



College of Law and Management Studies

School of Law

**The Challenges Arising From The Application Of
The ‘Gross Income Definition To Illegal Income.’**

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fulfilment of the regulations for the LLM Degree at
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DECLARATION

I **Kulani Maboko** declare that:

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10/12/2015

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ABBREVIATIONS

A. C:SARS	Commissioner for the South African revenue service
B. CIR	Commissioner for Inland Revenue
C. ITC	Income Tax Case
D. TR	Taxing Ruling
E. SIR	Secretary of Inland Revenue.

Chapter 1: THE RATIONALE FOR SUBJECTING ILLEGAL INCOME TO TAXATION.

(i) INTRODUCTION AND BACKGROUND OF THE PROBLEM.

As a result of the weakening rand, the economy has been unstable impacting negatively on people's livelihoods. Desperation has caused some people to engage in criminal activities in order to accumulate income.¹ The tax treatment of proceeds derived by the taxpayer is of concern. However, the taxman has put measures to retain all proceeds from both legal and illegal means which constitute normal tax and subject it to the Income Tax Act.² The problem faced by the Commissioner for the South African Revenue Service (hereafter referred to as the Commissioner) and the courts is in identifying and applying a single approach to subject illegal income to the gross income definition, section 1 of Income Tax Act (hereinafter referred to as the gross income definition).³ The gross income definition provides for the inclusion of taxable income of total amounts in cash or otherwise received by, accrued to or in favour of any resident during the current year of assessment, excluding those of a capital nature.⁴

Drawing from the gross income definition, it is apparent that only receipts and accruals are essential in the calculation of normal tax.⁵ For this reason, the Commissioner has a legal duty to collect tax and always challenge taxpayers to include either a receipt or accrual for normal tax purposes. The gross income definition is therefore, fundamental to the taxation of amounts received by taxpayers and the entire Income Tax Act.⁶

The problem experienced with the gross income definition is that it does not provide any interpretation as to what constitutes a receipt or an accrual and the words 'illegal income' are absent from its wording.⁷ Of great importance and focus in this dissertation is the application

¹ 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* 534-553.

² *ITC 1199* (1973) 36 SATC 16 (T), 19.

³ Section 1 of the Income Tax Act 58 of 1962 as amended.

⁴ *Ibid.*

⁵ L Olivier 'Taxing of Illegal income' 2008 *J. S. Afr. L.*, 814.

⁶ *Commissioner for Inland Revenue v Delfos* 1933 AD 242, 253.

⁷ 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* 535.

of the phrase ‘received by’. The courts have shed light on the problem by interpreting the phrase, and in *Geldenhuis v CIR*,⁸ the court held that the usufructuary who sold a flock of sheep on behalf of the holders of the bare dominium did not receive the proceeds realised from the sale on her own behalf and benefit, but the proceeds belonged to the bare dominium holders.⁹ While still on the issue of the meaning of a receipt, Schreiner JA in *CIR v Genn & Co (Pty) Ltd*¹⁰ provided limitation to the phrase ‘received by’, by stating that a receipt excludes money in the hands of a taxpayer acting in a representative capacity and borrowed money where there is an obligation to repay the money borrowed.¹¹ Furthermore, he highlighted an important principle that ‘it is not every obtaining of physical control over money or money’s worth that constitutes a receipt for purposes of the gross income definition.’¹²

The understanding of what constitute a receipt had been subject of debate in numerous cases especially insofar as it applies to the taxability of illegal income.¹³ In order to determine whether illegal income in the hands of the taxpayer is taxable or not, the enquiry turns on whether the amount is ‘received by’ for gross income purposes. This was witnessed in cases where the taxpayer misappropriated funds entrusted to him¹⁴ and where the taxpayer derives illegal proceeds while acting in a representative capacity¹⁵ and , where the taxpayer derives a profit from operating a scheme of selling dried milk cultures¹⁶ or from operating a pyramid scheme.¹⁷

The Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*¹⁸ finally dealt with the issue and provided the principle that the enquiry is to determine whether or not the taxpayer had the intention to personally benefit from the illegal activity.¹⁹ However, in reaching its decision, the Supreme Court of Appeal failed to clearly set out the test applicable

⁸ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419.

⁹ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419, 429.

¹⁰ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

¹¹ *Ibid*, 388.

¹² *Ibid*, 388.

¹³ *ITC 1792* 67 SATC 236; *ITC 343* (1935) 8 SATC 370 (U); *ITC 1624* 59 SATC 373; *ITC 1810* 68 SATC 189; *CIR v Delagoa Bay Cigarette co Ltd* 1918 TPD 391; *ITC 1199* (1973) 36 SATC 16 (T); *Partridge v Mallendaine* 1886 (2) TC 179; *ITC 1789* 67 SATC 205; *ITC 1545* (1992) 54 SATC 464; *MP Finance Group CC (In Liquidation) v C:SARS* (69) SATC 141.

¹⁴ *COT v G* 1981 (4) SA 167(ZA), 160.

¹⁵ *ITC 1792* 67 SATC 236, 237.

¹⁶ *ITC 1545* (1992) 54 SATC 464, 466.

¹⁷ *ITC 1789* (67) SATC 205; *MP Finance Group CC (In Liquidation) v C:SARS* (69) SATC 141.

¹⁸ *MP Finance Group CC (In Liquidation) v C:SARS* (69) SATC 141.

¹⁹ *MP Finance Group CC (In Liquidation) v C:SARS* (69) SATC 141, 145.

for determining the intention of the taxpayer. This may create a problem for future cases on the taxation of illegal income.

1.1 THE PUPOSE OF THE RESEARCH.

Firstly, this study will show that the requirement of a receipt may be used as a basis for including illegal income in gross income. It will determine whether or not the courts are justified in subjecting illegal income to taxation by considering and analysing South African case law. This study will also determine whether in the existing case law dealing with taxation of illegal income exist a suitable test which may be applicable in determining the outcome of all such cases.

Secondly, the study will determine whether or not the tests of intention used by the courts in determining whether an amount is capital or revenue may be used to determine a receipt. Thirdly, it will ascertain how illegal income is taxed in both Australia and New Zealand. Moreover, this study will decide whether or not their method of levying illegal income may assist in solving and improving the taxing of illegal income in our gross income definition.

1.2 THE PROBLEM STATEMENT.

The current approach of determining a receipt as provided in *MP Finance* does not adequately settle the problem of subjecting illegal income to taxation.

1.3 THE RESEARCH METHODOLOGY.

This study will be conducted based on the content analysis of journal articles and the case law. A comparative study between South Africa, Australia and New Zealand will be used to subject illegal income to taxation.

1.4 THE SIGNIFICANCE OF THE STUDY.

This study will be important to the existing jurisprudence on the taxation of illegal income in determining the best approach which the courts may use to assess whether the taxpayer has 'received' illegal income in his hands for gross income purposes. It will also consider the

methods used in foreign countries such as Australia and New Zealand, and if there are valuable principles that may be borrowed from their approach. This will be beneficial in developing our tax jurisprudence.

1.5 THE LIMITATIONS OF THE STUDY.

This study is only focused on the phrase 'received by' as contained in our gross income definition. The comparative study only focuses on Australia and New Zealand and makes reference to cases which were not decided in those countries. The cases only become applicable to the extent that they were referred to by the authorities in any one of those two countries. The findings and recommendations are only limited to the South African jurisprudence on the levying of normal tax on illegal income received by the taxpayer.

Chapter 2: THE APPLICATION OF A RECEIPT TO INCOME IN THE HANDS OF THE TAXPAYER.

2.1 INTRODUCTION.

In a statute, a definition section of key words is essential and assists in removing/avoiding ambiguities/inconsistencies as it provides direction towards the intention of the legislature. However, whenever a definition section is absent from a statute the intention of the legislature is more difficult to ascertain and may require the intervention of the courts in certain circumstances, for example if there is ambiguity. In relying on the courts for interpretation, what is present is that such interpretation does not always from the onset result in displaying the true intention of the legislature. This is seen by development in interpretation of key words of a section. This is apparent in the gross income definition which proves to be problematic. The court's interpretation of a receipt with respect to legal and illegal transactions will be considered below.

2.1.1 THE APPLICATION OF A RECEIPT TO LEGAL TRANSACTIONS.

The question of what constitute a receipt was considered by the court in *Geldenhuy v CIR*²⁰ where the taxpayer, the usufructuary of a flock of sheep, after experiencing a loss of the livestock due to drought, the taxpayer decided to give up farming and with the consent of the holders of the bare dominium, sold the animals on their behalf.²¹ After realizing a considerable amount from the sale, a dispute ensued between the Commissioner and the taxpayer in relation to whether or not such amount constituted a receipt.²² In considering the interpretation of a receipt, the court considered the legal relationship between the usufructuary and the holders of the bare dominium.²³ It concluded that the proceeds realized from the sale belonged to the holders of the bare dominium.²⁴ Although the taxpayer received the proceeds, they were not received by her on her own behalf and for her own benefit.²⁵ Therefore such proceeds do not form part of her taxable income.²⁶ By reaching such a

²⁰ *Geldenhuy v CIR* 1947(3) SA 256 (C); 14 SATC 419.

²¹ *Geldenhuy v CIR* 1947(3) SA 256 (C); 14 SATC 419, 421.

²² *Geldenhuy v CIR* 1947(3) SA 256 (C); 14 SATC 419,421- 422.

²³ *Ibid* 428.

²⁴ *Ibid* 428.

²⁵ *Ibid* 429.

²⁶ *Ibid* 431.

conclusion, the court provided a good starting point as to what constitutes a receipt under the gross income definition. Also, it has provided guidance as to what amounts to a receipt and what does not.

From this decision, it is evident that the phrase ‘received by’ relates to the portion of the income which the taxpayer receives for her own behalf and benefit.²⁷ Moreover, the existence of the law which relates to usufructs played a role in determining the outcome of the case.²⁸ This is because it brought into existence a legal relationship between the bare dominium holders and the usufructuary, which in turn created a legal duty upon the usufructuary to transact as an agent. The income which flowed from the sale of the flock of the sheep flowed through the usufructuary as a conduit pipe into the hands of the holders of the bare dominium.

This therefore means that from this decision a receipt is present where there is a personal benefit and the absence of an intervening law which creates a situation where money flows through a person as a conduit pipe from the recipient to the beneficiary. This means that a person will only be required to pay tax on the portion of the amount which is received for their own benefit.

Elaborating further on the interpretation of a receipt, Schreiner JA in *CIR v Genn & Co (Pty) Ltd*²⁹ provided an example of a farmer who borrows a tractor from someone else under the obligation to return it to the owner.³⁰ To conclude, if a taxpayer obtains a loan, the borrowed funds were not ‘received by’ the taxpayer for gross income purposes.³¹ The reason was that even though the tractor was ‘received by’ the farmer literally, the farmer was not entitled to use it any time he wished.³² The tractor still belonged to the original owner.³³ The position was the same with the loan funds.³⁴

The meaning of the phrase ‘received by’ in respect of a ‘deposit’ amount given in exchange for containers, was considered in *Brookes Lemos Ltd v CIR*³⁵ where the taxpayer operated a

²⁷ Ibid 430.

²⁸ Ibid 428.

²⁹ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

³⁰ Ibid 388.

³¹ Ibid.

³² Ibid.

³³ Ibid.

³⁴ Ibid.

³⁵ *Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A); 14 SATC 293.

wholesale trade of supplying goods to customers in glass containers.³⁶ Due to the short supply of glass jars caused by war, the taxpayer decided to create a scheme where customers were invited to return glass jars for re-use by charging a deposit on each glass jar supplied which was then refunded to the customer upon the return of the glass container.³⁷

In dealing with the deposits, the taxpayer banked the actual funds with its own business receipts and once a glass jar was returned, a refund was made out of funds held in the business account.³⁸ On the basis of such treatment of the deposits, the Commissioner sought to tax the taxpayer on the deposits on the basis that they constituted a receipt.³⁹

In considering the matter, the court found that the taxpayer's scheme did not amount to an ordinary deposit scheme and held that because the taxpayer did not keep the deposit in a separate trust fund, but merged them into the business account, the taxpayer received the deposit amounts for gross income purposes.⁴⁰

However, in *C:SARS v Cape Consumers (Pty) Ltd*⁴¹ where the taxpayer, a buy aid organization operating in the interest of the members (buyers), purchased goods at a discounted price from suppliers of which the full price of the sale was reimbursed by the buyers.⁴² At the end of the financial year, the taxpayer transferred into the buyers 'reserve fund' an amount comprising of the total amount of discounts obtained and investment income earned on behalf of the buyers.⁴³ The question which the court had to decide on was whether the taxpayer received the amount on his own behalf or on behalf of the buyers.⁴⁴ The court held that the taxpayer's memorandum and articles of incorporation and its conduct in respect of the money clearly showed that the amounts was not received by the taxpayer therefore it was excluded from the taxpayer's gross income.⁴⁵

The taxpayer's treatment of the amount by crediting the deposits into a separate account case is distinguishable from the taxpayer's approach in *Brookes Lemos Ltd v CIR*.⁴⁶ The case

³⁶ Ibid 296.

³⁷ Ibid.

³⁸ Ibid 297.

³⁹ Ibid 298.

⁴⁰ Ibid 229.

⁴¹ *Commission for SARS v Cape Consumers (Pty) Ltd* 61 SATC 91.

⁴² Ibid 92.

⁴³ Ibid.

⁴⁴ Ibid 100.

⁴⁵ Ibid 103.

⁴⁶ *Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A); 14 SATC 293.

clearly shows what the taxpayer in *Brookes Lemos Ltd v CIR*⁴⁷ should have done in order to escape liability.

In *CIR v Witwatersrand Association of Racing Clubs*,⁴⁸ the court considered the tax treatment of proceeds derived by the taxpayer from successfully holding a horse racing meeting on behalf of two charities.⁴⁹ Although there was a moral obligation on the taxpayer to hand over the proceeds to the two charities, the court held that such contemplation cannot defeat the fact that the taxpayer received the proceeds for gross income purposes.⁵⁰ This case also confirmed the principle that if a taxpayer wishes to act in an agency capacity, this capacity needs be evident in a document, which legally binds the taxpayer to act as an agent.⁵¹ From this decision it may be concluded that a receipt is present where there are personal benefits to the taxpayer and in the absence of a situation where the taxpayer receives money as an agent.

2.1.2 THE APPLICATION OF A RECEIPT TO ILLEGAL TRANSACTIONS.

The meaning of a receipt was further limited by the Appellate Division of the High Court of Zimbabwe, in *COT v G*⁵² when it considered the meaning of the word receive, in a section similar to the one appearing in our gross income definition, by concluding that it does not extend to an unilateral taking such as theft because a thief does not receive, but merely takes.⁵³ In *ITC 1545*⁵⁴ the court considered the position of the taxpayer who derived income through operating an illegal lottery of selling ‘dried milk cultures’ to the public.⁵⁵ It concluded that even though the transaction in question was *void ab initio*, the taxpayer received the amount in question for gross income purposes.⁵⁶

A great development in the interpretation of a receipt came about in *ITC 1789*⁵⁷ where the subject matter was whether the taxpayer, an operator of an illegal pyramid scheme, received

⁴⁷ *Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A); 14 SATC 293.

⁴⁸ *CIR v Witwatersrand Association of Racing Clubs* 1960(3) SA 291 (A); 23 SATC 380.

⁴⁹ *Ibid* 389.

⁵⁰ *Ibid* 398.

⁵¹ *Ibid*.

⁵² *COT v G* 1981 (4) SA 167.

⁵³ *Ibid* 162.

⁵⁴ *ITC 1545* 54 SATC 464(C).

⁵⁵ *Ibid* 466.

⁵⁶ *ITC 1545* 54 SATC 464(C),467.

⁵⁷ *ITC 1789* 67 SATC 205.

deposits made by investors.⁵⁸ Relying on *CIR v Genn & Co (Pty) Ltd*⁵⁹ the taxpayer argued that ‘the contract was an illegal one *ab initio* and thus the *condictio ob iniustam causa* was applicable and this meant that from the first moment the money was received the recipient acquired no right to retain it and it thus fell to be refunded.’⁶⁰ Therefore, during the transaction ‘there was no way it could be said that there had been an actual receipt for the purposes of computing the gross income of the various entities.’⁶¹

It was further contended that the money received by the recipient was similar ‘to borrowed money which can never be regarded as forming part of the gross income of the borrower; in this case the money does not form part of the taxpayer’s gross income because it was tainted with illegality at the very moment it was received.’⁶² However, the court held that the taxpayer, in forming the scheme, had the intention to personally benefit from the deposits of investors and as such the deposit amounts were received by him within the meaning provided in the gross income definition.⁶³

The taxpayer appealed and the appeal case was reported as *MP Finance Group CC (in liquidation) v C:SARS*⁶⁴ and the Supreme Court of Appeal confirmed the High Court’s decision by concluding that the taxpayer had the intention to personally benefit from operating the scheme and the deposits formed part of the taxpayer’s gross income.⁶⁵ From the moment the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*⁶⁶ settled the question of interpretation of the phrase ‘received by’, the illegal income will be taxed as long as the taxpayer received the amount with the intention of keeping it for his/her own benefit. Since the meaning of interpreting a receipt has been settled, a consideration of how the courts applied it with regard to cases dealing with illegal income will be undertaken. The starting point will be to consider cases where the taxpayer’s defence succeeded while the second and last part will consider cases where the taxpayer’s defence was not successful and thus the taxpayer was found liable to pay tax on the amounts derived from illegal activities.

⁵⁸ Ibid 207.

⁵⁹ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

⁶⁰ Ibid 206.

⁶¹ Ibid 208.

⁶² Ibid 2010.

⁶³ Ibid 2012.

⁶⁴ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

⁶⁵ Ibid 145.

⁶⁶ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

2.1.3 THE CASES WHERE THE TAXPAYER'S DEFENCE SUCCEEDED.

In *COT v G*⁶⁷ The taxpayer held an important government position as he was entrusted with dealing with money which was intended for secret operations.⁶⁸ In the course of his employment, the taxpayer requested more money than was necessary for the operations as he saw an opportunity to increase his patrimony.⁶⁹ As a result, he misappropriated the additional amounts.⁷⁰ After it was discovered that the taxpayer had committed this offence, he was charged and convicted of theft and required to repay the sum of money which he had stolen together with a penalty.⁷¹

In considering the tax assessment of the taxpayer, the Secretary for Inland Revenue included the misappropriated amount as a receipt in terms of section 8(1) of the Zimbabwean Income Tax Act.⁷² However, the taxpayer argued successfully against such inclusion at the Special Court on the basis that such amounts never became his and thus did not form part of his gross income.⁷³ The Commissioner of Taxes appealed.⁷⁴

The issues which the court had to decide on was whether or not the stolen amount satisfied the meaning of a receipt as provided in section 8(1) of the Zimbabwean Income Tax Act.⁷⁵ In considering its meaning, the court referred to the shorter version of the Oxford Dictionary which defines the word to receive as 'To take into one's hands, or into one's possession (something held out or offered by another); to take delivery of (a thing) from another either for oneself or for a third party.'⁷⁶ Additionally it is conceived that it does not extend to cover a unilateral taking such as theft which confers no right against the taker to the things taken and a thief takes but does not receive.⁷⁷

⁶⁷ *COT v G* 1981 (4) SA 167.

⁶⁸ *Ibid* 160.

⁶⁹ *Ibid*.

⁷⁰ *Ibid*.

⁷¹ *Ibid*.

⁷² *Ibid*.

⁷³ *Ibid*.

⁷⁴ *Ibid*.

⁷⁵ *Ibid*.

⁷⁶ *Ibid* 161, 162.

⁷⁷ *Commissioner of Taxes v G* 1981 (4) SA 167, 162.

Elaborating further on the meaning, the court touched on the previously decided cases of *Geldenhuis v CIR*⁷⁸ and *CIR v Genn & Co (Pty) Ltd*⁷⁹ which provided a good interpretation of a receipt to conclude that the stolen amount was not received by the taxpayer on his own behalf and for his own benefit.⁸⁰ Because a receipt is present where there is match of intention between the giver of the amount and the receiver, in this case, the Government never intended to give the amount to the taxpayer on his own behalf and for his own benefit and the taxpayer was not conscious of receiving the amount for his own benefit.⁸¹

In *ITC 1792*⁸² the taxpayer was a stock broker on the Johannesburg Stock Exchange, who was instructed to secure and buy specific shares by M and in securing the shares, through M's company bought and resold shares at a profit to M.⁸³ In preparing his tax return, the taxpayer initially included the profit realised from the sale of shares as a receipt forming part of his gross income.⁸⁴ However, after realizing that he made an error, the taxpayer excluded the same amount on the basis that it was not beneficially received and thus did not form part of his gross income.⁸⁵ After spotting the amendment, the Commissioner issued a revised assessment including the omitted amount.⁸⁶ The taxpayer objected.⁸⁷

The issues which the court was asked to decide was whether or not the part of the amount realised by the taxpayer from the sale of shares to M constituted a receipt in his hands for normal tax.⁸⁸ It was argued before the court that it was clear that when the taxpayer bought and resold shares to M, he had breached the fiduciary duty placed upon him.⁸⁹ Also when he bought and resold shares at a profit he had the intention to personally benefit from the sale.⁹⁰

In reaching its decision the court disregarded the subjective intention of the taxpayer and held that the phrase 'received by' has various qualifications.⁹¹ Relying on *CIR v Genn & Co (Pty)*

⁷⁸ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419ITC 1545 (54) SATC 464(C).

⁷⁹ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

⁸⁰ *Commissioner of Taxes v G* 1981 (4) SA 167, 163.

⁸¹ *Ibid.*

⁸² *ITC 1792* 67 SATC 236.

⁸³ *Ibid* 237, 238.

⁸⁴ *Ibid* 237.

⁸⁵ *Ibid.*

⁸⁶ *Ibid* headnote of the case.

⁸⁷ *Ibid.*

⁸⁸ *Ibid* 237.

⁸⁹ *Ibid* 238.

⁹⁰ *Ibid.*

⁹¹ *Ibid* 237.

Ltd,⁹² the court remarked that ‘it was not every obtaining of physical control over money or money’s worth that constituted a receipt for gross income purposes,’⁹³ that one receives an amount for gross income purposes when he receives it for his own benefit.⁹⁴ Although in the present case the taxpayer had the necessary intention to personally benefit from the sale of shares to M, the law disregards such intention because of the existence of a legally recognised relationship of agent and principal between the taxpayer and M (relationship regulated by the law of agency).⁹⁵ As such the amount was never received by the taxpayer because at all material times it belonged to M.⁹⁶

2.1.4 THE CASES WHERE THE TAXPAYER’S DEFENCE WAS UNSUCCESSFUL.

In *CIR v Delagoa Bay Cigarette Co Ltd*⁹⁷ the taxpayer operated a business of selling packets of cigarettes.⁹⁸ Each packet had a secret numbered coupon which entitled the purchaser to a chance of winning a range of prizes.⁹⁹ The draws were held on a monthly basis and the taxpayer would select and advertise the lucky winning numbers.¹⁰⁰ The lucky purchaser of the pack containing the winning number would receive the named prize.¹⁰¹ Since the start of the business the taxpayer had only made two draws when it caught the eye of the Commissioner.¹⁰²

In determining the taxpayer’s normal tax, the Commissioner included the excess profit duty on the proceeds realised by the taxpayer from operating the illegal lottery.¹⁰³ The Commissioner reasoned that these proceeds were income forming part of the taxpayer’s taxable income and applied to court for an order preventing the taxpayer from making further draws as it thought that it would inconvenience its claim.¹⁰⁴ In considering the treatment of the amount in issue, the court did not touch on the interpretation of the meaning of a

⁹² *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

⁹³ *ITC 1792* 67 SATC 236, 239.

⁹⁴ *Ibid* 237.

⁹⁵ *Ibid*.

⁹⁶ *Ibid*.

⁹⁷ *Commission for Inland Revenue v Delagoa Bay Cigarette Co Ltd* 1918 TPD 391.

⁹⁸ *Ibid* 392.

⁹⁹ *Ibid* 392, 393.

¹⁰⁰ *Ibid*.

¹⁰¹ *Ibid*.

¹⁰² *Ibid*.

¹⁰³ *Ibid*.

¹⁰⁴ *Ibid* 392, 393.

receipt.¹⁰⁵ However, it stated that it was immaterial whether the business carried on by the taxpayer was illegal or not.¹⁰⁶

In *ITC 343*¹⁰⁷ the taxpayer owned a stock-broking company which transacted on behalf of companies and in return received commission from the amount of the sale of shares.¹⁰⁸ During the course of its business the company transacted with a mining company in terms of which it sold shares of that company and derived a commission which it indicated in its books as income.¹⁰⁹ At the end of the year of assessment it was discovered that the payment of commission by the mining company was *ultra vires*, as the agreement to make the payment had not been disclosed in the prospectus of that company as required by section 82(1) (a) of the Companies Act.¹¹⁰ As a result, the taxpayer was prepared to refund the money paid to it if such amount was ever demanded.¹¹¹

In rendering its return for normal tax, the taxpayer claimed as deduction the amount received as commission.¹¹² The Commissioner disallowed this on the grounds that income deposited to a reserve fund was specially debarred from being deducted by section 12(e) of the Income Tax Act.¹¹³ The taxpayer appealed.¹¹⁴

On appeal, the court found that the commission amount was received by the taxpayer and that the subsequent discovery of the illegality surrounding the payment of the commission, could not change its liability for taxation in the hands of the taxpayer who had previously dealt with it as a receipt during the year of assessment.¹¹⁵

In *ITC 1545*,¹¹⁶ the taxpayer was involved in the buying and selling of stolen (uncut) diamonds¹¹⁷ and the operation of a scheme which involved the buying and selling of dried milk cultures termed 'activators' to the public (growers) who in return reproduced the dried seed (the crop) which they resold to the taxpayer.¹¹⁸ The life span of the scheme was short

¹⁰⁵ Ibid 392-401.

¹⁰⁶ Ibid 394.

¹⁰⁷ *ITC 343* (1935) 8 SATC 370 (U).

¹⁰⁸ Ibid headnote of the case.

¹⁰⁹ Ibid.

¹¹⁰ Ibid, Section 82(1) (a) of the Companies Act of 1926.

¹¹¹ *ITC 343* (1935) 8 SATC 370 (U) headnote of the case.

¹¹² Ibid.

¹¹³ Ibid, Section 12(e) of the Income Tax Act of 1925.

¹¹⁴ *ITC 343* (1935) 8 SATC 370 (U) headnote of the case.

¹¹⁵ Ibid.

¹¹⁶ *ITC 1545* 54 SATC 464(C).

¹¹⁷ Ibid 466.

¹¹⁸ Ibid 473.

lived as the number in sales of more activators to new growers decreased: as a result it became impossible for the taxpayer to pay the growers for their crops.¹¹⁹

After the collapse of the scheme, it came to the attention of the Commissioner that the taxpayer had derived a considerable amount of money from the operation of the illegal schemes.¹²⁰ This prompted the Commissioner to include the two amounts in the taxpayer's gross income on the basis that they satisfied the requirement of either a receipt or an accrual provided in the gross income definition.¹²¹

The taxpayer objected to this assessment on the following grounds.¹²² Firstly, with regard to the assessment of the amount derived from the sale of uncut diamonds, it was argued that the taxpayer's conduct amounted to theft and as such he had an obligation to repay back to the owner the stolen diamonds or their value.¹²³

Secondly, with regard to the amount derived from the sale of the dried milk cultures, it was argued that the operation of the scheme constituted a lottery as provided under section 2 (1) of the Gambling Act.¹²⁴ As such, the taxpayer's participation in operating the scheme which resulted in the disputed amount was void *ad initio*.¹²⁵ Thus, the taxpayer was not entitled to the amounts and for that reason they should be excluded from the taxpayer's gross income because they were neither 'received by nor accrued to' the taxpayer.¹²⁶

In considering the matter, the court, as per President Scott J, answered the taxpayer's arguments in the negative by assuming, without deciding the issue, that if the dried 'milk culture' scheme did constitute a lottery in terms of s 2(1) of the Gambling Act¹²⁷ the 'sales' in pursuance of which the 'growers' were paid for their crop were void *ab initio*.¹²⁸ Moreover, the amounts paid to the 'growers' for their 'milk cultures' were nevertheless amounts 'received by' the taxpayer within the ordinary literal meaning of the word;¹²⁹ that a prohibited contract that is void *inter-partes* has the necessary consequences.¹³⁰ Also, the taxpayer's

¹¹⁹ Ibid 473.

¹²⁰ Ibid.

¹²¹ Ibid.

¹²² Ibid 466.

¹²³ Ibid.

¹²⁴ Ibid, Section 2 (1) of the Gambling Act 51 of 1965.

¹²⁵ *ITC 1545 54 SATC 464(C) 466.*

¹²⁶ Ibid.

¹²⁷ Section 2 (1) of the Gambling Act 51 of 1965.

¹²⁸ *ITC 1545 54 SATC 464(C), 474.*

¹²⁹ Ibid 475.

¹³⁰ Ibid 474.

participation in the scheme as an ordinary grower amounted to ‘receipt’ as opposed to a ‘taking.’¹³¹

In *ITC 1624*,¹³² the taxpayer carried on the business of a customs clearing and freight forwarding agent on behalf of its customers.¹³³ During the 1991 year of assessment, the taxpayer entered into a contract with one A, where he acted as his agent and made payments to Portnet, the harbour authority, of wharfage fees which he was entitled to recover from A.¹³⁴ It was the recovery of this amount which became the subject matter of the case, because it was presented in evidence that the taxpayer had recovered more money than he was entitled to recover from A; that is the taxpayer recovered from its client A, more money than it had paid to the harbour authority on the client’s behalf.¹³⁵

After having included the overcharged amounts in its statement of account as fees and disbursements recovered, the taxpayer sought to claim as a deduction the same amount as an expense incurred in the production of income under section 11 (a) of the Income Tax Act.¹³⁶ However, the Commissioner refused to allow such deduction on the basis that it was not a business expense.¹³⁷

The issue which the court had to decide was whether or not the appellant ‘was paid the amounts as part of its business receipts which thus formed part of its business income.’¹³⁸ Also, ‘if it was then under an immediate legal obligation to repay the said amounts, were they deductible as having been incurred in the production of the income in terms of s 11(a) of the Income Tax Act.’¹³⁹

In conclusion, the court held that the fraudulent misrepresentation by the taxpayer to its client could not change the nature of the amount in its hands and as such the amount in question was received by the taxpayer.¹⁴⁰ It further held that the taxpayer acted as a conduit in which

¹³¹Ibid 475.

¹³² *ITC 1624* (1997) 59 SATC 373.

¹³³ Ibid 376.

¹³⁴ Ibid.

¹³⁵ Ibid.

¹³⁶ Ibid 374.

¹³⁷ Ibid.

¹³⁸ Ibid 374.

¹³⁹ Ibid.

¹⁴⁰ Ibid 375.

money flowed through it.¹⁴¹ As such, the money which it had to claim from A to reimburse other principals was never received by it.¹⁴²

But ‘if a dishonest attorney recovered from his or her client a sum for a witness’s fee and corruptly negotiated with the witness to accept a lesser sum than he or she had charged, so that he or she could retain the balance, it could surely not be suggested that the attorney had not received, in the tax sense, the overcharged amount and the same would apply to the disputed sum obtained by appellant in this case by overreaching its client.’¹⁴³

In *ITC 1810*,¹⁴⁴ the taxpayer took a decision to invest a considerable amount of money with one A, who operated a scheme known as a pyramid scheme.¹⁴⁵ Due to fear of the risks which are attached to these types of schemes, the two entered into a written agreement which made A indebted to the taxpayer, and that A was liable to pay interest in respect of amounts lent and advanced by the taxpayer to A.¹⁴⁶ Lastly, A, as debtor should make all the payments to the creditor by paying back the interest and thereafter the capital.¹⁴⁷

After operating for a short period, the scheme collapsed resulting in the sequestration of A’s assets.¹⁴⁸ As a result of the collapse of the scheme, the taxpayer instituted proceedings against the trustee of the scheme, seeking compensation in light of the acknowledgment of debt agreement entered into with A.¹⁴⁹

After learning of the taxpayer’s claim against A’s insolvent estate, the Commissioner issued an assessment including the interest due to the taxpayer as taxable amounts forming part of the taxpayer’s gross income, on the basis that it had accrued to the taxpayer.¹⁵⁰ However, the taxpayer objected to such inclusion by claiming that it never had the unconditional right to claim interest from A.¹⁵¹

¹⁴¹ Ibid.

¹⁴² Ibid.

¹⁴³ Ibid.

¹⁴⁴ *ITC 1810* 68 SATC 189.

¹⁴⁵ Ibid 190.

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ Ibid 191.

¹⁵⁰ Ibid headnote of the case.

¹⁵¹ Ibid 192.

The court, per Jansen J, held that:¹⁵²

- A's scheme was from its inception insolvent and appellant would not succeed in discharging the *onus* placed on him by s 26(1) (b) of the Insolvency Act.¹⁵³ Moreover, the very nature of the pyramid scheme dictated its insolvency- the proceeds of the loan received by A from one investor was used to pay other investors and for A's personal benefit.
- Any disposition made by A in terms of an agreement in terms of which monies were invested in the pyramid scheme would not be a disposition for value; moreover, had any interest been paid by A to appellant those payments of interest would have been dispositions without value and such a disposition may be set aside by a court on application.
- As was held by Conradie JA in *Fourie NO and Others v Edeling NO and Others*¹⁵⁴ that a promise to reward investors with returns paid by a pyramid scheme was a mere nullity and any payment of a profit or interest would be a disposition not made for value and, consequently, appellant never had an unconditional right to claim interest from A.
- However, the court could not come to a conclusion that it could ever have been the intention of the legislature to have a person taxed on income that he never got or, if he gets it, would lose it in terms of other legislation and that, accordingly, the interest claimed by appellant from the insolvent estate of A had not accrued to him as required by s 5(1) of the Income Tax Act.¹⁵⁵

The determining of a receipt where the taxpayer operated a pyramid scheme was considered by the court in *ITC 1789*,¹⁵⁶ where the taxpayer, through appointed representatives, operated a scheme commonly known as a pyramid scheme.¹⁵⁷ The nature of the scheme involved inviting members of the public to invest a specific amount of money on the basis of a promise

¹⁵² Ibid 190.

¹⁵³ Section 26(1) (b) of the Insolvency Act 24 of 1936.

¹⁵⁴ *Fourie NO and Others v Edeling NO and Others* 2005 (4) All SA 393 (SCA), 401.

¹⁵⁵ Income Tax Act 58 of 1962, as amended.

¹⁵⁶ *ITC 1789* 69 SATC 205.

¹⁵⁷ Ibid 207.

that they would receive high returns in the form of interest.¹⁵⁸ After making a deposit, the taxpayer would use the money in circulation within the scheme to pay an investor out of the deposits made by another investor.¹⁵⁹ After successfully paying out the first few claims by investors, the fast increase in number of fresh investments made it impossible for the taxpayer to pay out interest on new claims.¹⁶⁰ This resulted in the collapse of the scheme.¹⁶¹

After the collapse of the scheme, the assets of the taxpayer were sequestrated and it came to the attention of the Commissioner that the taxpayer derived a considerable amount of money (a benefit) from operating the illegal scheme.¹⁶² This prompted the Commissioner to include the investors' deposits as part of the taxpayer's gross income on the basis that they constituted a receipt for gross income purposes.¹⁶³ Upon notice of the Commissioner's intention, the taxpayer objected.¹⁶⁴

The basis of the objection was that the amounts in question did not constitute a receipt because the contract between the parties was *void ab initio* because the *condictio ob iniustam causa* was in operation, which deprives the recipient of a right to retain the money on the basis that the money had to be refunded and thus no receipt can ever arise for gross income purposes.¹⁶⁵ Further relying in *CIR v Genn*,¹⁶⁶ the taxpayer argued that from the moment the taxpayer received the amount in question she had no right to retain it and it was under a legal obligation to refund it as soon as it was received and on the basis that it was in a similar position as someone who borrowed money and was under the obligation to repay it.¹⁶⁷ In deciding upon the matter the court found that:¹⁶⁸

- In the present case the court was solely concerned with the concepts of 'received' or 'receipt' in the definition of 'gross income' in s 1 of the Income Tax Act¹⁶⁹ which related to the physical act of taking possession of the amounts paid by the investors to the various entities making up the taxpayer.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid 207, 208.

¹⁶⁰ Ibid 207.

¹⁶¹ Ibid.

¹⁶² Ibid 206.

¹⁶³ Ibid.

¹⁶⁴ Ibid.

¹⁶⁵ Ibid 208.

¹⁶⁶ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

¹⁶⁷ *ITC 1789* 69 SATC 205, 206.

¹⁶⁸ *ITC 1789* 69 SATC 205, 206.

¹⁶⁹ Income Tax Act 58 of 1962, as amended.

- As to the question whether the scheme’s investors knew that appellant’s enterprise was an illegal one, no finding could be made one way or the other and to the extent that appellant bore the *onus* of proving that the scheme investors were not in *pari delicto*, this *onus* had not been discharged by appellant.
- Schreiner JA in *CIR v Genn & Co (Pty) Ltd*¹⁷⁰ was essentially concerned with borrowed money in that the borrowings there could not be regarded as being received as part of the taxpayer’s gross income notwithstanding the wide definition of this concept and the present case was virtually on all fours with the *dicta* in *Genn*’s¹⁷¹ case in this sense that because of the underlying illegality, there was no ‘receipt’ within the meaning of the definition of ‘gross income’ and the money fell to be repaid at the very moment that it was received.
- It was necessary to look at the essential nature of the receipt before a determination could be made to find out whether it ought to form part of gross income – deriving a benefit or indeed a potential benefit from the receipt would of course point clearly in that direction.
- In the instant case money was received by Mrs B pursuant to an illicit enterprise. Her intention was fraudulent and designed to profit from ill-gotten gains and clearly she intended to benefit and by all accounts did benefit from the money received in the sense that commissions were appropriated therefrom.
- It would be wrong to say that merely because of the inherently unlawful nature of the transactions and the availability of the *condictio* it could be contended that Mrs B derived no benefit and thus the receipts in question should not be regarded as forming part of ‘gross income’. This appears to accord with a well-recognized and fundamental principle of taxation law in regard to the receipt of income tainted with illegality which was lucidly set forth by Scott J (as he then was) in *ITC 1545*.¹⁷²
- Accordingly, notwithstanding the illegal nature of the transactions and the consequences that flowed therefrom *inter partes*, there were ‘receipts’ within the meaning of the definition of ‘gross income’ and the Commissioner had correctly assessed them as such.

¹⁷⁰ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

¹⁷¹ *Commissioner of Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

¹⁷² *ITC 1545* (1992) 54 SATC 464, 474.

The taxpayer appealed against this decision and the appeal case is *MP Finance Group CC (in liquidation) v C:SARS*.¹⁷³ The issue which the court had to decide was whether or not the deposits made by the investors into the pyramid scheme constituted a receipt within the gross income of the taxpayer notwithstanding that they were derived through the operation of an illegal entity.¹⁷⁴

The main argument advanced on behalf of the taxpayer was that once an investor made a deposit, such amount constituted a loan due to the investors as such the taxpayer was under a legal obligation to repay back the invested amount plus interest.¹⁷⁵ In support of this argument, the taxpayer relied on the Supreme Court of Appeal case of *Fourie v Edeling*.¹⁷⁶

In its decision the court held that:¹⁷⁷

- In s 1 of the Income Tax Act 58 of 1962 ‘gross income’ meant the total amount ‘received by or accrued to or in favour’ of a taxpayer during a tax year but this case was concerned with receipt, not accrual.
- The inference on the facts must be that whatever intention there was at any time on the part of investors to enter into a contractual relationship with the entities concerned and whatever corresponding intention to contract there might possibly have been on the relevant entities’ part prior to 1 March 1999, there can no longer have been any such corresponding intention after that date as from that date onwards the entities run by Prinsloo made their money by swindling the public.
- It followed that the amounts the entities run by Prinsloo were paid in that period were ‘received’ within the meaning of the Income Tax Act 58 of 1962 and it was for appellant to prove the contrary and that *onus* was not discharged.
- The court’s judgment in the matter of *Fourie NO v Edeling*¹⁷⁸ did not assist appellant as that case dealt with the relationship between investor and scheme and the present case was about the relationship between scheme and *fiscus*. Moreover, even if the scheme was legally obliged

¹⁷³ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

¹⁷⁴ *Ibid* 142.

¹⁷⁵ *Ibid*.

¹⁷⁶ *Fourie NO and Others v Edeling NO and Others* 2005 (4) All SA 393 (SCA).

¹⁷⁷ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141, 142.

¹⁷⁸ *Fourie NO v Edeling NO* 2006 (4) All SA 393 (SCA).

to repay an investor immediately on receipt, that was because of the legal principles applicable to the parties to an illegal contract, as between themselves.

- An illegal contract is not without all legal consequences and it can have fiscal consequences, *i.e.* the sole question as between scheme and *fiscus* was to understand whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Income Tax Act and unquestionably they did.
- The amounts paid to the scheme were accepted by the operators of the scheme with the intention of retaining them for their own benefit and notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Income Tax Act.

2.1.5 CONCLUSION.

From the analysis of the cases above, it is clear that an inquiry into determining a receipt lies in respect of whether or not the taxpayer personally derived a benefit. In inquiring, the courts applied a specific type of approach depending on the facts of the case. It is in the application of a particular approach that the court has decided in favour or against the taxpayer. However, since the courts have failed to adopt a single approach, such inconsistency forces one to conclude that they may not be a single approach applicable to all cases of the taxation of illegal income. For the moment, the lower courts are bound to apply the Supreme Court of Appeal approach in *MP Finance Group CC (in liquidation) v C:SARS*.¹⁷⁹

This means that whenever a new case dealing with the taxation of illegal income is presented, an inquiry into whether or not the taxpayer had the intention to benefit from the illegal activity determines a receipt. In order to determine whether or not such inquiry is the best approach in determining a receipt, the courts approaches in cases prior to *MP Finance Group CC (in liquidation) v C:SARS*.¹⁸⁰ Will be considered in Chapter 3 in order to determine the gap in such approaches and *MP Finance Group CC (in liquidation) v C:SARS*.¹⁸¹

¹⁷⁹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

¹⁸⁰ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

¹⁸¹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

Chapter 3: THE APPLICATION OF THE SA CASES TO *MP FINANCE GROUP CC (IN LIQUIDATION) v C:SARS.*

3.1 INTRODUCTION.

From the above analysis of case law, attention is drawn to the ways in which the courts dealt with the issues before them. In considering these issues the court's approach differed from case to case. The reason for this, one may assume exists because of the different transactions which arose in each case. The result produced from the analysis is that the court's approach in determining a receipt is either through the taxpayer's intention or a consideration of surrounding factors which brought about the amount.

Since the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*¹⁸² considered the subjective approach to determine that the operator of a pyramid scheme received the deposit amounts for gross income purposes, it is proposed to apply the cases dealing with the taxation of illegal income discussed in Chapter 2 to determine whether or not there is a gap in approaches between the previously decided cases and that adopted in *MP Finance Group CC (in liquidation) v C:SARS*¹⁸³ and to determine whether or not the different approaches may be applicable to the operator of a pyramid scheme. In doing so, an application of cases where the taxpayer's illegal gains escaped liability from taxation will be considered first, while cases where the taxpayer's illegal gains were held to be taxable will be considered second and lastly a determination of the existence of the gap between these cases and *MP Finance Group CC (in liquidation) v C:SARS*¹⁸⁴ will be considered.

3.1.1 THE CASES WHERE THE TAXPAYER'S DEFENCE WAS SUCCESSFUL.

In *ITC 1792*¹⁸⁵ the court ruled on the issue of an agent who made a secrete profit where it disregarded the subjective intention of the taxpayer, who then upon transacting had the intention of benefiting from the sale of shares by fraudulently overcharging his principal.¹⁸⁶

¹⁸² *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

¹⁸³ *Ibid.*

¹⁸⁴ *Ibid.*

¹⁸⁵ *ITC 1792* 67 SATC 236.

¹⁸⁶ *Ibid* 237.

The court applied the law of agency, which in all circumstances considers all transactions and its fruits to belong to the principal.¹⁸⁷

From the court's decision it is clear that the existence of a legal relationship between the taxpayer (stockbroker) and the principal relieved the taxpayer from being liable for normal tax. This is because whenever the taxpayer transacts, the law of agency recognises that he will be transacting on behalf of his principal. As such, all benefits derived by the agent are benefits belonging to the principal. This therefore means that the taxpayer becomes a conduit pipe through which flows money belonging to the principal.

If we consider this in light of *Geldenhuis v CIR*¹⁸⁸ where the court held the phrase 'received by' meant 'received by the taxpayer on his own behalf and for his own benefit,'¹⁸⁹ it becomes clear that the first part of the *Geldenhuis v CIR*¹⁹⁰ principle is absent, that is, the taxpayer in a representative capacity does not receive on his own behalf, but receives on behalf of and for the benefit of the principal and as such his subjective intention to personally benefit from the transaction becomes irrelevant.

Considering this from another perspective one may assume that the reason why the court held strongly that at all material times the proceeds belonged to the principal, might have been because of the existence of an agent and principal relationship which required the principal to pay for the shares secured by the agent on his behalf and not the fraudulent conduct of the taxpayer towards the principal.

The existence of an intervening law thus defeats the intention test of a receipt which was relied upon in *MP Finance Group CC (in liquidation) v C:SARS*.¹⁹¹ This is because one may be forced to assume that whenever there is a presence of an intervening law, the natural Income Tax Act¹⁹² rules relating to determining a receipt are relaxed and thus the court considers the treatment of a receipt in light of what the intervening law provides. In other words it considers the meaning of beneficial receipt in terms of the law regulating the party's relationship.

¹⁸⁷ Ibid.

¹⁸⁸ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419; ITC 1545 (54) SATC 464(C).

¹⁸⁹ Ibid 430.

¹⁹⁰ Ibid.

¹⁹¹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141, 145.

¹⁹² Income Tax Act 58 of 1962, as amended.

In *Cot v G*¹⁹³ the High Court of Zimbabwe found that there was no receipt for tax purposes in respect of money entrusted to a taxpayer who misappropriated it.¹⁹⁴ This was because the court found that the interpretation of the word ‘to receive’ as provided in the shorter Oxford Dictionary, excludes the unilateral taking of property (this is because a thief has no right over the stolen property)¹⁹⁵ and as such the match of intention between the giver and the receiver of the amount is necessary.¹⁹⁶

3.1.2 THE CASES WHERE THE TAXPAYER’S DEFENCE WAS UNSUCCESSFUL.

In cases where the court found that there was a receipt in respect of illegal income derived by the taxpayer, its application has been through considering the intention of the taxpayer or surrounding factors. The reason behind this is the different means employed by the taxpayer to derive illegal income.

In *ITC 1545*¹⁹⁷ the court, in considering surrounding factors found that a void contract between the contracting parties did not affect the question of determining the presence of a receipt when interpreted in the literal sense of the word.¹⁹⁸ Additionally, that the contract between the parties made it impossible for the taxpayer’s action to amount to a taking and thus the fruits flowing from such contract were ‘received by’ the taxpayer for gross income purposes.¹⁹⁹ By concluding this way, the court answered two questions at once. Firstly, the court answered the question that an illegal transaction and the fruits which flows from it, forms part of the taxpayer’s gross income and secondly, it answered the question that the void contractual relationship between the taxpayer and the growers did not mean that the taxpayer did not derive a benefit or receive the fruits from the transaction which constitute normal tax.

Taking a look at the court’s entire decision, one may assume that the court’s position in deciding upon the matter was thus: the taxpayer, in operating the scheme, was in a position where he was receiving amounts coming into the scheme on his behalf and that this constitutes a benefit in the taxpayer’s hands. From this position, it is quite clear that the

¹⁹³ *COT v G* 1981 (4) SA 167 this approach is discussed in detail under 3.1.4.

¹⁹⁴ *Ibid* 162.

¹⁹⁵ *Ibid*.

¹⁹⁶ *Ibid* 163.

¹⁹⁷ *ITC 1545* 54 SATC 464(C).

¹⁹⁸ *Ibid* 474.

¹⁹⁹ *Ibid* 467.

meaning of a receipt as held in *Geldenhuis v CIR*²⁰⁰ is satisfied (the amounts were received by the operator of the scheme on his own behalf and benefit).

The court also found that in operating the scheme, the taxpayer's conduct in handling the amounts, did not amount to theft, but a 'receipt' which forms part of the taxpayer's gross income. From this decision, it seems reasonable that the court was making a distinction between situations where the taxpayer unilaterally takes money and where the taxpayer beneficially receives the amount in question – the latter situation applies to the operation of a pyramid scheme while the former does not.

In applying this decision to the facts of *MP Finance Group CC (in liquidation) v C:SARS*,²⁰¹ what comes to light is that in both cases there is void contractual relationship between the parties. In taking the approach in *ITC 1545*,²⁰² it means that Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*²⁰³ was correct in finding that the deposit amounts were 'received by' taxpayer for gross income purposes, because the fruits from a prohibited contract are taxable. However in reaching such a decision it means that the Supreme Court of Appeal should not have relied on the subjective method of interpreting a receipt, but should have determined whether or not the taxpayer in operating the scheme derived a benefit for tax purposes.

Furthermore, the question of whether or not the taxpayer knew beforehand that the illegal scheme it intended to operate was illegal, which the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*²⁰⁴ answered to the affirmative, would not play a significant role in determining the outcome of the case. This is because in *ITC 1545*²⁰⁵ the court inquired about, whether or not from the position of operating the scheme, the taxpayer derived a benefit and not whether the taxpayer knew beforehand that the scheme she intended to embark on was illegal and the taxpayer's conduct in respect of investors' deposits would also not amount to theft. This reasoning satisfies the definition of a receipt under the gross income definition.

²⁰⁰ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419; *ITC 1545* 54 SATC 464(C).

²⁰¹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁰² *ITC 1545* 54 SATC 464(C).

²⁰³ *Ibid.*

²⁰⁴ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁰⁵ *ITC 1545* 54 SATC 464(C).

In considering the position of the taxpayer which fraudulently overcharged its customer, the court, in *ITC 1624*,²⁰⁶ considered the existence of a legally binding contract between the parties to conclude that the taxpayer received the amount flowing from the relationship (contract) for gross income purposes. By concluding in this manner, one may assume that the court applied what one may term an ‘accounting method approach’²⁰⁷ of business, this is because in reaching its decision it considered that from the transaction the taxpayer derived something more than what was lost and from that position the additional amount constituted a (gain) receipt for tax purposes.

By taking such a view, it is inarguable that the court was correct in finding that there was a receipt in respect of the overcharged amount. This view conforms to the decision in *Geldenhuis v CIR*,²⁰⁸ that is, the taxpayer received the overcharged amount, on his own behalf and for his own benefit. This position seems correct because during the operation of the scheme the overcharged amount fell in the pockets of the taxpayer and as such constituted a receipt which fell into the taxpayer’s gross income. Furthermore, just like in the cases above it seems that the fraudulent conduct of the taxpayer did not affect the court’s approach in determining the presence of a receipt.

In applying what I term an ‘accounting method approach’ to the facts in *MP Finance*,²⁰⁹ the Supreme Court of Appeal would have had to determine whether or not the investors’ deposits added a gain into the taxpayer’s pockets and from this view only an affirmative answer would mean that the deposits were received by the taxpayer for gross income purposes.

A close analysis of the case indicate that by keeping the investors’ deposits to herself, such conduct added an advantage to the taxpayer’s pocket and as such the taxpayer would still be liable to pay tax on the investors’ deposits. The taxpayer’s intention beforehand to defraud investors would not add an advantage in making investors’ deposits taxable. This is because the taxpayer’s intention to fraudulently overcharge its customer in *ITC 1624*²¹⁰ did not influence the outcome of the case.

²⁰⁶ *ITC 1624* (1997) 59 SATC 373.

²⁰⁷ This is termed for convenience purposes.

²⁰⁸ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419 ITC 1545 54 SATC 464(C).

²⁰⁹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²¹⁰ *ITC 1624* SATC 59 373.

In *ITC 1789*²¹¹ the intention to benefit test was adopted, where the court investigated the nature of the scheme to determine the essential nature of a receipt. This was done by looking at the intention of the taxpayer in forming the scheme and the nature of the scheme and the court found that in forming and operating the scheme the taxpayer had the intention to personally derive a benefit and as such the deposit amounts were ‘received by’ the taxpayer for gross income purposes. This decision was subsequently confirmed by the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*.²¹² It is good to note that such a conclusion is in line with the decision in *Geldenhuis v CIR*²¹³ and it reflects the law correctly. What may be arguable is the method of interpretation applied by the court to come to such a conclusion. The cases dealing with the interpretation of a receipt in cases where there is an amount that is tainted with illegality will be discussed in reference to *MP Finance Group CC (In Liquidation) v C:SARS*.

3.1.3 THE INTERPRETATION OF A RECEIPT WITH REFERENCE TO *MP FINANCE GROUP CC (IN LIQUIDATION) v C:SARS*.

The interpretation of a receipt under the Income Tax Act requires a careful approach. In *CIR v Delfos*²¹⁴ Wessels CJ stated that:²¹⁵

‘I do not understand this to mean that in no case in a taxing Act are we to give to a section a narrower or wider meaning than its apparent meaning, for in all cases of interpretation we must take the whole statute into consideration and so arrive at the true intention of the Legislature. When, however, we are dealing with a definition which is the very basis of the Act,²¹⁶ it can only be in very exceptional circumstances that we can modify the plainly expressed meaning of the words.

In cases other than the basic definition of gross income the difficulty is not so great, but to modify the plain words of the Legislature in a crucial definition such as the one we are dealing with is to strike at the very heart of the statute. We are dealing with the most important definition in the whole statute, and it would indeed be bold to say that the Legislature did not mean by it exactly what it said, especially when we remember that the

²¹¹ *ITC 1789* 69 SATC 205.

²¹² *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²¹³ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419; *ITC 1545* 54 SATC 464(C).

²¹⁴ *Commissioner for Inland Revenue v Delfos* 1933 AD 242, 6 SATC 92.

²¹⁵ *Ibid* 102.

²¹⁶ Income Tax Act 58 of 1962, as amended.

system of taxation in our law differs much from other taxing Acts. The whole structure of the Act is based on this definition, and we have no right to say that the Legislature did not intend to throw its net out as widely as the definition states.’

This problem and the development of the interpretation of a receipt have been considered above under the meaning of a receipt.²¹⁷ This section aims to consider questions and loop holes which arise because of the subjective method of interpretation adopted by Supreme Court of Appeal in *MP Finance*.²¹⁸ Although one scholar has dealt with the issue of how the Supreme Court of Appeal failed to provide a proper interpretation of a receipt by relying on the wrong test of interpretation to conclude that illegal income is taxable,²¹⁹ the focus will be to determine whether or not such interpretation conforms to previously decided cases on the interpretation of a receipt to illegal income and to consider other available possibilities which the court might have considered in order to provide the interpretation of the meaning of a receipt which will solve the problem of inconsistency in interpretation.²²⁰

The method of interpretation in *MP Finance Group CC (in liquidation) v C:SARS*,²²¹ by interpreting the phrase ‘received by’ in light of the taxpayer’s subjective intention is one which is not a common method of interpreting a taxation statute especially with reference to interpreting a receipt. This is because it focused heavily on determining the subjective state of mind of the taxpayer rather than trying to determine the taxpayer’s actions and consequences in line with previous interpretations of a receipt by the courts. By going into the subjective state of mind of the taxpayer the Supreme Court of Appeal determined and concluded the amount was ‘received on own behalf and for own benefit’, as previously held by the court in *Geldenhuis v CIR*.²²² In concluding this way it reflects the intention of the legislature, however previous decisions reflect that the courts interpreted the phrase ‘received by’ by placing much weight on the ordinary literal meaning of the phrase ‘received by’²²³ and

²¹⁷ Check Chapter 2 of the dissertation.

²¹⁸ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²¹⁹ E.W Chawira ‘Taxation of illegal schemes – should the term received by be interpreted with reference with the taxpayers subjective activities?’ Available at <http://repository.up.ac.za/bitstream/handle/2263/29694/dissertation.pdf?sequence=1&isAllowed=y> accessed 14/03/2015.

²²⁰ L.G Classen ‘Legality and Income Tax – Is SARS ‘entitled to’ Levy Income Tax on Illegal Amounts ‘received by’ a Taxpayer?’ (2007) 19 *SA Merc LJ* 549.

²²¹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²²² *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419; *ITC 1545* 54 SATC 464(C).

²²³ *ITC 1545* (1992) 54 SATC 464, 474 (the court found that the ordinary literal meaning of the phrase ‘received by’ applies to a taxpayer who receives money in pursuant of a void transaction); *COT v G* 1981 (4) SA 167, 162 (the Court considered the meaning of a receipt by interpreting it in line with the shorter version of the oxford dictionary which defines a receipt as to mean ‘to take into ones possession or one’s hand.’)

surrounding factors.²²⁴ One may conclude that that the Supreme Court of Appeal deviated from the common method of interpretation in order to tax the operator of a pyramid scheme.

This interpretation has resulted in a questionable decision which has produced the effect that a receipt will be present for as long as the taxpayer subjectively intended to receive proceeds on her own behalf and for own benefit (*Geldenhuis v CIR*).²²⁵ This is inconsistent with the ordinary literal grammatical meaning of the phrase ‘received by’ as held in *COT v G*²²⁶ and the surrounding factors that the court considered in *ITC 1624*²²⁷, *ITC 1545*²²⁸ and *ITC 1792*²²⁹ which exclude intention. However, since it is a Supreme Court of Appeal decision, it is precedent and binding to the lower Courts and they are obliged to apply the subjective method of interpretation to determine whether or not illegal proceeds derived in whatever manner constitute a receipt as provided for in the gross income definition. If that idea is accepted as reflecting the correct position without much challenge, then it would mean that the court has finally settled the question of the interpretation of a receipt.

However, judging from the fact that the court failed to touch on previous decisions on the interpretation of the phrase ‘received by’ in relation to the taxation of illegal income, its silence may be indicative of the fact that the court was only focused on interpreting the phrase ‘received by’ in relation to the taxation of the operator of an illegal pyramid scheme only. Evidence from previously decided cases such as *COT v G*²³⁰ and *ITC 1792*²³¹ however, indicate that there is a loophole in interpretation as the subjective method of interpretation in *MP Finance Group CC (in liquidation) v C:SARS*²³² fails to cater for situations where there

²²⁴ In *Brookes Lemos Ltd v Commissioner for Inland Revenue* 1947 (2) SA 976 (A) and *C:SARS v Cape Consumers (Pty) Ltd* 1994 (4) SA 1213 (C). (the Court considered the financial treatment of the deposits by the taxpayer on behalf of its customers to determine whether or not the deposits in the hands of the taxpayer constituted a receipt for gross income purposes); *ITC 1789* 67 SATC 205 (the Court considered the subjective intention of the taxpayer who knew before-hand that pyramid scheme would result in failure and that investment into the pyramid scheme would result in the investors losing their money); *ITC 1792* 67 SATC 236 (the Court considered the presence of the law of agency to conclude that money in the hands of an agent was not received by him by remained the property of the principal despite the agents intention to benefit from the illegal transaction).

²²⁵ *Geldenhuis v Commissioner of Inland Revenue* 14 SATC 419.

²²⁶ *COT v G* 1981 (4) SA 167, 162.

²²⁷ *ITC 1624* 59 SATC 373.

²²⁸ *ITC 1545* (1992) 54 SATC 464.

²²⁹ *ITC 1792* 67 SATC 236.

²³⁰ *COT v G* 1981 (4) SA 167.

²³¹ *ITC 1792* 67 SATC 236.

²³² *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

is a unilateral taking such as theft (*COT v G*)²³³ and where there is the presence of an intervening law(ITC 1792).²³⁴

3.1.4 THE CONSIDERATION OF PREVIOUSLY DECIDED CASES ON THE INTERPRETATION OF A RECEIPT WHERE THE AMOUNT IS TAINTED WITH ILLEGALITY.

Had the Supreme Court of Appeal considered the historical interpretation of the phrase ‘received by’ on illegal income, it would have for example applied the test of interpretation set out by the High Court of Zimbabwe in *COT v G*.²³⁵ In this case the court considered the meaning of the word ‘receive’ in a section similar to the gross income definition by visiting the shorter version of the Oxford Dictionary which interprets the word ‘receive’ to mean ‘to take into one’s hands, or into one’s possession (something held out or offered by another); to take delivery of (a thing) from another either for oneself or for a third party.’²³⁶ By taking the position that from such interpretation a thief receives where there is a match of intention between the giver and the receiver of the amount, in the sense that the giver must have the intention to give the amount in question and that the receiver must also be conscious that the giver intends to give the amount to him.²³⁷

Had this test been applied by the Supreme Court of Appeal, it would have interpreted the meaning of a receipt by matching the intention of the investors and the taxpayer. That is, it should have first determined whether the investors had the intention to give the deposit amount to the taxpayer in order for him to receive it on his own behalf or to use it for his own benefit and that the taxpayer should have also intended to receive the amount in question for her personal benefit.

By considering the facts of *MP Finance Group CC (in liquidation) v C:SARS*²³⁸ what we can infer is that had the Supreme Court of Appeal applied this test of interpretation to the facts of the case, the outcome may have been that the taxpayer did not receive the deposits owing to an absence of the matching of intention. This is because the investors never intended the

²³³ *COT v G* 1981 (4) SA 167.

²³⁴ *ITC 1792* 67 SATC 236.

²³⁵ *COT v G* 1981 (4) SA 167.

²³⁶ *Ibid* 162.

²³⁷ *Ibid* 163.

²³⁸ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

deposit amounts to be a receipt in his hands; that is they never intended that the taxpayer should personally benefit from the deposits.²³⁹

The absence of this intention should have, on the basis of *Cot v G*,²⁴⁰ influenced the Supreme Court of Appeal to rule in favour of the taxpayer by excluding the deposit amounts of the investors from the taxpayer's gross income. However such application would not be helpful since *MP Finance Group CC (in liquidation) v C:SARS*²⁴¹ was not dealing with a situation where there was a unilateral taking such as theft.

Another test of interpretation which the Supreme Court of Appeal should have considered was applied in *ITC 1792*²⁴² where the court first had to determine the true nature of the business, the inherent duty/relationship of the parties and the law regulating such duty/relationship. Also, to interpret that the presence of intention on the part of the taxpayer to personally receive and benefit from the sale of the overcharged shares was insufficient to satisfy the meaning of a receipt.

Although the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*,²⁴³ did consider the true nature of the business of the taxpayer, by concluding that such business was illegal, and relying on the above test, it is clear that the court should have considered the other two tests: it should have determined the inherent duty/relationship and the law which regulates the duty/relationship between the taxpayer and investors.

By applying these two tests to the facts of the case, and considering the inherent duty/relationship of the parties, what we can infer from the facts of the case is that the taxpayer was under an obligation to receive the deposits from the investors and to subsequently pay out returns to investors while the investors had a duty to make deposits and claim a return on their invested amount. This therefore means that the taxpayer was in the same position as the taxpayer in *ITC 1792*.²⁴⁴ The only difference here is that there is an absence of a law which regulates the nature of the relationship between the taxpayer and the investors. This is based on the findings of the Supreme Court of Appeal that the operation of the pyramid scheme was illegal. However, according to my own assumption, the operation of

²³⁹ *Ibid* 145 (the investors made deposits on the basis that they will receive good returns).

²⁴⁰ *COT v G* 1981 (4) SA 167, 162.

²⁴¹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁴² *ITC 1792* 67 SATC 236.

²⁴³ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁴⁴ *ITC 1792* 67 SATC 236 check discussion of the case in chapter 2.

the scheme was legal while the misrepresentation on the returns was illegal. Based on these assumptions, it would mean that the situation would be the same as that in *ITC 1792*.²⁴⁵

Another method of interpretation which the Supreme Court of Appeal should have considered may have been to interpret the phrase ‘received by’ in light of the surrounding factors.²⁴⁶ This entails enquiring into whether or not the taxpayer’s illegal conduct results in her deriving a benefit,²⁴⁷ or the taxpayer’s conduct results in her deriving more than what she was entitled to get from the transaction.²⁴⁸

By taking this step of interpretation the Supreme Court of Appeal will be determining whether or not any single interpretation applies in determining if the taxpayer has received the deposits for tax purposes. If such interpretation is identified and made applicable to a pyramid scheme, it will be preferred, since it was confirmed by the highest Court of Appeal and would have been applied in more than one case.

Furthermore, the selection of the application of any previous interpretation strengthens the position that illegal income is taxable on the basis that the taxpayer has received the amount in question without focusing much on the illegal conduct of the taxpayer which brought about the amount in question. By adopting such a view, it is something which is meant to strengthen the position that illegal income should be taxable when received by the taxpayer and it should not be confused as trying to imply that the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*²⁴⁹ should not have touched on the issue of illegality, but should not have extended it in literally interpreting the meaning of a receipt in light of the taxpayer’s subjective intention.

3.1.5 CONCLUSION.

In considering the different approaches used by the courts to determine whether or not the taxpayer has received the illegal amount for gross income purposes, it is clear that each case adopts a slightly different approach. This may be because of the different means employed to derive illegal income. From the analysis of the court’s approaches, it is clear that a receipt

²⁴⁵ *ITC 1792* 67 SATC 236.

²⁴⁶ These factors were discussed above under 3.2.

²⁴⁷ *ITC 1545* (1992) 54 SATC 464 (C).

²⁴⁸ *ITC 1624* (1997) 59 SATC 373.

²⁴⁹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

may be determined without touching on the intention of the taxpayer. Such approach(s), however have not been applied to the operation of a pyramid scheme. However the application of the approach in *ITC 1545*²⁵⁰ to *MP Finance Group CC (In Liquidation) v C:SARS*²⁵¹ shows that such approach may be used to subject income derived by the operator of a pyramid scheme, to taxation.

Furthermore, the subjective intention approach used by the Supreme Court of Appeal in *MP Finance Group CC (In Liquidation) v C:SARS* is inadequate in cases where there is a unilateral taking such as theft and also where there is an agent principal relationship. This is due to the issue of considering the taxpayer's intention. A consideration of the factors applicable when determining the intention of the taxpayer will be considered under Chapter 4.

²⁵⁰ *ITC 1545* (1992) 54 SATC 464.

²⁵¹ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

CHAPTER 4: SOUTH AFRICA'S TEST FOR DETERMINING THE TAXPAYER'S INTENTION.

4.1 INTRODUCTION

From the analysis of *MP Finance Group CC (in liquidation) v C:SARS*,²⁵² it is clear that in reaching its decision the Supreme Court of Appeal was silent on the factors which it considered when applying the subjective test. Its failure to elaborate on what the subjective test implies and the factors which satisfy the test may create a problem in applying the test to facts which varies from *MP Finance Group CC (in liquidation) v C:SARS*.²⁵³

It is necessary to consider whether or not the court should in future rely on the factors of determining the taxpayer's intention when enquiring whether an amount is capital or revenue.²⁵⁴ Before proceeding further, it is noteworthy that in considering the elements of the gross income definition, the court's enquiry in determining whether or not an amount constitutes a receipt is separate from when it is determining whether or not the amount is capital or revenue in nature. Since the issue in *MP Finance Group CC (in liquidation) v C:SARS*²⁵⁵ revolved around determining a receipt, this indicates that the Supreme Court of Appeal conceived that such proceeds were revenue in nature and this reasoning was also not in dispute between the parties. In order to achieve this, the starting point will be to understand what the taxpayer's intention is.

4.1.1 WHAT IS THE TAXPAYER'S INTENTION?

The taxpayer's intention can be defined as his/her mental direction towards achieving a particular result in respect of an object.²⁵⁶ This therefore means that in achieving this, we are determining something subjective, but the test is partly objective. In many cases where the issue of intention was central to determining the outcome of the issues before the court, the taxpayer bore the onus of explaining what his or her intention was at a particular time of action and in *SIR v Trust Bank of Africa Ltd*²⁵⁷ the court stated that 'in an enquiry as to the

²⁵² *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141 (see discussion of the case in Chapter 2).

²⁵³ *Ibid.*

²⁵⁴ L.G Classen 'Legality and Income Tax – Is SARS 'entitled to 'Levy Income Tax on Illegal Amounts 'received by' a Taxpayer?' (2007) 19 *SA Merc LJ* 546.

²⁵⁵ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁵⁶ M. Stiglingh et al *Silke South African Income Tax* (2015), 31.

²⁵⁷ *SIR v Trust Bank of Africa Ltd* 1975 (2) SA 652 (A) 106, 37 SATC 87.

intention with which a transaction was entered into for the purpose of the law relating to income tax, a court of law is not concerned with that kind of subjective state of mind required for the purposes of the criminal law, but rather with the purpose for which the transaction was entered into.²⁵⁸

This therefore means that the court is concerned with what the taxpayer perceived in his mind when acting. This usually relates to the time in respect of which the taxpayer formed a business, acquired an asset or disposed an asset or decides to commit an illegal activity. The problem faced by the courts in applying the subjective test is in determining the true intention of the taxpayer. This was explained by Snyman J in *ITC 1071*²⁵⁹ as follows:

As a Court we were much impressed by the appellant and the manner in which he gave his evidence. We have formed the view that he is not only an honest witness but an honourable man who has approached the giving of his evidence on that footing and has tried to give his evidence as objectively as possible. We attach considerable weight to his statement of what his intention was, but we must, of course, bear in mind that even honest men can never quite free themselves of the influence of their personal interests, and it is necessary for us to test his evidence of his intention against, and in the light of, the surrounding circumstances and outward manifestations.²⁶⁰

One may assume that the court foresaw the danger of the taxpayer explaining what his/her intention was in order to elucidate evidence, thus displaying an intention which will determine the outcome of the case in his favour. This resulted in the courts adopting a more strict approach into determining the intention of the taxpayer, for example in *ITC 1185*²⁶¹ the court stated that ‘the *ipse dixit* of the taxpayer as to his intent and purpose should not lightly be regarded as decisive.’²⁶² However, it should be determined on an objective review of all the relevant facts and circumstances, such as ‘the conduct of the taxpayer in relation to the transaction in issue, the nature of his business and the frequency of his past participation in similar transactions.’²⁶³ From these factors the court will draw its own inferences and weigh and test it against the direct evidence of the taxpayer’s intention.²⁶⁴

²⁵⁸ Ibid 106.

²⁵⁹ *ITC 1071* (1963) 27 SATC 185 (T).

²⁶⁰ Ibid 187.

²⁶¹ *ITC 1185* (1972) 35 SATC 122(N).

²⁶² Ibid 123.

²⁶³ Ibid 124.

²⁶⁴ Ibid 124.

The other factors which may be adopted in determining a receipt includes the nature of the asset in the taxpayer's hands, the dominant intention of the taxpayer in cases where there is mix of intention and determining whether the taxpayer is a natural person or a company.²⁶⁵

4.1.2 PRECEDENT ON THE TAXPAYER'S INTENTION WITH REFERNCE TO CASE LAW ON ILLEGAL INCOME.

Since the question of determining the taxpayer's intention was not firstly considered in *MP Finance Group CC (in liquidation) v C:SARS*,²⁶⁶ an inquiry into the factors considered by the courts in determining the taxpayer's intention with regard to illegal income will be considered. Since the question of determining the intention of the taxpayer was brought by the court, it had the responsibility to first determine how earlier decisions dealing with the taxation of illegal income had approached the question of determining the intention of the taxpayer and from that it would have been in a position to set out key factors which may assist in determining the intention of the taxpayer.

In cases dealing with the taxation of illegal income, these factors were previously considered by the courts when determining the taxpayer's intention in respect of a taxpayer who accumulates secret profits²⁶⁷ and where there is a unilateral taking by the taxpayer.²⁶⁸ In determining a receipt in respect of the taxpayer who accumulated a secret profit²⁶⁹ the court placed much weight on the intention of the principal because of the existence of an agent principal relationship, by concluding that although evidence clearly showed that the taxpayer had the necessary intention to personally benefit from fraudulently overcharging M (its principal), since the taxpayer was acting as an agent on behalf of the principal, the law of agency deems all transactions flowing and concluded through the agent to have been conducted and concluded by the principal, thus the taxpayer's intention to benefit in respect of the transaction became useless. It is good to note that this factor (agent and principal relationship) distinguishes this case from *MP Finance Group CC (in liquidation) v C:SARS*.²⁷⁰

²⁶⁵ M. Stiglingh (note 247 above) 32.

²⁶⁶ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁶⁷ *ITC 1792 67 SATC* 236.

²⁶⁸ *COT v G* 1981 (4) SA 167.

²⁶⁹ *ITC 1792 67 SATC* 236.

²⁷⁰ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

The High Court of Zimbabwe in *COT v G*²⁷¹ considered the position of the taxpayer who unilaterally takes funds entrusted to it. The court reasoned that in order for stolen proceeds to constitute a receipt there has to be a match of intention between the giver of the amount and the receiver of the amount, in other words the giver should have the intention to give the amount to the receiver for personal benefit and the receiver should also have the intention to receive the amount given for personal benefit. This therefore means that in order to determine the intention of the taxpayer, the court has a duty to determine whether there was a match of intention.

This would have meant the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*²⁷² should have interpreted the intention of the taxpayer by investigating the presence of intention from both the investors and the taxpayer. In other words it means that it should have determined whether the investors intended to give the taxpayer the deposits for own use and benefit and that the taxpayer should share the same intention that the amounts from investors was for her own personal use and benefit (in other words the taxpayer should have no intention that her conduct amounts to theft). It is noteworthy that this case considered the position of a thief.

If the Supreme Court of Appeal in *MP Finance Group CC (in liquidation) v C:SARS*²⁷³ had considered the above mentioned tests for determining the intention of the taxpayer it should have considered whether or not there was an existing agent and principal relationship, that is whether or not the taxpayer was acting as an agent of the investors and the deposits which investors deposited into the account of the taxpayer were dealt with by the taxpayer as an agent acting on behalf of the investors.

If the Supreme Court of Appeal would have answered this question in the affirmative it would have produced the result that the intention of the taxpayer which played an important role in *MP Finance Group CC (in liquidation) v C:SARS*²⁷⁴ would have had to be disregarded because whenever there is a *nova causa interveniens* such as the law of agency, which played a major role in the outcome of the case in *ITC 1792*,²⁷⁵ the court disregards the intention of the taxpayer(agent) and determines the question of a receipt on the case based on the intention of the principal.

²⁷¹ *Cot v G* 1981 (4) SA 167.

²⁷² *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁷³ *Ibid.*

²⁷⁴ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

²⁷⁵ *ITC 1792* 67 SATC 236.

4.1.3 CONCLUSION.

Based on the understanding of what the taxpayer's intention implies and the factors which the court considers in applying this test when determining whether or not an amount is capital or revenue in nature. The consideration of such approach may assist in determining the factors which the court needs to apply in determining whether or not the taxpayer had the intention to personally benefit from pursuing illegal transactions. Such consideration may be beneficial when applied in cases other than where the taxpayer operates an illegal scheme.

If the consideration of such factors are applied successfully in determining whether or not the taxpayer had the intention to personally benefit by engaging in illegal activities, such application may strengthen the correctness of the Supreme Court of Appeal decision in *MP Finance Group CC (In Liquidation) v C:SARS*.²⁷⁶

Since we have considered some of the ways in respect of which illegal income may be subjected to the taxpayer's gross income for normal tax purposes in terms of the South African jurisprudence, it is necessary to determine the approach used by foreign courts in respect of subjecting illegal income to taxation. In Chapter 5 a consideration of the Australian and New Zealand method of subjecting illegal income to taxation will be considered.

²⁷⁶ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

CHAPTER 5 TAXATION OF ILLEGAL INCOME IN AUSTRALIA AND NEW ZEALAND.

5.1.1 INTRODUCTION.

The desire for success is one of the things that people have in common, but the manner in which people seek to achieve it differs. As in South Africa, the use of illegal means to derive income is also a problem in Australia and New Zealand. Once the perpetrator has been discovered, the gains realised from the illegal act attract the attention of the tax collector. In both these countries, the collector of revenue has wide arms to collect illegal income and include it in the taxpayer's taxable income.

5.1.2 THE JUSTIFICATION FOR TAXING ILLEGAL INCOME

The ability of the taxing authority in each jurisdiction to tax illegal income stems from its taxation legislation. In Australia the Income Assessment Act²⁷⁷ defines income derived by the taxpayer as all proceeds derived from the carrying on of a business for the purpose of earning assessable income.²⁷⁸ Section 25A (1) of the Income Assessment Act²⁷⁹ goes further to state that assessable income includes all profits derived from the carrying on or carrying out of any profit making undertaking or scheme²⁸⁰ and the Taxation Ruling²⁸¹ issued by the Australian Tax Office explicitly provides that all proceeds derived by the taxpayer from systematically engaging in prohibited activities forms part of the taxpayer's assessable income²⁸² and provides that the test provided in section 25A (1) of the Income Assessment Act²⁸³ applies when determining whether or not illegal income should form part of the taxpayer's assessable income.²⁸⁴ Section 25A (1) provides for the carrying on of a business test which is satisfied when the elements of a business such as repetition, regularity, aim of profit making and organisation are present.

²⁷⁷ Income Assessment Act 27 of 1936, as amended.

²⁷⁸ Section 21A (5) of the Income Assessment Act 27 of 1936, as amended.

²⁷⁹ Income Assessment Act 27 of 1936, as amended.

²⁸⁰ Section 25A (1) of the Income Assessment Act 27 of 1936, as amended.

²⁸¹ Taxing Ruling 93/25.

²⁸² *Ibid* 5.

²⁸³ Income Assessment Act 27 of 1936.

²⁸⁴ Taxing Ruling 93/25, 9.

In terms of this Taxing Ruling²⁸⁵ the concept underlying the taxation of illegal income stems from the British and American concept of taxing illegal income. This is seen by making reference to British cases on the taxation of illegal income such as *Partridge v. Mallandaine*²⁸⁶ where the court reasoned that that the Commissioner would be correct in assessing a taxpayer who derives a profit of £2000 per year, through carrying on a trade of systematically receiving and selling stolen goods. Such reasoning thus makes illegal income taxable and conforms with *Lindsay v. IRC*²⁸⁷ where the court held that the act of trafficking in drugs, although being illegal, resembles carrying on a trade of selling drugs under a permit and because the law permits the sale of certain drugs, the profits realized from illegally dealing in drugs can be taxable. In conclusion, the court pointed out that such an illustration indicates that the test to tax incidental illegal gains is to identify a similar or parallel legal business and if one is discovered then the activity is taxable.²⁸⁸

In New Zealand, section BD1 (5) of the Income Tax Act²⁸⁹ defines assessable income as any income which forms part of the taxpayer's gross income other than that which is exempt, excluded income and non-resident foreign income. Section CB 32 caters for a situation where the taxpayer is in possession of stolen property.²⁹⁰ In both Australia and New Zealand, the courts have, as will be seen below, used the carrying on of a business test to determine whether or not illegal proceeds in the hands of the taxpayer is taxable or not. In terms of the application of this test, the court investigates whether or not the taxpayer had the intention to make a profit and the nature of the business with respect to the frequency of activities, scope of the operation of the business, volume of the transaction undertaken, financial result achieved by the taxpayer and the effort of the taxpayer to name a few.²⁹¹

In Australia for example the application of the carrying on of a business test was successfully used by the court in the case of *CIR v La Rosa*²⁹² where the taxpayer, a dealer in heroin, made a huge amount of money from dealing in drugs. After the illegal trade was discovered, the taxpayer was committed to prison for a period of 12 years.²⁹³ As a result of the imprisonment, the taxpayer's illegal gains from dealing in drugs were disclosed and came to the attention of

²⁸⁵ Taxing Ruling 93/25.

²⁸⁶ *Partridge v Mallandaine* 1886 (2) TC 179.

²⁸⁷ *Lindsay v IRC* 1932 (18) TC 43.

²⁸⁸ R Gupta 'Taxation of Illegal Income In Australia and New Zealand' (2008) Vol.3 No.2 *JATTA* 106, 112.

²⁸⁹ Section BD1 (5) of the Income Tax Act 97 of 2007.

²⁹⁰ Section CB 32 of the Income Tax Act 97 of 2007.

²⁹¹ *Grieve v CIR* 1984 (6) NZTC 61,682.

²⁹² *CIR v La Rosa* 2003 (50) ATR 450 [2003] FCAFC 125 (5 June 2003).

²⁹³ *La Rosa v The Queen* (1999) 105 A Crim R 362,363.

the Commissioner who issued an assessment, taxing the taxpayer for all gains made for the previous 7 years.

After receiving notice of the Commissioner's intention, the taxpayer objected. In considering the issue of whether the profits derived by the taxpayer should form part of his assessable income, the court visited the 'Taxation Ruling'²⁹⁴ which provided that 'receipts from a systematic activity where the elements of a business are present are income, irrespective of whether they are legal or illegal and on the strength of it, held that the proceeds in the taxpayer's hands satisfied the requirements of section 25 (1) of the Income Assessment Act²⁹⁵ and as such should form part of the taxpayer's assessable income.

In terms of this decision what one can assume is that the court considered whether or not there was a legal business of dealing in drugs, which it found that there was and on the basis of this, the requirement provided in section 25 (1) of the Income Assessment Act²⁹⁶ was thus satisfied. This therefore means that since the taxability of illegal income is based on the wording of section 25 (1) of the Income Tax Assessment Act,²⁹⁷ the reading of the section indicates that an illegal transaction which is *void ab initio* will not be taxable. The basis for this will be the absence of a legally recognised business which has similar features to the illegal one. A good example of an analysis of the case law dealing with this aspect will be illustrated when considering the New Zealand treatment of illegal income.

In New Zealand, the Income Tax Act,²⁹⁸ unlike the Income Tax Assessment Act,²⁹⁹ does not have a section where it provides that income should be derived from the carrying on of a business for the purpose of earning assessable income. Section CA 1 defines amounts that are income as income belonging to the taxpayer in terms of any of the provisions of the Act³⁰⁰ or if the amount within the ordinary meaning constitutes income³⁰¹ and section CB 32 caters for situations where there is no similar systematic business transaction permitted in law.³⁰²

²⁹⁴ Taxation Ruling TR 93/25.

²⁹⁵ Section 25 (1) of the Income Assessment Act 27 of 1936, as amended.

²⁹⁶ Income Assessment Act 27 of 1936.

²⁹⁷ Income Assessment Act 27 of 1936, as amended..

²⁹⁸ Income Tax Act 97 of 2007.

²⁹⁹ Income Assessment Act 27 of 1936, as amended.

³⁰⁰ Section CA 1 (1) of the Income Tax Act 97 of 2007.

³⁰¹ Section CA 1 (2) of the Income Tax act 97 of 2007.

³⁰² Section CB 32 of the Income Tax Act 97 of 2007.

However it is good to note that before section CB 32 was inserted into the Act³⁰³ the position was that the court used the doctrine of claim of right test to determine whether or not illegal income derived by the taxpayer in cases where a systematic business transaction was absent, was taxable. This test was applied by the court in *A Taxpayer v CIR*.³⁰⁴ where the taxpayer, an accountant, systematically embezzled over 2 million US Dollars from its employer, which money was invested in the futures market. Due to the risk attached to these kinds of investments, the taxpayer was unfortunate and lost all the money invested. After the discovery of the embezzlement, the taxpayer repaid half of the amount embezzled. As a result of this the Commissioner assessed him for the funds embezzled and on income from his trading activities. The taxpayer objected to the assessment.

Relying on the ‘constructive trust doctrine’³⁰⁵ the taxpayer argued that the embezzled funds in its hands were conditional, similar to a loan, and the taxpayer had an obligation to repay the stolen amount back to the owner. In response, the Commissioner, relying on Canadian and American cases, argued that the nature of stolen funds in the hands of the taxpayer is not affected by an obligation to repay the money or the constructive trust doctrine.

In deciding upon the issue the court relied on the Canadian and American decisions which provided for the doctrine of a claim of right which ignores any restitution of the stolen property and taxes the thief on the gain derived from theft. Morris J held stated that:

The respondent (taxpayer) was under an obligation to return the stolen money. For the money returned no question of taxation arose, while the remaining money he converted to his own use. While he is still liable in law to account for the monies, he is taxable on them because he was in effect holding and using the money for his own account. He is obliged to return the money because of the manner in which he acquired it. He is taxable on the money because of the manner in which he held it. His duty to return the money is a separate issue to the question of taxation. While he is not the strict legal owner of the money he is holding it for his own use. The reality of the situation is that the respondent regarded the money as his own to use for his purposes as he chose. I therefore, conclude that the stolen monies do constitute income and are assessable for income tax.³⁰⁶

³⁰³ Income Tax Act 97 of 2007.

³⁰⁴ *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) 13,350.

³⁰⁵ R Gupta ‘Taxation of Illegal Income In Australia and New Zealand’ (2008) Vol.3 No.2 *JATTA*, 115 (the constructive trust doctrine provides that a thief does not have beneficial ownership over stolen property because at all material times it has to account to the rightful owner).

³⁰⁶ *CIR v A Taxpayer* 1996 (17) NZTC 12,574, 12,578.

However, on appeal, the court of Appeal strongly rejected reliance on Canadian and American cases and adopted the Australian approach of *Murray (NSW) Pty Ltd v C of T*³⁰⁷ and stated that:

The Court obviously considered that sums received subject to a trust or charge did not have the quality of income derived by the recipient. In principle, an embezzler is liable to return or repay the stolen property and the innocent party to embezzlement retains the right to trace the property or its proceeds into the hands of the embezzler. The embezzler does not have any claim of right to the stolen property. In the absence of a specific statutory provision allowing for a re-characterisation or different characterisation of the misappropriation receipt for tax purposes, the ordinary rules apply. Legal rights and obligations cannot be ignored. There is no gain to a taxpayer unless the receipt is derived beneficially by the taxpayer. Taxation by economic equivalence is impermissible.³⁰⁸

5.2 A COMPERATIVE ANALYSIS BETWEEN SOUTH AFRICA’S APPROACH AND THE AUSTRALIAN AND NEW ZEALAND APPROACH.

As has been enumerated above, it is clear that in both Australia and New Zealand, illegal income in the hands of the taxpayer is taxable. The starting point with regard to subjecting illegal income to taxation lies with the Taxing Ruling³⁰⁹ and the legislation which caters for the approach in respect of which the courts should go about in subjecting illegal income to taxation. With regard to the Australian approach evidence shows that the court applies the parallel business test to determine whether or not illegal income in the hands of the taxpayer is taxable. If the illegal activity committed by the taxpayer satisfies the parallel business test, the proceeds derived from such illegal act will form part of the taxpayer’s assessable income. By looking at this approach, one may assume that the taxpayer in *MP Finance*³¹⁰ would have been taxed on the application of this test, while on the other hand it would also indicate that the taxpayer who performs a unilateral taking such as theft would escape liability from taxation on the basis of the absence of a parallel business (agreeing with *COT v G*)³¹¹

³⁰⁷ *Arthur Murray (NSW) Pty Ltd v C of T* 1965 (114) CLR 314.

³⁰⁸ *A Taxpayer v CIR (1997) 18 NZTC 13,350 (CA) 13,350.*

³⁰⁹ Taxation Ruling TR 93/25.

³¹⁰ *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

³¹¹ *Cot v G* 1981 (4) SA 167.

The issuing of a taxation binding ruling by SARS similar to the Taxation Ruling³¹² would not help in solving the problem in South Africa. The reason for this is because all that it does is to state that illegal income in Australia is taxable and provides that the test to apply is the one provided under section 25 (1) of the Act.³¹³

The reason for this is, firstly, if SARS were to issue a taxing binding ruling the applicable test would not be in terms of the gross income definition.³¹⁴ This would be because of the absence of the definition of key phrases in that definition. Secondly, the problem in South Africa is not whether illegal income is taxable or not, but the application of the correct test which determines the levying of tax on illegal income, the presence of the phrase ‘illegal income is taxable’ in the taxation binding ruling would not assist in solving the problem and thirdly it would mean that if it had to do so it would refer to a test applied by the courts as the applicable test to follow which at present is the one applied by the Supreme Court of Appeal in *MP Finance Group CC (In Liquidation) v CSARS*.³¹⁵

Now turning to the New Zealand approach, which makes illegal income taxable on the basis that the taxpayer has derived a gain from the illegal act: its application to determining a receipt in our gross income definition³¹⁶ may be helpful because it will adhere to the meaning provided by the court in *Geldenhuis v CIR*.³¹⁷ This is because one may assume that there cannot be a receipt without a benefit, so if this application was applied to all cases dealing with the taxation of illegal income it would not be difficult for the courts to determine whether or not the proceeds derived by the taxpayer are taxable or not.

Furthermore in New Zealand the court has identified the need to tax proceeds derived from theft in situations where the taxpayer received the property without a claim of right.³¹⁸ If the legislature could adopt such a provision into our South African Income Tax Act³¹⁹ it would make proceeds derived from theft taxable and be included into the taxpayer’s gross income. By doing this the Commissioner would be widening the scope of taxing all form of illegally derived income.

³¹² Taxation Ruling TR 93/25

³¹³ Section 25 (1) of the Income Assessment Act 27 of 1936

³¹⁴ Section 1 of the Income Tax Act 58 of 1962, as amended.

³¹⁵ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

³¹⁶ Section 1 of the Income Tax Act 58 of 1962, as amended.

³¹⁷ *Geldenhuis v CIR* 1947(3) SA 256 (C); 14 SATC 419; *ITC 1545* 54 SATC 464(C).

³¹⁸ Section CB 32 of the Income Tax Act 97 of 2007.

³¹⁹ Income Tax Act 58 of 1962.

On the strength of the analysis, my recommendation is that South Africa should adopt the New Zealand approach which is designed to make the Commissioner run on a fat belly and as such will result in the collecting of more money than if it were to apply the Australian approach which is limited and does not cater for situations where the taxpayer's illegal conduct cannot be equated to a legally recognised business.

5.3 CONCLUSION AND RECOMENDATIONS

From the application of the phrase 'received by' to illegal income, the result produced is that the problem of subjecting illegal income to taxation is not created by the illegality underlying the transaction, but difficulty arises as to the applicable test which the court has to adopt for a specific case. This is caused by the different means in respect of which the taxpayer obtained illegal income which is the subject matter of taxation. This then results in inconsistencies in the applicable test. Even though the question of determining a receipt in respect of illegal income has finally reached the Supreme Court of Appeal, the application of the subjective method of interpretation to determine whether or not the taxpayer had the intention to benefit from an illegal transaction, is inadequate where the taxpayer is acting in a representative capacity³²⁰ and where there is a unilateral taking such as theft.³²¹

Furthermore since the Supreme Court of Appeal was silent in indicating the factors it considered in order to come to the conclusion that the taxpayer had the requisite intention to receive the amount in question for gross income purposes, one may assume that such test may prove to be difficult in cases where the facts of the case are different from those in *MP Finance Group CC (in liquidation) v C:SARS*.³²² Recommendations are that the courts should in future apply the test of intention used when determining whether an amount is capital or revenue in nature in order to determine whether or not illegal income in the hands of the taxpayer constitutes a receipt.

Another way of determining whether illegal income in the hands of the taxpayer constitutes a receipt or not is by importing the New Zealand method and inserting into our Income Tax Act³²³ a section which will provide an alternative test in cases where the *MP Finance Group*

³²⁰ *ITC 1792 67 SATC 236.*

³²¹ *COT v G 1981 (4) SA 167.*

³²² *MP Finance Group CC (In Liquidation) v C:SARS 69 SATC 141.*

³²³ Income Tax Act 58 of 1962, as amended.

*CC (in liquidation) v C:SARS*³²⁴ decision is inadequate in subjecting illegal income in the hands of the taxpayer who has derived a benefit to form part of his gross income.

³²⁴ *MP Finance Group CC (In Liquidation) v C:SARS* 69 SATC 141.

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27 May 2015

Mr Kulani Maboko (214582132)
School of Law
Howard College Campus

Dear Mr Maboko,

Protocol reference number: HSS/0544/015M

Project title: The challenges arising from the application of the 'gross income' definition to illegal income

Full Approval – No Risk / Exempt Application

In response to your application received on 19 May 2015 the Humanities & Social Sciences Research Ethics Committee has considered the abovementioned application and the protocol has been granted **FULL APPROVAL**.

Any alteration/s to the approved research protocol i.e. Questionnaire/Interview Schedule, Informed Consent Form, Title of the Project, Location of the Study, Research Approach and Methods must be reviewed and approved through the amendment /modification prior to its implementation. In case you have further queries, please quote the above reference number.

PLEASE NOTE: Research data should be securely stored in the discipline/department for a period of 5 years.

The ethical clearance certificate is only valid for a period of 3 years from the date of issue. Thereafter Recertification must be applied for on an annual basis.

I take this opportunity of wishing you everything of the best with your study.

Yours faithfully

Dr Shenuka Singh (Chair)

/ms

Cc Supervisor: Mr Chris Schembri
Cc Academic Leader Research: Dr Shannon Bosch
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