross income meant that the taxpayer should receive the amount 'on his own behalf and for his own benefit'.¹³ Thus, courts have taken the view that for a receipt to occur the recipient must be legally entitled to that amount and that there be no outstanding obligation on him or her to transfer the amount to another, in other words the money must be received by him or her for his own benefit.¹⁴

The above approach is known as the objective interpretation method. It has been argued that the objective method of interpretation is limiting when it comes to the taxability of income from illegal activities,¹⁵ and was seen as an escape route by taxpayers who derive their income from illegal activities. This is due to the fact that the recipient of the income derived

¹⁰ Income Tax Act, No 58 of 1962, Section 1.

¹¹ *Ibid*, see Interpretation of the South African Income Tax Act.

¹² *Geldenhuis v Commissioner for Inland Revenue* 1947 (3) SA 256 (C).

¹³ *Ibid* at 431.

¹⁴ *Ibid*.

¹⁵ SARS interpretation note No.80, (2014) at 2.

from illegal activities firstly, may not disclose its existence and secondly, the objective interpretation requires entitlement on the part of the recipient for the income derived from illegal activities to form part of his gross income. In such instances the unlawful recipient can simply escape tax liability by hiding behind his lack of entitlement, in that while he has the money in his possession he is not entitled to it and it therefore does not fall into his gross income. However, in the *MP Finance*¹⁶ case the SCA applied the subjective approach which focuses on the subjective intention of the taxpayer as the basis for his tax liability. This means that if a taxpayer receives income from illegal activities with the intention of keeping the money for himself even though it is stolen money, he will then be taxed on such an amount in terms of gross income.

It is trite that ‘in determining whether an amount is ‘income’ it is irrelevant that it was derived from an activity that is illegal, immoral or *ultra vires*.’¹⁷ In other words the legality or illegality of the business which produced the income is irrelevant to liability for income tax purposes. However, a question that may arise is whether a distinction should be drawn between activities that are illegal per se, such as professional robbery or drug-dealing,¹⁸ and those that are tainted with illegality, such as involving incidental breaches of criminal law.¹⁹ It is important to note that these issues have not yet been decided by the South African courts.²⁰ The courts should not exempt either of the above illegal activities for as long as they fall within the definition of trade. This is so because if the activity is a trade, it is irrelevant for taxation purposes whether it is legal or illegal. It is submitted that;

‘If taxing income implies moral responsibility for the activities from which it flows, the government could preserve its soul only by exempting not only the income from wholly unlawful activities, but also the income from activities tainted by illegality such as manufacturing unsafe products, and misrepresenting the quality of the taxpayer's merchandise.’²¹

¹⁶ *MP Finance Group CC supra*.

¹⁷ RC Williams *Income tax in South Africa: Cases and Material* (1995) 181.

¹⁸ *Ibid*.

¹⁹ *Ibid*, such as trading without the requisite licence.

²⁰ *Ibid* at 182.

²¹ Bittker, BI ‘Taxing income from unlawful activities’ (1974) 25(1) *Case Western Reserve Law Review* 145.

This is so because ‘a dollar of profit from unlawful activity will buy just as much as a dollar of lawful profit hence, the criminal should be subject to the same income tax principles applicable to those incomes considered lawful’.²²

1.3. Statement of Purpose

This dissertation seeks to answer the question of whether the use of the taxpayer subjective intention (subjective approach) is the best method in computing taxability in respect of income derived from illegal activities, as opposed to the objective approach. This dissertation will argue that ‘the root of the problem, in the cases that dealt with illegal receipts, is the inconsistent application of various approaches to the meaning of ‘beneficial receipt’, as the courts have followed an objective approach in some cases, and a subjective approach in others’.²³ It is against this background that Muller opines that, ‘by consistently applying the subjective approach of paying regard to the intention of the taxpayer for purposes of “beneficial receipt”, the current confusion can be rectified’.²⁴

Furthermore, the research will examine the extent of the protection that legislation provides to lawful owners of said embezzled funds. This dissertation will also deal with the treatment of income derived from illegal activities for the purposes of taxation, and it will also discuss the deductibility of expenses which are incurred from carrying on of illegal activities. The Income Tax Act does not specifically provide for taxability of income derived from illegal activity, as a result there is little guidance from the Act with regard to the taxation of income derived from illegal activities.²⁵

1.4. Rationale of the Study

This study is important because state revenue is lost by the government due to income derived from illegal activities being seen as existing outside the realm of taxable income, in that money ‘received by a taxpayer by sheer virtue of lack of entitlement to such money

²² M Stein ‘Tax on the fruits of fraud – A tale of two cases’ (1998) 12 *Tax Planning* 116. R Gupta ‘Taxation of illegal activities in New Zealand and Australia’ (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 108; CM Black ‘Taxing crime: The application of income tax to illegal activities’ (2005) 20 *Australian tax forum* 440.

²³ E Muller (see note 3 above) 166.

²⁴ Ibid.

²⁵ D Warneke & D Warden ‘Fraudulent transactions – Are the receipts taxable?’ (2003) 17 *Tax Planning* 26. See also J Silke ‘Illegal and secret profits – Gross income?’ (2005) 19 *Tax Planning* 114.

would not fall within the definition of his gross income'.²⁶ The continued use of this method did not only allow for revenue to be lost but it also increased the margins of gains the taxpayer made without consequence of possible taxation.

There are many instances in which the stolen funds were not taxed as part of the thief's gross income due to them being seen by the court as constituting 'unilateral taking'²⁷ due to the thief having no entitlement to that money in the first place.²⁸ Another example is when there was undisclosed profits resulting from the conduct of embezzling agents who hide profits from their principal with the intention of retaining it for themselves as in *ITC 1972*.²⁹ Even such a violation of trust between an agent and a principal was allowed to go unpunished, as the undisclosed profits in the hands of the embezzling agent were taken to be held on behalf of the principal, even if the agent had no such intention. This dissertation also endeavours to identify the best interpretation method to be used to tax income derived from illegal activities that is received by a taxpayer.

1.5. Main Research Questions

1. Whether the use of the taxpayer subjective intention is the best method in computing taxability in respect of income received by a taxpayer from illegal activities?

1.6. Research Sub Questions

- a. Should the phrase 'received by', be interpreted with reference to a subjective intention of the taxpayer?
- b. Is the term 'received by' clear and unambiguous such that stolen amounts could be included in the gross income of a taxpayer?
- c. Whether expenses and salaries incurred in the carrying on or production of illegal activities can be deducted the purposes of income tax?

²⁶ E Muller (see note 3 above) 167.

²⁷ 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 536.

²⁸ *Commissioner of Taxes v G* supra at 168D-F.

²⁹ ITC 1972 (2005) 68 SATC 236).

- d. Whether the government should stop imposing tax illegally received income as to do so would amount to legitimising the illegitimate?³⁰

1.7. Methodology

The research method used in this dissertation is qualitative analysis, which is used in evaluating the underlying issue of the taxability of illegally gained income. The research will comprise of a review of existing literature on the stated subject topic, income tax legislation and various principles applied by the courts over the years (case law), journal articles, and various reputable internet sources. All these aforementioned sources will be easily accessible through the University's online databases.

This dissertation will refer to previously decided cases with specific reference to the *MP Finance Group* case which dealt with the question of whether income derived from illegal activities should be subject to income tax. This reference will be discussed in order to provide a clear understanding of how our courts have applied the law in the said cases, to understand the principles applied by the court in determining the term 'received by' and also to set the background for determining whether or not the past cases have been correctly decided.

1.8. Limitations of the Study

Despite the importance of the study into the taxation of income derived from illegal activities, there has been little interest in the subject compared to more recent case law that has directly dealt with the subject after the decision taken by the Supreme Court in the case of *MP Finance Group*. This dissertation will also present a limited comparative study of the taxation of income from illegal activities using the United States of America approach. This dissertation is limited to the discussion of the phrase 'received by' rather than 'accrued to' because the discussion of the phrase 'accrued to' falls outside the scope of this dissertation.

³⁰ E Bonthuys and C Monteiro 'Sex for sale: the prostitute as businesswoman' (2007) 121(3) *SALJ* 659-676.

1.9. Overview of the chapters

This dissertation is divided into five chapters. Chapter One serves as an introduction to the dissertation. In this chapter the purpose, research questions, methodology and limitations of the study are set out and the rationale of the study considered. The structure of this dissertation is also set out.

Chapter Two focuses on the meaning of the phrase ‘received by’ for both legal and illegal proceeds. This chapter will also look at taxability of illegally obtained income and the different interpretation methods that the courts have used to determine the taxability of income derived from illegal activities. The chapter will show how the courts have dealt with the cases brought before them. This chapter will also investigate the deductibility of expenses incurred in the production of income derived from illegal activities.

Chapter Three looks at how the United States of America has dealt with the issue of the taxability of illegally derived income, the interpretation methods used and the deductibility of expenses incurred in the production of the income.

Chapter Four is the conclusion of the dissertation.

CHAPTER TWO

2. The Taxing of income derived from illegal activities in terms of the South African Law

2.1. Introduction

2.1.1. Is income derived from unlawful activity taxable?

In determining whether an amount of money is income, it is immaterial whether that money was obtained from an activity which is illegal, immoral or *ultra vires*.³¹ It is against this background that Williams opines that if the taxpayer's activities constitute 'trading',³² any income from that trade is assessable for income tax, notwithstanding that the taxpayer's activities were illegal or not.³³ To support this reference is made to the English case of *Commissioners of Inland Revenue v Aken*³⁴ where the court held that;

.... if the activity is a trade, it is irrelevant for taxation purposes that it is illegal ...I do not think that the word "trade" in itself has any connotation of unlawfulness. There may be lawful trade; there may be unlawful trade. But it is still trade.³⁵

It is thus submitted that 'legality is not an essential characteristic of a trade'.³⁶ Also, 'the gross income definition does not provide that a receipt must have been derived in the course of a legal pursuit in order to be included in a taxpayer's gross income, as a result this question has been left to the courts to decide.'³⁷ In ITC 1199,³⁸ it was held that the tax collector has cast his net wide enough to catch all income so that once a receipt is held to constitute income it is taxable in terms of the Act, irrespective of whether it is income derived from illegal activities or not. In other words, the revenue collector taxes 'incomes, from whatever source

³¹ RC Williams (see note 17 above) 181.

³² See *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271 at 280, where the court observed that whether or not a taxpayer was trading 'must be determined by applying ordinary common sense and business standards'.

³³ RC Williams *Income tax in South Africa: Law and Practice* 4th ed (2006) 121. In the United Kingdom illegal proceeds will be taxed as long as they arise or accrue from a trade, whether legal or illegal.

³⁴ *Commissioners of Inland Revenue v Aken* 63 TC 395, [1990] STC 497.

³⁵ *Ibid* 63 TC 395 at 405F-H.

³⁶ *Griffiths (Inspector of Taxes v J P Harrison (Watford) Ltd* [1963] AC 1 at 20.

³⁷ E Bonthuys and C Monteiro (see note 30 above) 664.

³⁸ *ITC 1199* (1973) 36 SATC 16 (T) at 19.

derived'.³⁹ It is thus submitted, 'income received is subject to tax notwithstanding the fact that it is tainted with illegality or is received from illegal activities.'⁴⁰

The case of *CIR v Delagoa Bay Cigarette Co*,⁴¹ provided clarity on the taxability of income derived from illegal activities when the court had to decide 'if the income earned from an illegal transaction could be subject to income tax. Relying on the precedent of English case law, the court found that the legality or illegality of a business was irrelevant to the issue of whether income is subject to taxation'. In this regard Bristowe J stated that

I do not think it is material for the purpose of this case whether the business carried on by the company is legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum....The source of the income is immaterial. This was so held in *Partridge v Mallandaine*⁴² where the profit of a betting business was held to be taxable to income tax, Denman J saying that 'even the fact of a vocation being unlawful could not set up against the demand for income tax'.⁴³

The judge then referred to *ITC 1545*,⁴⁴ to reinforce the point that 'illegality itself does not preclude an amount from being included as gross income', as was said by Scott J that;

Where, however, an amount is received by a taxpayer on his own behalf and for his own benefit but in pursuance of a void transaction there seems to me to be no reason for holding that such amount is not 'received' within the meaning of that section, if that word is to be given its ordinary literal meaning. Not to do so could lead to anomalies.⁴⁵

It is thus submitted that the general contention is that illegal business ventures and agreements are not robbed from all legal result just because they may be regarded as void

³⁹ H Hubbard 'From whatever source derived' (1920) 6(7) *American Bar Association Journal* 202.

⁴⁰ *CIR v Delagoa Bay Cigarette Co Ltd* 1918 TPD 391 at 394.

⁴¹ *Delagoa Bay Cigarette Co Ltd* supra. This is the first decided case on the issue of taxability of income. A brief summary of the facts is as follows: 'the taxpayer was a company that sold packets of cigarettes. The price was considerably inflated on a batch of these packets. Each packet in the batch contained a numbered coupon that put the buyer in line to win a monthly prize. The issue was whether two-thirds of the inflated price, allocated by the taxpayer for the distribution of prizes, would be included in its gross income, since the amount had been received in contravention of an Act regulating lotteries. It was held that the transaction between the taxpayer and the purchasers of the cigarettes was essentially a sale and that when the company distributed prizes, these were not refunds of the purchase price. This was because some purchasers received no prizes, while those who did, received more than they had paid for the cigarettes. There was therefore a receipt that was taxable, and its taxability was not affected by its illegality'.

⁴² *Partridge v Mallandaine* [1887] L.R. 18 Q.B.D. 276.

⁴³ *Delagoa Bay Cigarette Co Ltd* supra at 394, 399.

⁴⁴ *ITC 1545* (1992) 54 SATC 464.

⁴⁵ *Ibid* at 474.

between the parties.⁴⁶ As a result the amounts received by the taxpayer are regarded as receipts within the definition of gross income, notwithstanding the illegal nature of the transactions and the consequences that flow therefrom inter parties.

However, it is important to note that income obtained in pursuance of illegal activities has not always been considered as 'received' by the taxpayer in the true legal sense of the word.⁴⁷ For income to be subject to taxation, it must have been received for that specific taxpayer's personal benefit.⁴⁸ The precedent for this principle was set in *Geldenhuis v CIR*⁴⁹ where the court held that;

Both 'income' and 'taxable income' are in their respective definitions linked up with the definition of 'gross income' and it seems to be clear that in the definition of gross income' the words 'received by....' Must mean 'received by the taxpayer on his own behalf for his own benefit.'⁵⁰

In other words, for an amount to be received by a taxpayer, it must be received in such circumstances that the taxpayer becomes entitled to the money.⁵¹ This principle found support from the case of *CIR v Genn*⁵² where it was held that an amount was not 'received' for purposes of gross income if there was a legal obligation upon such receipt to pay the amount to somebody else.⁵³ However, there have also been court decisions in which income derived from illegal activities has been found to be taxable, despite that the facts that the taxpayer did not receive the amounts for his or her own benefit.⁵⁴

⁴⁶ See *Commissioner for Inland Revenue v Insolvent Estate Botha* 1990 (2) SA 548 (A) at 556C-557B where it was held that an illegal contract is not without all legal consequences.

⁴⁷ *Commissioner of Taxes v G* supra at 168D-F.

⁴⁸ *Geldenhuis v Commissioner for Inland Revenue* supra at 266; *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) at 301F; *Secretary for Inland Revenue v Smant* 1973 (1) SA 754 (A) at 764B-D.

⁴⁹ *Geldenhuis v Commissioner for Inland Revenue* supra.

⁵⁰ Ibid at 266. See also RC Williams *Income tax in South Africa: Cases and Materials* (1995) 100.

⁵¹ Ibid.

⁵² *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

⁵³ Ibid at 269. 'In order to clarify the point, the Court used the example of a farmer who borrowed a tractor from someone else. From the very moment that this tractor is delivered to the farmer, he is under an obligation to return it to the owner; the tractor is not received by the farmer for his own benefit to use it as he pleases. It is for this reason, that he will not be liable to pay income tax in respect of this receipt.'

⁵⁴ See *Commissioner for Inland Revenue v Delogoa Bay Cigarette Co Ltd* 1918 TPD 391 at 394; Income Tax Case 1545 (1992) 54 SATC 464 at 474; *Income Tax Case 1789* (2005) 67 SATC 205 at 213A-B.

2.2. Should income derived from illegal activities be taxed?

Taxation of income derived from illegal activities has always been a highly controversial subject of debate in South Africa and other jurisdictions, as the question always arose whether or not income derived from illegal activities should be subject to income tax. It is submitted that;

the failure to tax income derived from illegal activities can have far reaching implications for any country in that those involved in criminal business activities will gain a competitive edge over those engaged in lawful business practices. The unlawful businesses will produce products at a reduced cost, and then sell them at a lower rate than those businesses that pay their taxes. Criminals generate better gains and expect such gains not be subject to tax on the grounds that they originate from illegal activities.⁵⁵

Some authors have argued that taxing income derived from illegal activities is tantamount to legitimising the illegal that generated the income:

... Tax law should not play a role in the matter of criminal activities, Government should not obtain revenue from ill-gotten gain which has negative impact on the society....illegal activities should rather attract criminal sanction and should only be dealt with in terms of the criminal law Act. Indeed, to refrain from taxing ill-gotten gains or turning a blind eye to taxing such income and proceed by the relevant authorities would amount to exempting such persons from one law simply because they had committed another.⁵⁶

By taxing proceeds from illegal activities the State would be 'keeping its revenue eye open and its eye of justice closed'.⁵⁷ A question to be asked at this point is whether or not the State should refrain from taxing illegal activities because to tax would amount to legitimising the illegitimate.⁵⁸ Policy considerations against the taxing of income from illegal activities are, that by levying income tax on income generated from illegal activities the government benefits from crime.

⁵⁵ O Ogunnsanwo 'A comparative study and analysis of the taxability of illegal income in South Africa and United States of America' (Unpublished LLM thesis, University of Pretoria 2013) 6.

⁵⁶ See E Bonthuys and C Monteiro (see note 30 above) 664; PriceWaterhouseCoopers Inc. 'The taxability of illegal pyramid schemes' 2007 *Synopsis* 2-3.

⁵⁷ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752, 16 TC 523 at 530.

⁵⁸ E Bonthuys and C Monteiro (see note 30 above) 663.

It has been argued that by taxing such illegal activities South African Revenue Services (SARS) is not necessarily condoning them. As SARS has not been involved in the commission of the illegal activity; it merely recognises income derived from what appears to be a trade, and the revenue laws provide for the taxation of income from trades. Support for the above contention can be found from an English case of *Mann v Nash (HM Inspector of Taxes)*⁵⁹ where the court found that by taxing income from illegal activities that government is not condoning the illegal activities;

The Revenue, representing the State, is merely looking at an accomplished fact. It is not condoning it; it has not taken part in it; it merely finds profits made from what appears to be a trade, and the Revenue laws happen to say that the profits made from trades have to be taxed, and they say: 'Give us the tax' It is not the purpose in my judgement to say: 'but the same State that you represent has said they are unlawful'; that is immaterial altogether and I do not see that there is any contact between the two propositions . . . It is said again: 'Is the State coming forward to take a share of unlawful gains?' It is mere rhetoric. The State is doing nothing of the kind; they are taxing the individual with reference to certain facts. They are not partners; they are not principals in the illegality, or sharers in the illegality; they are merely taxing a man in respect of those resources. I think it is only rhetoric to say that they are sharing in his profits, and a piece of rhetoric which is perfectly useless for the solution to the question which I have to decide.⁶⁰

SARS is simply carrying out its function as a tax collection agency as provided for in the Income Tax Act. The reason for this rationale is that it would be unfair for SARS to allow illegal traders to enjoy better benefits than those who are involved in legal trade. Tax neutrality plays an important role in any tax regime and can therefore not be overlooked on the basis of illegality of certain transaction.

This chapter seeks to evaluate the ways the courts decide whether income derived from illegal activities can be classified as falling into the gross income of the taxpayer, therefore subject to taxation. This will be done by analysing the exact meaning of the words 'received by' as provided for in the definition of gross income,⁶¹ and by determining how this phrase has been interpreted by the courts whilst making reference to the SCA decision in *MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service*.⁶² This

⁵⁹ *Mann v Nash (H M Inspector of Taxes)* [1932] 1 KB 752, 16 TC 523.

⁶⁰ *Ibid* at 530-1.

⁶¹ Section 1 of the Income Tax Act, (see note 10 above).

⁶² *MP Finance Group CC supra*.

is so because the question of whether or not the government is entitled to impose tax on income is best answered by examining the phrase ‘received by’ and by applying it correctly. This chapter will demonstrate that income from illegal activities is subject to income tax, even though there is some doubt whether expenses incurred in generating that income would be deductible.

2.3. Can income derived from illegal activities constitute taxable income?

2.3.1. The definition of gross income

In order to determine whether or not income from illegal activities is taxable, the definition of gross income is the starting point since the Act makes no reference to the taxation of income derived from illegal activities. It is important to note that most elements of the gross income definition are self-evidently not in dispute where the taxation of income derived from illegal activities has been contested.⁶³ The debates in the context of income derived from illegal activities have largely hinged on one section of the gross income definition, the phrase ‘received by’.⁶⁴ Since the Act does not define the terms used in the gross income definition reliance will be placed on the meaning given to the phrase ‘received by’ by the judiciary, as interpreters of the law.

The starting point in calculating the taxpayer’s tax liability is to determine his or her gross income. This is so because the gross income definition is central to the entire Act. In terms of the Act gross income is defined as

the total amount in cash or otherwise, received by, or accrued to or in favour of a person, in the case of a person who is a resident, from any source, and in the case of a non-resident, from a South African or deemed South African source, other than receipts or accruals of a capital nature.⁶⁵

⁶³ JMP Venter, WR Uys & MC van Dyk ‘MP Finance Group CC (In Liquidation) v C: SARS: Adding to the financial hardship of victims of illegal transactions’ (2015) 19 *Southern African Business Review: Tax Stories: Special Edition 1*, 128.

⁶⁴ *Ibid* 128.

⁶⁵ RC Williams *Income Tax and Capital Gains Tax in South Africa: Law and Practice* 3rd ed (2001) 25.

2.3.2. The meaning of the phrase ‘received by’

The general rule applicable to income tax is that no liability for tax can arise when there is no ‘receipt’. The question whether or not income which is received by a taxpayer in the course of carrying on illegal activities should be regarded as being received by a taxpayer for purposes of assessing such person’s gross income has been an object of debate, both in South Africa and abroad. To add to the problem is the fact that the phrase ‘received by’ is not defined in the Act, but, it has been the subject of judicial interpretation.⁶⁶ The phrase ‘received by’ is a very important requirement that gives rise to tax liability for a taxpayer. It is trite that for an amount to attract tax, it must have been received as an income or for the benefit of the taxpayer. The reason why this is very important is because not all money received is regarded as an income.

The question that usually arises when determining the meaning of the phrase ‘received by’ is whether or not the phrase should be given its widest meaning. This is so because, for example a person who borrows a car can be regarded as having ‘received’ the car, if we use the ordinary meaning of the word. The same applies to, ‘a person who borrows money from a bank has, in normal usage, “received” the money.’⁶⁷ This gives rise to a question of whether this should be the interpretation to be placed on the phrase as provided for in the Act’s definition. It is submitted that, ‘as soon as an object or an amount of money is borrowed, a corresponding obligation arises to return the item or repay the amount.’⁶⁸ However a question then arises, ‘if ‘received’ should not be given its broadest meaning, what the word should mean, for income tax purposes?’

It is submitted that ‘received by’ must mean ‘received by the taxpayer on his own behalf for his own benefit’. If we are to use the above interpretation, it can be argued that an agent who collects rentals for and on behalf of his principal can be said to not have ‘received’ the income since he would not have received it for his own benefit. This view is clarified in the case of *Geldenhuis v Commissioner for Inland Revenue*⁶⁹ where the phrase ‘received by’ was interpreted to mean ‘received by the taxpayer on his own behalf and for his own benefit,’⁷⁰ the court held that:

⁶⁶ SARS Interpretation Note: No. 80 *The Income Tax Treatment of Stolen Money* (2014).

⁶⁷ JMP Venter, WR Uys & MC van Dyk (see note 63) 129.

⁶⁸ *Ibid.*

⁶⁹ *Geldenhuis v Commissioner for Inland Revenue* *supra*.

⁷⁰ *Ibid* at 260 per Steyn J.

Technically it may be said that if the purchase price is paid to him it is “received by him”. ... the expression 'received by him' means that the money must be received by him in such circumstances that he becomes entitled to it.⁷¹

However, it is submitted that the term ‘received by’ has a qualification since physical control over money does not necessarily mean that ‘receipt’ has taken place. In the case of *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd*⁷² the court was of the view that ‘not every obtaining of physical control over money or money's worth constituted a receipt for the purposes of the definition of ‘gross income’’. The court held that

... It is certainly not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent or trustee for another, the former has not received it as his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his....⁷³

The America Supreme Court in *Commissioner v Wilcox*⁷⁴ agrees with the above statement when it stated that:

Taxable income [does not] accrue from 'the mere receipt of property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit. Moral turpitude is not a touchstone of taxability. The question, rather, is whether the taxpayer in fact received a statutory gain, profit or benefit. That the taxpayer's motive may have been reprehensible or the mode of receipt illegal has no bearing on the application of the taxing statute.⁷⁵

In the same vein, the United States Supreme Court in the case of *Rutkin v United States* held that extorted funds are taxable:

An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. . . That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been

⁷¹ Ibid at 269. [Approved in *CIR v Cape Consumers (Pty) Ltd* 1999 (4) SA 1213 (C) at 1223A].

⁷² *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* supra.

⁷³ *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* supra at 301.

⁷⁴ *Commissioner v Wilcox* 327 U.S. 404 (1946).

⁷⁵ Ibid at 408.

obtained by fraud and his freedom to use it may be assailable by someone with a better title to it.⁷⁶

It is submitted that our courts have not always applied the meaning of the phrase ‘received by’ consistently. As a result taxpayers have relied on the linguistic meaning of the phrase ‘received by’ as applied in *Geldenhuis v CIR*,⁷⁷ to escape tax liability by arguing that they were not ‘entitled to’ the amounts received for their own benefit.

It can be argued that in the case of *Commissioner of Taxes v G*⁷⁸ there was an unwarranted extension of the meaning of the phrase, which eventually led to the exclusion of amounts from gross income which should have been included.⁷⁹ The issue in this case was whether amounts stolen by a person could form part of his gross income and so become assessable to tax. In making the determination Fieldsend CJ construed the word ‘received’ as follows:⁸⁰

I can see no warrant on the face of the statute for construing the word 'received' in any but its ordinary meaning. To extend it to cover a unilateral taking such as theft, which in any event confers no right upon the taker to the things taken, would be to give the word a meaning that could not be justified on any rational construction of the Act as a whole. In short a thief takes, he does not receive, and that is what the respondent in this case did.⁸¹

In its judgment, the word ‘received’ was given its ordinary meaning and a ‘unilateral taking’ such as theft could not be regarded as falling within the ambit of the ‘received by’ definition. The Court followed a very technical and systematic approach. It analysed the meaning of ‘receipt’ in terms of the Oxford English Dictionary. There a receipt was described as something which is accepted by one person after being offered to her by another. It was held

⁷⁶ *Rutkin v. United States* 343 U.S. 130 (1952).

⁷⁷ *Geldenhuis v Commissioner for Inland Revenue* supra.

⁷⁸ *Commissioner of Taxes v G* supra. The brief facts of the case were as follows. ‘Over a period of four years, G was placed in a position of responsibility with the government which entailed his being entrusted with funds for secret operations. He took advantage of his position to obtain from government from time to time, more money than was legitimately required for official purposes and to appropriate it for himself. Over the period he stole some \$58 000. The appellant in this case (COT), argued that gross income as defined by s 8(1) of the Section 8(1) of the Income Tax Act [Chapter 23:06] 1967., means every amount received by a person and that the respondent (G) had received the money that he had stolen in terms of that definition. On the other hand the respondent argued that the money he took never became his, despite his intention to treat it as his own, and was therefore never received by him within the meaning of that word as used in the definition of gross income in s 8. This argument was based on the presumption that stolen money or property can never belong to or become the property of a thief. The criminal cannot therefore be said to have ‘received’ the money in the way in which the term is used in the ‘gross income’ definition. Thus, the court had to make a determination of whether the respondent (G) received the money he stole within the meaning of that word in section 8(1) of the Act. G was convicted and sentenced to imprisonment a part of which was suspended on condition of repayment. He was subsequently assessed for tax on the amounts he stole.’

⁷⁹ LG Classen ‘Legality and income tax – Is SARS ‘entitled to’ levy income tax on illegal amounts ‘received by’ a Taxpayer?’ (2007) 19(4) SA Merc L J 542.

⁸⁰ *Commissioner of Taxes v G* supra at 169H-170A.

⁸¹ *Ibid.*

that a receipt required the action of taking delivery of something from another person and that it was not a unilateral act.⁸² The Court further held that the plain meaning of the words used in this definition could only be modified in exceptional cases because the definition of gross income struck at the very core of the Act.⁸³ It held the proceeds of theft not to be a receipt because a thief ‘takes’ money. The Court found that it could not have been the intention of the Legislature to allow such a drastic extension of the plain meaning of the phrase used.⁸⁴ The decisions in *CIR v Genn* and *Geldenhuis v CIR*, which confirmed that a receipt had to be obtained for the personal benefit of the taxpayer, were quoted with approval and applied.

2.3.3. Criticisms of *Commissioner of Taxes v G*

It is important to note that the *Commissioner of Taxes v G*⁸⁵ discussed above case has been subjected to criticism and since the *MP Finance Group* case, it no longer reflects the South African position. The term ‘receive’ in *Commissioner of Taxes v G* was held to require both the act of giving and receiving.⁸⁶ The unilateral ‘taking’ of an amount was not regarded as sufficient by the Court.⁸⁷ Yet, in *MP Finance* case this is precisely what the Court found to be taxable.⁸⁸ It is submitted that the reason for this linguistic leap is not clear from the judgment.⁸⁹ Williams submits that the above decision misconceives the underlying issue.⁹⁰ He further submits that the question of whether a thief is taxable on what he steals does not turn on whether there was a ‘receipt’, the real issue is whether stolen property possesses the quality of ‘income’ in the thief’s hands.⁹¹

Another criticism of the *Commissioner of Taxes v G* case lies in the analysis of the Oxford English Dictionary definition of the word receive.⁹² It is submitted that ‘received by’ can be described as having received in such a way that the person becomes entitled to the amount.

⁸² *Commissioner of Taxes v G* supra at 169E-G.

⁸³ *Commissioner of Taxes v G* supra at 170A.

⁸⁴ *Commissioner of Taxes v G* supra at 170A.

⁸⁵ *Commissioner of Taxes v G* supra.

⁸⁶ LG Classen (see note 79 above) 549.

⁸⁷ *Commissioner of Taxes v G* supra at 169E-G.

⁸⁸ LG Classen (see note 79 above) 549.

⁸⁹ Ibid.

⁹⁰ RC Williams (see note 17 above) 103.

⁹¹ Ibid. See also *CIR v Delagoa Bay Cigarette Co Ltd* 1918 TPD 391.

⁹² LG Classen (see note 79 above) 549. The *Oxford English Dictionary* describes receive as ‘to take or accept (a person) in some capacity . . . ; to take for, regard as . . . ; to make use of to have (a thing) given or handed to oneself; to get from another or others. . . ; to have (some quality, attribute, or property) given, bestowed, conferred or impressed . . . ; to take, accept, or get, in various senses; . . . an act of taking; a definite amount taken’.

Classen submits that the description of the word receive in terms of the Oxford English Dictionary includes the act of taking, ‘which indicates that the analysis in *Commissioner of Taxes v G*, in terms of which it was held that a taxpayer had to be entitled to an amount in order to receive it, contained certain shortfalls. The Court was incorrect to find that the act of taking could not form part of the meaning of receipt⁹³ as is evident from the definition referred to.’⁹⁴

2.4. Case law governing receipt of income from illegal activities

In ITC 1624,⁹⁵ the question before the court was whether an overcharged amount received by an attorney should be subject taxation. The tax court held that the amount was received for the purposes of taxation because;

No authority exists for the proposition that where a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent, misrepresentation to a customer, it does not receive that money or that it has not intended to receive it as part of its business income and in the course of its business.⁹⁶

It is submitted that the above decision reached taken in *ITC 1624*,⁹⁷ can be reconciled with the decision reached taken in *Commissioner of Taxes v G*⁹⁸ on the basis that ‘in the case of stolen money, the thief unilaterally takes the money whereas in the case of amounts derived from illegal activities, the recipient does not unilaterally take the money, but the customers/clients intend the recipient to receive it’.

Classen submit that the failure of the SCA in the *MP Finance Group* case to define the meaning of the phrase 'received by' was a wasted opportunity for clarifying the law and this is disappointing to say the least as the matter would have been put to rest. Classen further submits that, ‘to state that the literal meaning must be adhered to and to apply a literal

⁹³ *Commissioner of Taxes v G* supra at 170A.

⁹⁴ LG Classen (see note 79 above) 551.

⁹⁵ ITC 1624 (59 SATC 373).

⁹⁶ Ibid 378.

⁹⁷ Ibid.

⁹⁸ *Commissioner of Taxes v G* supra.

approach without analysis of what such a literal approach or literal meaning entails, does not provide guidance to future litigants'.⁹⁹

In ITC 1545,¹⁰⁰ where the appellant had been taxed on the proceeds from the sale of stolen diamonds and the receipts from the growing and sale of dried 'milk cultures'. The latter activity was described by the court as a money-making racket similar to a chain-letter scheme and was accepted as amounting to an illegal lottery. The court held that the amounts were 'received by' the taxpayer for the purposes of the definition of 'gross income' notwithstanding that they were in pursuance of a void transaction. It distinguished the facts of the case from *G*'s case above, noting that the instant case was not one in which there had been no receipt but merely a 'taking' by a thief.

In ITC 1624,¹⁰¹ where the appellant, acting as agent, fraudulently overcharged its principal for wharfage fees which it claimed it had paid to Portnet on the principal's behalf. The fraud was discovered in a later year of assessment and the appellant had refunded the overcharged amounts to its principal. The appellant argued that the amounts were not received by it as it was under an immediate obligation to repay them. Alternatively, the appellant argued that it was entitled to a deduction in the same year of assessment for the liability it had incurred to repay the amounts. The court rejected these arguments holding that the amounts were received by the appellant as part of its business receipts and that the amount was not an expenditure or loss incurred during the year of assessment in question. The court considered *G*'s case above but declined to follow the ratio in that case.

In ITC 1792¹⁰² where the appellant, a stockbroker, had acted as agent for a principal on behalf of whom, he bought and sold shares. The appellant, together with others, had become aware of the shares that his principal would be acquiring. He acquired those shares in a separate company and later sold them at a profit to his principal. The issue was whether the appellant was liable to tax on these illegal secret profits. The court found, based on the law of agency, that an agent is not entitled to make secret profits and that those profits belong to the principal. It accordingly held that the amounts had not been received by the appellant on his own behalf for his own benefit.' It is argued that, 'based on the outcome of the *MP Finance* case above, it is considered that this case was not correctly decided. The issue is not the legal

⁹⁹ LG Classen (see note 79 above) 550. See *MP Finance Group v Commissioner, SARS* supra at 524E-F.

¹⁰⁰ ITC 1545 (1992) 54 SATC 464 (C).

¹⁰¹ ITC 1624 (1996) 59 SATC 373 (T).

¹⁰² ITC 1792 (2005) 67 SATC 236 (G).

relationship between principal and agent but between the agent and the fiscus. An illegal contract is not without all legal consequences; it can, indeed, have fiscal consequences. The sole question as between scheme and fiscus is whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act.¹⁰³

2.5. *MP Finance Group v Commissioner, SARS*

2.5.1. The Facts

Brief summary of facts are that, a businesswoman operated an illegal investment business commonly known as a pyramid scheme. She canvassed ‘investors’ who would pay amounts to her in the belief that their investments would yield large returns. For a while she also managed to repay large amounts to the depositors, as so-called returns on their ‘investments’. Her particular scheme operated through a vast array of entities, some incorporated, others not. Eventually all the entities were insolvent. In order to facilitate the administration of the various entities, they were consolidated into one, namely MP Finance Group CC (‘the corporation’) by an order of court. The Pretoria High Court also ordered that all actions that had been taken against the previous entities were to be regarded as having been taken against the corporation. All claims that had been proved against the original entities during the insolvency procedures at the offices of the Master of the High Court were to be treated as claims against the new, consolidated corporation. As a result of this order, the Commissioner of SARS assessed the corporation for income tax originally due by the respective entities during the 2000, 2001 and 2002 years of assessment. The liquidators objected to these assessments on the basis that the amounts paid to the pyramid scheme had not been ‘received’ within the meaning of the definition of gross income in the Income Tax Act. The Commissioner disallowed the objection. The corporation appealed to the Tax Court in Durban where the appeal was dismissed. The corporation then appealed to the Supreme Court of Appeal with the leave from the Court a quo.

¹⁰³ *MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service* 2007 (5) SA 521 (SCA).

2.5.2. Decision of the Court a quo

The court a quo¹⁰⁴ held that illegal amounts taken by the operators of a pyramid scheme were considered as having been ‘received’ within the ambit of the definition of gross income. The Court’s reasoning was focused on the intention of the taxpayer and that she intended to benefit, and did in fact benefit, from the profits she had created by stealing investors’ money. The Court held that the argument that the illegal nature of the transactions and the immediate obligation to repay the investors had deprived her of all benefit did not prevent the inclusion of the amounts that had been taken in her gross income.¹⁰⁵

2.5.3. The Legal Question and the Taxpayer’s Arguments

The question before the SCA was whether or not the deposits that had been obtained by the corporation could be regarded as having been ‘received by’ it in terms of the definition of gross income, notwithstanding the fact that the taxpayer had operated an illegal pyramid scheme and the deposits were received in the course of the running of such a scheme.

The main argument on behalf of the corporation was that the deposits that had been received were loans to it by the investors. In law they were repayable at the moment they were granted. The corporation argued that the deposits had never been ‘received’ in terms of the Act. As authority for this argument, it relied on *Fourie v Edeling*,¹⁰⁶ The corporation argued that as in *Fourie v Edeling*,¹⁰⁷ it had not become entitled to the deposits because the amounts had not been ‘received by’ it, nor had the amounts accrued to it. It argued that the scheme had no entitlement to the investors’ money because the operation of the scheme and the consequent investments had been illegal, and that the Court could not enforce the illegal contracts. It argued further that the relationship between the parties would be exactly the same as in *Fourie v Edeling*, that the investors would have a claim in terms of the relevant *condictio*, and that the scheme would be liable to repay them immediately at the very moment of receipt of the deposits. It was for this reason that the deposits concerned had not been

¹⁰⁴ ITC 1789 (2005) 67 SATC 205.

¹⁰⁵ *Ibid.*

¹⁰⁶ *Fourie v Edeling* 2005 (4) All SA 393 (SCA).

¹⁰⁷ *Fourie v Edeling supra.*

received by the corporation and could therefore not be included in the gross income of the corporation.¹⁰⁸

The Court rejected the contentions based on *Fourie v Edeling*.¹⁰⁹ It held that the relationship between the operators of a scheme and the investors had been at issue in *Fourie v Edeling* case and not the relationship between the scheme and the fiscus. For that reason the case had to be distinguished.¹¹⁰ The Court found that an illegal contract was not always without consequences and that it could have fiscal consequences as was in fact held in *Commissioner for Inland Revenue v Insolvent Estate Botha*.¹¹¹ The sole question as between scheme and fiscus is whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act.¹¹² Unquestionably they did.¹¹³ Therefore, the Supreme Court of Appeal found amounts taken by illegal and fraudulent pyramid scheme constitute amounts ‘received’ within the meaning of ‘gross income’ in the Act where intention of scheme operator is not to contract with the investors but to appropriate their money to facilitate the fraud. This is so notwithstanding that in law they are immediately repayable, they constituted receipts within the meaning of the Act.¹¹⁴

2.6. The Intention of the Taxpayer as a Test for ‘receipt’

The South African courts have been inconsistent in their application of various approaches to the meaning of the phrase ‘received by’. The courts followed an objective approach in some cases, and a subjective approach in others. In cases dealing with legal receipt the court never made a reference to the subjective intention of a taxpayer and they stuck to the objective test.¹¹⁵ However, the inconsistencies and controversy arose when the courts were determining liability of a taxpayer on income derived from illegal activities. This created confusion as it became exceedingly difficult to determine which approach to follow when dealing with

¹⁰⁸ *MP Finance Group v Commissioner, SARS* supra at 523A-E.

¹⁰⁹ *Fourie v Edeling* supra.

¹¹⁰ LG Classen (see note 79 above) 550.

¹¹¹ *Commissioner for Inland Revenue v Insolvent Estate Botha* (1990 (2) SA 548 (A) at 556C-557B.

¹¹² *Ibid* at 557I-558A.

¹¹³ *MP Finance Group v Commissioner, SARS* para 12.

¹¹⁴ *Ibid*.

¹¹⁵ W Chawira 'Taxation of illegal schemes: – should the term ‘received by’ in the definition of gross income be interpreted with reference to the taxpayer’s subjective intention?' (Unpublished LLM thesis, University of Pretoria, 2011) 3.

income for purposes of tax liability. This then raised a question of which approach should be followed when dealing with income from illegal activities.

It is submitted that the intention of the taxpayer is the yardstick used to determine the moment when an illegal amount was beneficially received by a taxpayer. Therefore an enquiry to determine the taxpayer's intention is a recognised test when deciding whether or not a receipt is of an income or a capital nature.¹¹⁶ Thus, the evaluation of the taxpayer's intention is a very useful tool to determine taxability.¹¹⁷ Classen opines that the enquiry to determine the taxpayer's intention should focus on two questions namely; who has the use of the money, and who derives the benefit of it.¹¹⁸ The use of the money for personal benefit is a factual enquiry.¹¹⁹ It is submitted that this is the approach that the SCA in *MP Finance Group* used to determine what the taxpayer's intention had been.¹²⁰ This approach is correct because on the facts of the case, the money was taken and used as a source of income.¹²¹ The taxpayer's income-earning activity was to steal money.¹²² Therefore its illegality did not influence the tax treatment of the amount so received.¹²³

It is submitted that, a new and a different way to interpret the phrase 'received by' emerged after the *MP Finance Group* case, and the phrase can be interpreted using the subjective intention of a taxpayer. This is so because the SCA in the *MP Finance Group* case held 'that the essential element of a receipt is the intention of the taxpayer to hold an amount with the purpose of deriving a benefit for himself. In other words, a person receives an amount if he claims a right to it, regardless of whether he is entitled to it or not.'¹²⁴ In this case the court felt that if a person accepts an amount with the intention of retaining it for his benefit, then he has received it, regardless of whether he is entitled to an amount or not.

In support of the subjective approach as a way for determining the taxpayer's intention Muller opines that:¹²⁵

¹¹⁶ LG Classen (see note 79 above) 546.

¹¹⁷ *Ibid.*

¹¹⁸ *ibid*

¹¹⁹ *Ibid.*

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² *Ibid.*

¹²³ *Delogo Bay Cigarette Co v CIR* supra at 394.

¹²⁴ *W Chawira* (see 115 above) 21.

¹²⁵ *E Muller* (see note 3 above) 166.

‘by following the subjective approach all income derived from illegal activities will fall into the tax net if the taxpayer intends to benefit from proceeds except where the taxpayer received the income as an agent (in the broad sense) on behalf of another. This approach will also be consistent with public policy. Surely it is not in the interest of public policy that a trader who cheats his customer in the course of his business should be subject to income tax while one who actually steals from them should enjoy exemption from income tax. If the subjective approach was followed in *COT v G* the court may well have found that the thief indeed received the stolen property’¹²⁶

2.7. Deductions

Taxing income from illegal activities invites a debate concerning whether the taxpayer should be entitled to a deduction of any expenditure incurred in producing income from illegal activities. To qualify for deduction, the expenditure in question must, in addition to satisfying the ‘trade’ requirement, be incurred ‘in the production of income’, that is, it must be so closely linked to the act giving rise to it that it can be regarded as part of the cost of performing it.¹²⁷ In *Joffe and Co (Pty) Ltd v CIR*¹²⁸ the court referred to expenses incurred bona fide for the purposes of trade. If, therefore, a criminal is carrying on a trade and incurs expenditure which meets the requirements of ‘in the production of income’, the expenditure should be deductible.

The South African income tax jurisprudence provides little clarity on the deductibility of any expenditure incurred in producing income from illegal activities. Like the gross income definition in the Act, the general deduction formula is neutral with regard to the deductibility of illegal expenditures and losses. The ‘general deduction formula consists of section 11(a) read with section 23. These lay down certain positive requirements (which must be fulfilled in order for an amount to be deductible) and certain negative requirements, (which, if present, are a bar to deductibility).’¹²⁹ Section 11(a) provides as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived — expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.¹³⁰

¹²⁶ E Muller (see note 3 above) 177.

¹²⁷ *Port Elizabeth Electric Tramways Company Ltd v CIR* 1936 CPD 241, 8 SATC 13.

¹²⁸ *Joffe and Co (Pty) Ltd v CIR* 13 SATC 354.

¹²⁹ RC Williams *Income tax in South Africa: Law and Practise* 4th ed (2006) 262.

¹³⁰ Section 11(a) of the Income Tax Act. (see note 10 above).

Section 23 prohibits deductions from being made in certain circumstances. For example, s 23(g) states that no deduction shall be made in respect of ‘any moneys claimed from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade’.¹³¹

Some authors have argued that the revenue collector should deduct the expenses that are incurred by a taxpayer in producing income from illegal activities. It is against this background that it is submitted that¹³²

if taxpayers who derive their income from illegal activities are not taxed, the question of equal treatment of taxpayers arises and if they are not allowed deductions the same question also arises. The policy which justifies the inclusion of illegal proceeds in gross income is one of revenue collection; the revenue laws place all taxpayers on an equal footing, as far as the taxability of their receipts goes. In other words, the Income Tax Act provides for the taxation of taxpayers on all their receipts, irrespective of their source. It follows, then, that the policy underlying the deductibility of expenditure should also be one which seeks to place honest and dishonest taxpayers on an equal footing. If the honest taxpayer cannot be discriminated against through the taxpayer being allowed to escape the inclusion of his receipts in gross income, then the taxpayer who derives his income from illegal activities should not be discriminated against through the honest taxpayer being allowed deductions to which he (the taxpayer who derives his income from illegal activities) is not entitled.¹³³

From the above statement, the principle that has been established is that no distinction is made between income obtained legally or illegally. In *ITC 1199*¹³⁴ Margo J stated obiter that since income from unlawful trading is assessable to tax, expenditure in the production thereof is deductible.¹³⁵ In *CIR v Delagoa Bay Cigarette CO*,¹³⁶ Bristowe J, held that

if the income [from an illegal business] itself is taxable, it follows I think that if the prizes had been a legitimate deduction [and not a disposal after they had been earned] had the business been legal, they would equally be a legitimate deduction if the business is illegal.

¹³¹ Section 23(g) of the Income Tax Act. (see note 10 above).

¹³² E Bonthuys and C Monteiro (see note 30 above) 663.

¹³³ E Bonthuys and C Monteiro (see note 30 above) 668.

¹³⁴ ITC 1199 (1973) 36 SATC 16 (T).

¹³⁵ Ibid at 19.

¹³⁶ *CIR v Delagoa Bay Cigarette Co* supra.

The principle may, however, be different when it comes to the deductibility of expenditure incurred in the production of legal and income derived from illegal activities. In order to determine the deductibility of expenses incurred from undertaking illegal activities the question is whether considerations of public policy should deny a person involved in illegal activities the deduction of the expenses they incur in deriving their income illegal activities. It is submitted that, considerations of public policy may prevent the deduction of expenses relating to an illegal activity.

The reason behind the denial of deductions is that the government does not want to allow taxpayers to benefit from their illegal activities through the tax law.¹³⁷ It is submitted that the motive for involvement in illegal activities is the profit so derived, thus if the profit is taxed, it decreases the lucrative nature of such activities. The role of taxation in such cases would be to deprive organised crime of substantial amounts of money. This non-deductibility is based on public policy and supports the Legislature's intention to decrease crime and thus allowing the deduction would be inconsistent with the aim of the legislature.

However some argue against using public policy to justify the denial of deductions from income that is generated from illegal activities. They argue that there should be no moral interpretation or consideration of public policy in interpreting the provisions of the Income Tax Act.¹³⁸ If an amount falls within the ambit of the Act it must be taxed and if on the other hand an amount meets the deductibility requirements it must be deductible.¹³⁹ This is so because tax law is designed to collect revenue and criminal law is designed to punish wrongdoers. Tax law should therefore be neutral and provide for the taxation of the income and the deduction of expenditure incurred in earning such income. Being neutral entails taxing income if it meets the requirements of income and allowing a deduction if it meets the requirements of a deduction.¹⁴⁰

In a legal system there are many branches of law that discourage certain behaviour, but tax law is designed to be a neutral body of financial rules for revenue collection and, other than revenue crimes, tax law leaves punishment for bad behaviour to other branches of law. Denial of deductions punishes taxpayers for non-revenue crimes and this is inconsistent with a neutral structure. The main objective of tax law is to collect revenue by taxing a taxpayer's

¹³⁷ LB Mtshawulana 'Gains derived from illegal activities: An analysis of the taxation consequences' (Unpublished LLM thesis, Rhodes University, 2008) 64.

¹³⁸ Ibid 64.

¹³⁹ SARS interpretation note (see note 66 above).

¹⁴⁰ Ibid.

net income, not to reform his or her character, so that tax law should not be used to punish taxpayers for their non-revenue crimes.¹⁴¹

2.8. Conclusion

The principle to be drawn from the above cases is that the receipt of stolen money comprises gross income and is thus taxable. While the *MP Finance* case dealt with money fraudulently received under an illegal contract, its principles are considered to apply equally to the theft of money through robbery, burglary or other criminal means. The key issue is whether the thief intended to benefit from the stolen funds. If so, the requisite ingredients for a receipt have been met and there is no justification for the view taken in *G*'s case above that a thief 'takes' rather than 'receives'. The issue is not whether the victim intended to part with the money but rather whether the thief intended to benefit from it.¹⁴²

The court held that 'it does not matter for present purposes that the scheme was not entitled to, as against the investors, to retain their money. What matters is that what they took in was income received and duly taxable'.¹⁴³ It is submitted that this is a subjective approach that focused on the intention of the taxpayer. This is so because if a taxpayer merely retains an amount as his, he would be liable under the definition of gross income, even when he does not have a legal right and entitlement over it. However, this approach is only applicable when the courts are faced with the question of whether income derived from illegal activities constitutes taxable income in terms of the Act. The court in *Geldenhuys v CIR* believed that a person must have a right to an amount, whilst the court in the *MP Finance* case believed that if one claims a right to an amount, regardless of the fact that he is not entitled to it, he is taxable under receipt.

The current legal position is therefore that the term 'received by' is interpreted subjectively when determining the tax liability of an illegal scheme with the result that a person who steals an amount is taxable if he regards such an amount to be his. The use of taxpayer intention as a test for receipt could be problematic from a practical point of view. It is conceivable that the

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ *MP Finance Group supra* at 524E-F.

operator of the pyramid scheme in *MP Finance Group v Commissioner SARS* initially had the intention to repay all the investors in the naïve belief that her investment scheme had been legal. Would this mean that she had not received the amounts concerned or would it mean that she had received the amounts as an agent on behalf of the investors? This discussion will show that, by consistently applying the subjective approach of paying regard to the intention of the taxpayer for purposes of 'beneficial receipt', the current confusion can be rectified.

Revenue laws should tax the economic gain derived by the taxpayer by allowing the taxpayer to reduce his or her taxable income by the cost of earning the income. Thus, if tax law is looked at in isolation, the ideal outcome would be to include the proceeds from illegal activities in the gross income, while the allowing the perpetrator to claim the deductions to which he or she would have been entitled, had he or she been an 'honest' trader.

CHAPTER THREE

3. Taxation of income derived from illegal activities in the United States of America

3.1. Background

The Congress of the United States of America derives its power to levy and collect income in terms of the Sixteenth Amendment to the Constitution of the United States of America.¹⁴⁴ The American courts have considered whether earnings derived from unlawful activities constitute taxable income in a series of cases dating as far back as the 1920's,¹⁴⁵ and the courts have classified income derived from illegal activities as gross income which can be subject to tax.¹⁴⁶ The court's interpretation of section 61(a)'s definition of gross income, is that it includes 'all income from whatever source derived,' to encompass even illegally obtained income.¹⁴⁷ It is important to note that, Section 61 is silent on the issue of income derived from illegal activities. However, despite the fact that income derived from illegal activities is specifically mentioned nowhere in section 61¹⁴⁸ or the rest of the Act,¹⁴⁹ it is well settled that income derived from illegal activities constitutes gross income.¹⁵⁰

3.2. Introduction

The United States used to have a 'claim of right' doctrine which held that income derived from illegal activities cannot constitute income for tax purposes because the taxpayer has no claim of right to the income and is under an obligation to return the proceeds.¹⁵¹ As will be seen from the discussion below, the United States government has treated illegally acquired income as taxable 'when its recipient has such control over it that, as a practical matter, he

¹⁴⁴ Sixth Amendment to the United States of America Constitution.

¹⁴⁵ BI Bittker (see note 21 above) 130.

¹⁴⁶ D DePass. 'Reconsidering the classification of illegal income' (2013) 66(3) *The Tax Lawyer* 771.

¹⁴⁷ Internal Revenue Code section 61(a) cited in D DePass. 'Reconsidering the classification of illegal income' (2013) 66(3) *The Tax Lawyer* 771.

¹⁴⁸ Section 61(a) of the Internal Revenue Code has an illustrative list of gains defined as income, none of which are illegal.

¹⁴⁹ MP Geller & E Rogers 'How the federal income tax applies to illegal and unlawful gains' (1945) 27 *TAXES* 215.

¹⁵⁰ D DePass (see note 146 above) 776.

¹⁵¹ I Monterio 'Money doesn't smell' (2005) 5(7) *Without Prejudice* 12.

derives readily realizable economic value from it.¹⁵² For the purposes of this dissertation, income derived from illegal activities shall be defined as, ‘any and all gains or profits made by virtue of carrying on a business, enterprise, or transaction, or by the commission of any act or the failure to act, which is contrary to law or to which the law is opposed’.¹⁵³

It is trite that before the sixteenth amendment authorised Congress to tax ‘incomes from whatever source derived,’¹⁵⁴ Congress imposed a tax only on ‘lawful’ business carried on for gain or profit.¹⁵⁵ However, Congress later eliminated the qualifying word ‘lawful’ from the statute,¹⁵⁶ thereby providing for the possibility that income derived from illegal activities could fall under the scope of the taxing power.¹⁵⁷ In other words the system does not consider the right to income but the benefit derived from it.¹⁵⁸

3.3 Is Income Derived from Illegal Activities Taxable in the United States?

It has been argued that taxation of income derived from illegal activities seems inconsistent with prohibiting the illegal activities,¹⁵⁹ and that ‘it might be thought degrading for the government to become a ‘silent partner’ in an unlawful business by taxing its profits.’¹⁶⁰ Despite this line of argument, the American courts firmly held the belief that it was not the Congress’ intention to exempt income from unlawful activities.¹⁶¹ It is against this background that the court in *Sullivan v United States*,¹⁶² pointed out that

It does not satisfy one's sense of justice to tax persons in legitimate enterprises, and allow those who thrive by violation of the law to escape. It does not seem likely that Congress intended to allow an individual to set up his own wrong in order to avoid taxation, and thereby increase the burdens of others lawfully employed... Can it be said that in all such cases Congress intended to tax the law-abiding, and let the criminal go free?¹⁶³

¹⁵² *ibid.*

¹⁵³ MP Geller & E Rogers (see note 149 above) 216.

¹⁵⁴ BI Bittker (see note 21 above) 131.

¹⁵⁵ Chapter 16 of the Revenue Act of 1913.

¹⁵⁶ Section 2(a) of Revenue Act of 1916, chapter 463, now Internal Revenue Code of 1954, section 61.

¹⁵⁷ MP Geller & E Rogers (see note 149 above) 215.

¹⁵⁸ LB Mtshawulana (see note 137 above) 64.

¹⁵⁹ *Steinberg v. United States* 14 F.2d 564, 566 (2d Cir. 1926).

¹⁶⁰ *Ibid.*

¹⁶¹ BI Bittker (see note 21 above) 132.

¹⁶² *Sullivan v United States* 15 F.2d 809 (4th Cir. 1926), *rev'd*, 274 U.S. 259 (1927).

¹⁶³ *Ibid* at 811.

The court held that income derived from illegal activities was taxable despite the illegality of the activity from which it is derived as the court saw, ‘no reason ... why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay.’¹⁶⁴

It is important to note that at first the American courts used not to tax income from embezzlement or burglary. The court viewed the taxpayer who embezzles funds in the same light as a borrower in that the money could not be subject to tax because of the obligation to pay back the embezzled money.¹⁶⁵ The court in *Commissioner v Wilcox*,¹⁶⁶ held that embezzled funds are not taxable:

Taxable income [does not] accrue from 'the mere receipt of property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit. Moral turpitude is not a touchstone of taxability. The question, rather, is whether the taxpayer in fact received a statutory gain, profit or benefit. That the taxpayer's motive may have been reprehensible or the mode of receipt illegal has no bearing on the application of the taxing statute.’¹⁶⁷

On the other hand the court in *Rutkin v United States*,¹⁶⁸ distinguished extortion from embezzlement, and departed from the claim of right theory advanced in *Wilcox* in favour of a control-dominion theory. The court held that extorted funds are taxable;

An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. ... That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it.¹⁶⁹

¹⁶⁴ *United States v Sullivan* supra.

¹⁶⁵ The Court determined that ‘a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. *Commissioner v Wilcox* 327 U.S. 404, 405 (1946) at 408. Thus, because an embezzler had no *bona fide* legal claim to the embezzled funds and had an unqualified duty to repay the embezzled money, the embezzler did not receive taxable income from the embezzlement.

¹⁶⁶ *Commissioner v Wilcox* supra.

¹⁶⁷ *Commissioner v Wilcox* supra at 408.

¹⁶⁸ *Rutkin v United States* 343 U.S. 130 (1952).

¹⁶⁹ *Ibid* at 137.

In other words the case of *Rutkin v United States* held that income is taxable as gross income when a person exercises control and derives realisable economic value from it.¹⁷⁰ The Court emphasised that when the acquirer exerts enough control over taken money such that he derives ‘readily realizable economic value from it,’ the gain is taxable.¹⁷¹ Thus, when the acquirer has the freedom to ‘dispose of it at will,’ the gain is taxable despite the fact that someone else may have a superior claim of right to it.¹⁷²

In 1961, the court in the case of *James v United States*¹⁷³ settled the uncertainty by upholding the dictum in the *License Tax* cases. The court held that the term ‘gross income’ had long been interpreted to include gains from unlawful, as well as lawful, activities.¹⁷⁴ The court also held that the taxability of unlawful income had long been recognised administratively and judicially. The court rejected the claim of right doctrine and replaced it with the economic benefits approach. According to this approach, the question is whether the tax-payer has control over the illegal gains and whether he has derived economic value from it.¹⁷⁵ The findings of the court were subsequently incorporated into the regulations of the IRC. The court in the case of *United States v Mueller*¹⁷⁶ also adopted the economic benefits approach; holding whether the profits are lawful or unlawful, constitute taxable income when its recipient has such control over it that, practically he derives readily realisable economic value from it.

The court in the case of *United States v Thompson*¹⁷⁷ was of the opinion that corporate income which the defendant had diverted for personal use constituted income in his own individual personal capacity and was therefore taxable. Furthermore, it was held in *Collins v Commissioner of Internal Revenue*¹⁷⁸ that an employee of a betting parlour stole racing tickets with the sole purpose placing personal bets. The court held that the income he derived from such ‘gross income’ as envisaged by income tax legislation despite that the employee’s bet resulted in net loss. It was also held further that the gambling loss was irrelevant and it

¹⁷⁰ *Rutkin v United States* supra.

¹⁷¹ *Rutkin* supra at 137.

¹⁷² *Rutkin* supra at 137.

¹⁷³ *James v United States* 366 U.S. 213 (1961).

¹⁷⁴ *Ibid.*

¹⁷⁵ *James v United States* at 219.

¹⁷⁶ *United States v Mueller* 113 US 153 (1885).

¹⁷⁷ *United States v Thompson* 251 U.S. 407 (1920).

¹⁷⁸ *Collins v Commissioner of Internal Revenue* 393 U.S. 215 (1968).

did not have the effect of off-setting his gain in the form of chances to gamble that he obtained by as a result of his theft.

3.4. Should Illegally Derived Income be Taxed in Terms of American Law?

The decision to tax income from illegal activities raises a question of how that income should be treated. However, it has been argued that the collection of tax from income illegally derived cannot be justified on policy grounds. According to Keesling,

...to take a 'cut' or share of income from illegal activities, it may be urged, is the equivalent of putting the government into partnership with criminals. Such a relationship is degrading from the standpoint of the government on the one hand, and on the other, accords to participants in illegal activities a certain status of respectability.¹⁷⁹

Bittker poses a question that 'assuming that it is both fair and profitable to tax the profits of unlawful activities is it degrading for the government to do so?'¹⁸⁰ In answering this question Judge Manton in *Steinberg v United States* argued that it was:

It is hard to conceive of Congress ever having had in mind that the government be paid a part of the income, gains, or profits derived from successfully carrying on this crime, or entering into a combination with the person engaged in this unlawful business to ascertain how and to what extent he shall be taxed.... It is incredible to believe that it was intended that a bootlegger be dignified as a taxpayer for his illegal profit, so that the government may accept his money for governmental purposes, as it accepts the money of the honest merchant taxpayer.¹⁸¹

However Bittker, submits that Judge Manton's above theory is 'farfetched to the point of absurdity because the relationship between the government and the taxpayer entails no moral responsibility for the behavior of the private member of this fictional partnership'.¹⁸² He further submits that, 'A tax is an enforced exaction that reduces the profits of the taxed enterprise, and this no more implies approval than does the confiscation and sale of a drug peddler's automobile and merchandise by the police'.¹⁸³

¹⁷⁹ FM Keesling 'Illegal transactions and the income tax' (1958) 26(5) *UCLA LRev* 29.

¹⁸⁰ BI Bittker (see note 21 above) 144.

¹⁸¹ *Steinberg v United States* 14 F.2d 564, 569 (2d Cir. 1926).

¹⁸² BI Bittker (see note 21 above) 144.

¹⁸³ *Ibid.*

Some authors argue that that a dollar of profit from unlawful activity will buy just as much as a dollar of lawful profit.¹⁸⁴ This basically can be interpreted to mean that illegally obtained income should be taxed as it the same as income derived from legal activities.

3.5. Deductions

The mandate to levy tax is provided for in the Constitution but the Constitution does not make any provision for the granting of deductions.¹⁸⁵ Deductions are thus creatures of statute and a taxpayer has no intrinsic right to them. Congress thus has the power, but not the obligation, to enact laws that allow for deductions.¹⁸⁶ In *New Colonial Ice Company v Helverin*,¹⁸⁷ the court ruled that the tax deductibility of expenses depends merely on legislative grace, which means that all exclusions from gross income and every deduction can be viewed as gifts from Congress. The United States jurisprudence offers clarity on the deductibility of expenses incurred in producing income derived from illegal activities. Tax law in the United States allows taxpayers to deduct most business expenses.¹⁸⁸ An illegal enterprise may deduct lawful expenses and salaries involved in the actual earning of income¹⁸⁹

Although revenue laws allow for the deduction of certain expenses incurred in the production of income, other deductions are disallowed on public policy grounds.¹⁹⁰ The denial of deductions for expenditure incurred in the production of income from illegal activities developed from case law and the courts held that the deductibility of such expenditure would frustrate public policy.¹⁹¹ Colliton,¹⁹² points out that

some business expenses are not deductible because allowance of a deduction would violate public policy. Specific statutory provisions and case law deny these deductions even though the expenditures are real economic costs of earning income. This deduction denial results in a few taxpayers paying tax on their gross receipts as punishment for their crimes or other bad acts.

¹⁸⁴ *ibid.*

¹⁸⁵ Sharp 'Tax accounting for illegal activities' 2003 *The National Public Accountant* 1

¹⁸⁶ JW Colliton 'The tax treatment of criminal and disapproved payments' (1989) 9 *Virginia Tax Review* 280.

¹⁸⁷ *New Colonial Ice Company v Helvering* 292 U.S. 435 (1934).

¹⁸⁸ E Bonthuys and C Monteiro (see note 30 above) 669.

¹⁸⁹ *Cohen v Commissioner* 176 F.2d 394 (1947).

¹⁹⁰ LB Mtshawulana (see note 137 above) 64.

¹⁹¹ *Ibid.*

¹⁹² JW Colliton (see note 186 above) 273.

These taxpayers are not allowed to adjust their taxable income to reflect the costs of earning the income.¹⁹³

It is argued that ‘the allowance of a deduction will, through the consequent reduction of tax liability, benefit, and hence encourage, participants in illegal activities, contrary to the policy of the laws prohibiting such activities’.¹⁹⁴

Colliton argues that the denial of deductions leads to inequitable results¹⁹⁵ and that the tax law is not the correct medium through which to punish wrongdoers:

The basic idea behind the deduction denial is simple: the government should not allow wrongdoers to benefit from their misdeeds through the tax law. While this idea is appealing, it is inconsistent with the structure of the tax law and leads to arbitrary results. It results in additional punishment for some taxpayers who have already been punished under other laws . . . Denial of the business expense deduction is neither an appropriate nor an effective way to punish wrongdoers and it is not consistent with the general purposes and structure of the tax law. The tax system is intended to provide revenue for the government. Although there are many provisions designed to encourage or discourage particular behavior, the tax law exists to raise revenue and not to punish people for bad behavior . . . The purpose of the business expense deduction and other adjustments is not to benefit people for approved behavior. Rather, these adjustments are to accurately compute taxable net income. They are computational in nature and morally neutral.¹⁹⁶

It is against this background that some authors argue that

It must be acknowledged that the policy which justifies the inclusion of illegal proceeds in gross income is one of revenue collection which, in turn, entails placing all taxpayers on an equal footing, as far as the taxability of their receipts goes. It follows, then, that the policy underlying the deductibility of expenditure should also be one which seeks to place honest and dishonest taxpayers on an equal footing. ‘What’s good for the goose is good for the gander’: if the honest taxpayer cannot be discriminated against through the taxpayer who derives his income from illegal activities being allowed to escape the inclusion of his receipts in gross income, then the taxpayer who derives his income from illegal activities should not be

¹⁹³ JW Colliton (see note 186 above) 274.

¹⁹⁴ FM Keesling (see note 179 above) 35.

¹⁹⁵ JW Colliton (see note 186 above) 274.

¹⁹⁶ *Ibid.*

discriminated against through the honest taxpayer being allowed deductions which he (the taxpayer who derives his income from illegal activities) is not entitled to.¹⁹⁷

It is against this background that the decision to deny a taxpayer who derives his income from illegal activities his deductions is based on the view of taxation as moral barometer which is not right.

3.6. Conclusion

It is well settled that income gained from illegal activities is taxable to those who obtain such illegal funds.¹⁹⁸ The sixteenth amendment abolished the notion of taxing income from legitimate sources only and thus income from both legal and illegal sources is subject to tax. The United States used to have a claim of right doctrine which held that income derived from illegal activities cannot constitute income for tax purposes because the taxpayer has no claim of right to the income and is under an obligation to return the proceeds.¹⁹⁹ It is submitted that the tax system of the United States has moved away from a regime of only taxing the rightful owners of income, to a regime that taxes the benefit derived by the taxpayer or by the person dealing with the asset or the money in the way that an owner would. The United States jurisprudence offers clarity on the deductibility of expenses incurred in producing income from illegal activities. Tax law in the United States allows taxpayers to deduct most business expenses.²⁰⁰ An illegal enterprise may deduct lawful expenses and salaries involved in the actual earning of income.²⁰¹

¹⁹⁷ E Bonthuys and C Monteiro (see note 30 above) 669.

¹⁹⁸ D DePass (see note 146 above) 771.

¹⁹⁹ Monterio (see note 151 above) 12.

²⁰⁰ E Bonthuys and C Monteiro (see note 30 above) 669.

²⁰¹ *Cohen v Commissioner* supra.

CHAPTER FOUR

4. Conclusion

4.1. Is income derived from illegal activities taxable?

It has been seen from the discussion above that taxation of income from illegal activities is a well-established tax principle both in South Africa and in the United States of America,²⁰² notwithstanding the fact that it is tainted with illegality.²⁰³ It has been established that in both jurisdictions income is taxed irrespective of the legality of the source or that income is taxed from whatever source derived. In *CIR v Delagoa Bay Cigarette Co Ltd*²⁰⁴ it was put beyond doubt that, where a business is engaged in profit-making, the amounts generated are deemed subject to tax, irrespective of whether the transaction is tainted with illegality or not. This is so because in *ITC 1199*,²⁰⁵ it was held that

In the Income Tax Act, the tax-gatherer has cast his net wide enough to catch all income, so that once a receipt constitutes income, it is subject to the provisions of the Act, regardless of whether it is income derived from illegal activities or not.

It is submitted that, there is now no doubt that the illegality of receipts cannot negate its taxability.²⁰⁶

In the United States, gross income for taxation purposes refers to all income received whatever its source. The United States follows an ‘economic benefits approach’, which asks the question whether the taxpayer ‘has such control over ill-gotten gains that, as a practical matter, he derives readily realisable economic value from it’.²⁰⁷ Thus for an amount to be taxed the taxpayer must derive an economic benefit from such income. On the other hand South Africa follows the ‘beneficial receipt’ approach which provides that no liability for tax

²⁰² D Lusty ‘Taxing the untouchables who profit from organized crime’ (2003) 10(3) *Journal of Financial Crime* 209.

²⁰³ *Ibid.* See also *CIR v Delagoa Bay Cigarette Co Ltd* supra.

²⁰⁴ *CIR v Delagoa Bay Cigarette Co Ltd* supra.

²⁰⁵ *ITC 1199*, 36 SATC 16 19.

²⁰⁶ E Muller (see note 3 above) 181.

²⁰⁷ *James v United States* supra.

can arise when there is no 'receipt'. 'Received by' in this instance means 'received by the taxpayer on his own behalf for his own benefit'.²⁰⁸

4.2. Should the government subject income from illegal activities to taxation

Apart from the main research question that was raised as to whether income derived from illegal activities can be deemed taxable as it falls within the gross income definition, a further question was asked whether income derived from illegal activities should indeed be taxable.²⁰⁹ The question raises both legal and policy issues. Al Capone once said, 'income tax law is a lot of bunk. The government cannot collect legal taxes from illegal money'.²¹⁰ This statement has been relied upon by the taxpayers who hold the belief that income derived from illegal activities should not be subject to taxation.

It is submitted that taxing income derived from illegal activities may seem inconsistent with prohibiting it,²¹¹ and that it might be thought degrading for the government to become a 'silent partner' in an unlawful business by taxing its profits.²¹² However the justification for the taxability of income derived from illegal activities has been provided above and it is worthy reiterating what was held in an American case of *Sullivan v US*²¹³ that

It does not satisfy one's sense of justice to tax persons in legitimate enterprises, and allow those who thrive by violation of the law to escape. It does not seem likely that Congress intended to allow an individual to set up his own wrong in order to avoid taxation, and thereby increase the burdens of others lawfully employed.... Can it be said that in all such cases Congress intended to tax the law-abiding, and let the criminal go free?²¹⁴

The court further stated that, 'we see no reason ... why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay.'²¹⁵

The above statement is supported by the case of *Lindsay v IRC*,²¹⁶ where it was held that

²⁰⁸ *Geldenhuys v Commissioner for Inland Revenue supra*.

²⁰⁹ L Olivier 'Taxability of illegal income' 2008 *Journal of South African Law* 814.

²¹⁰ See *Capone v United States* (1932) 56 F 2d 927.

²¹¹ See, e.g., *Steinberg v United States* 14 F.2d 564, 566 (2d Cir. 1926).

²¹² *Ibid*.

²¹³ *Sullivan v US supra*.

²¹⁴ *Ibid* at 811. See also *Steinberg v United States* 14 F.2d 564 (2dCir. 1926).

²¹⁵ *Sullivan v US supra*.

It is, in my opinion, absurd to suppose that honest gains are charged to tax and dishonest gains escape.... The burglar and the swindler, who carry on trade or business for profit, are as liable to tax as an honest business man.

It has been further argued that the non-taxability of such businesses will result in them gaining advantages over those who pay their taxes legally.²¹⁷

4.3. Intention of the taxpayer

The evaluation of the taxpayer's intention is a very useful tool to determine taxability and the fact that this was the *ratio* of the *MP Finance Group* court's decision is to be commended.²¹⁸ The court in *MP Finance Group* found that the deposits had been received by the corporation because the operators had had the intention to deceive the public and steal their money.²¹⁹ This can be interpreted as 'an indication of their intention to keep the funds for their own benefit'.²²⁰ Thus it is submitted that by applying the intention-based subjective approach to the concept of 'beneficial receipt,' the current definition of gross income will suffice in taxing income derived from illegal activities.²²¹ The intention of the taxpayer should be used to determine the moment when an illegal amount was beneficially received by, or had accrued in favour of, a taxpayer.²²²

4.4. Conclusion

It is trite that 'once it has been determined that illegal proceeds should be included in the gross income of a taxpayer, the issue of that taxpayer's entitlement to a deduction of his expenditure or losses, arises.'²²³ Like the general gross income definition in the South African Income Tax Act, 'the general deduction formula is neutral with regard to the deductibility of illegal expenditures and losses.'²²⁴ The South African law does offer very

²¹⁶ *Lindsay v IRC* (1933) 18 TC 43 58.

²¹⁷ O Ogunnsanwo (see note 55 above) 77.

²¹⁸ LG Classen (see note 79 above) 553.

²¹⁹ *MP Finance Group v Commissioner, SARS* supra at 524D-F.

²²⁰ LG Classen (see note 79 above) 553.

²²¹ E Muller (see note 3 above) 181.

²²² LG Classen (see note 79 above) 553.

²²³ E Bonthuys and C Monteiro (see note 30 above) 667.

²²⁴ E Bonthuys and C Monteiro (see note 30 above) 667.

little clarity on the deductibility of expenses incurred in producing income derived from illegal activities. The United States is, however, a richer source of information in this regard.²²⁵ Tax law in the United States allows taxpayers to deduct most business expenses. It is submitted that deductions have been disallowed for income derived from illegal activities based on public policy reasons. It is argued that ‘the allowance of a deduction will, through the consequent reduction of tax liability, benefit, and hence encourage, participants in illegal activities, contrary to the policy of the laws prohibiting such activities’.²²⁶ As the experience of the United States indicates, the decision to deny a taxpayer who derives his income from illegal activities his deductions is based on the view of taxation as moral barometer.

Even the landmark decision of the Supreme Court of Appeal in *MP Finance*,²²⁷ ‘although settling in the affirmative the question whether amounts paid to an illegal pyramid scheme are considered to be ‘received’ within the meaning of the Income Tax Act,²²⁸ left a lot of questions regarding the blanket taxability of income derived from illegal activities unresolved.’²²⁹ It raises questions the following questions;

Is the decision authority for the statement that the proceeds of all types of illegal activities must be included in gross income, or should it apply only to the proceeds derived by means of illegal pyramid schemes? How far will the authorities go to collect income derived from illegal activities?²³⁰

All of the above remains to be seen.²³¹ It is submitted that the significance of *MP Finance Group* case lies in the fact that, ‘it puts to a rest the debate as to whether income derived from pyramid schemes is taxable or not in South Africa.’²³² It is important to note that in terms of the doctrine of precedent the Supreme Court of Appeal did not discuss any of the previous decisions by other courts in dealing with this issue of whether the income derived from illegal activities is taxable or not. However, the Court a quo had referred to such

²²⁵ E Bonthuys and C Monteiro ‘Sex for sale: the prostitute as businesswoman’ (2004) 121(3) *SALJ* 667.

²²⁶ FM Keesling. ‘Illegal transactions and the income tax’ (1958) 5 *UCLA L Rev* 35.

²²⁷ *MP Finance Group CC supra*.

²²⁸ Sec 1 of the Act (see note 10 above).

²²⁹ LG Classen (see note 79 above) 551.

²³⁰ *Ibid*.

²³¹ *Ibid*.

²³² JMP Venter, WR Uys & MC van Dyk (see note 63 above) 130.

decisions and the inference could perhaps be drawn that it regarded the decisions relied on a quo by the Commissioner as correct.²³³

It is submitted that the conclusion which can be drawn from the discussion is that income derived from illegal activities is still received by the trader, and will be subject to taxation as it would have been received on the trader's own behalf and for the trader's own benefit. The challenge faced by the taxing authorities is the integrity of such systems in the public eye. If income from illegal activities is taxed, the public may not see that as the equal treatment of all income, but may interpret it as government condoning and benefiting from unlawful activities.²³⁴ On the other hand, if income from illegal activities is not taxed it would appear that criminals are above the law. Adoption of the policy of not taxing income from illegal activities would, in view of the current high income tax rates, place an enormous premium on illegal enterprises.²³⁵ Furthermore, such a policy would give rise to the curious practice of individuals insisting on the illegality of their activities in order to escape taxation.²³⁶

²³³ LG Classen (see note 79 above) 545

²³⁴ LB Mtshawulana (see note 137) 75.

²³⁵ FM Keesling (see note 179 above) 31.

²³⁶ Ibid.

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