

Taxation of illegal schemes: – should the term 'received by' in the definition of gross income be interpreted with reference to the taxpayers subjective intention?

by

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Submitted in partial fulfilment of the requirements for the degree of LLM

Prepared under the supervision of Adv C Louw of the University of Pretoria

July 2011



DECLARATION

I, Elijah W. Chawira, the undersigned, hereby declare that the work contained in this
thesis is my own original work and that I have not previously, in its entirety or in part,
submitted it at any university for a degree.
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ABBREVIATIONS

AAT Administrative Appeals Tribunal

C.SARS Commissioner for South African Revenue Services

CIR Commissioner for Inland Revenue

COT Commissioner of Taxes

IRC Internal Revenue Code

ITAA Income Tax Assessment Act

SARS South African Revenue Services

SCA Supreme Court of Appeal

SIR Secretary for Inland Revenue



CHAPTER 1. BACKGROUND TO THE RESEARCH

1.1. Introduction

The definition of gross income includes any amount 'received by' a taxpayer. The term 'received by' was interpreted by applying an objective interpretation. This was achieved by applying the concept of legal rights and obligations, in particular the principle of entitlement. There is a general consensus by the courts when they apply this principle over amounts derived legally by a taxpayer. However, there has been a growing debate over the years as to whether stolen amounts could be taxable as a receipt under the Income Tax Act. It became clear that taxation of stolen amounts could not be achieved under the principle of entitlement because a thief or an embezzler cannot acquire a 'right' and has no legal entitlement over an amount.

A new approach to the interpretation of the term 'received by' emerged, and that was interpreting the term with reference to the subjective intention of a taxpayer. This concept was only introduced and applied only when the courts were faced with the question whether stolen amounts were taxable under the Act. However, there was no general agreement between the courts over the application of the subjective approach and there was a dissensus over the use of this principle. Other courts clearly felt that legal rights and obligations determined a receipt and that the Act did not provide for the taxation of stolen amounts. The issue finally came before the Supreme Court of Appeal in the case of MP Finance Group CC v C.SARS¹. The term 'received by' was interpreted with reference to the subjective intention of the taxpayer, meaning that if a person retains an amount for his own benefit he has received it, regardless of the fact that the amounts do not belong to him and are repayable.

The purpose of this study is to determine the true position of the term 'received by'. The Supreme Court of Appeal interpreted the term with reference to the subjective intention of a taxpayer in favour of a long standing principle that focused on the legal rights and obligations of a taxpayer. The main question that arises is whether the term

¹ MP Finance v Commissioner for SARS 69 SATC 141.



'received by' must be interpreted with reference to the subjective intention of a taxpayer?

Was this approach adopted by the Supreme Court due an increasing pressure to subject stolen amounts under income tax? It is doubtful that the issue of tax liability for illegal receipts has been finally settled by the Supreme Court, and therefore it is pertinent to analyse the court ruling in detail.

1.2. Geldenhuys v CIR

In Geldenhuys v CIR², Steyn J, stated that:

'Received by must mean received by the Taxpayer on his own behalf and for his own benefit'.

In respect of legal contracts there is a long standing ruling delivered by the Appellate Division, now the Supreme Court, in the case of CIR V Genn & Co. (Pty) Ltd.,³ noting that:

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

These courts applied an objective approach and focused on the legal rights and obligations of a taxpayer. It must be noted that the courts that applied this principle believe that ownership of a property right amounted to a receipt under the Act.

² Geldenhuys v Commissioner for Inland Revenue, 14 SATC 419, at 431.

³ Commissioner for Inland Revenue v Genn 1955 (3) SA 293.



The objective approach was rejected in 2007. The Supreme Court of Appeal ruled in the case of MP Finance Group CC v Commissioner of SARS⁴ (hereafter referred to as the MP Finance case) that:

'[An] illegal contract is not without all legal consequences and it can have fiscal consequences. Amounts paid to the scheme that was 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.'

The court in the MP Finance Group CC v C.SARS⁵ followed a subjective approach that focused on the intention of the taxpayer. It held that if a taxpayer merely retains an amount as his, he would be liable under the definition of gross income, even when he does not have a legal right and entitlement over it.

A distinction will be made between cases that dealt with legal and illegal receipts. This will show that in cases that dealt with legal receipts, the court followed only an objective approach and never departed from this principle. The taxpayer's entitlement to the proceeds was the deciding factor. No controversies ever arose on the use of entitlement on proceeds derived from legal activities. There never arose a reference to the subjective intention of a taxpayer. The distinction between cases that determined between legal and illegal receipts will highlight that inconsistencies only arose when the courts were determining liability of a person to tax on stolen amounts. It will be clear that the courts that felt that a receipt is determined according to legal rights and obligations applied an objective approach, whereas those that felt that stolen amounts must be subject to tax applied a subjective approach.

In applying these principles the rules of statutory interpretation played a major role. The courts that applied the objective interpretation rejected the literal rule because they felt a literal interpretation was too wide.

These courts determined that individuals acting in a fiduciary capacity would be subjected to tax on the receipt of amounts that belong to their Principals and avoided

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⁴ MP Finance v Commissioner for SARS 69 SATC 141.

⁵ Ibid.



this absurdity by applying a purposive rule. This rule is a subjective approach that focuses on the intention of the legislature when they were enacting a provision but does not consider the taxpayers subjective thoughts. In contrast to the courts that applied the purposive rule, the Supreme Court of Appeal in the MP Finance case applied the literal rule and referred to the subjective intention of a taxpayer. This brings the question as to whether the literal rule has provision for the subjective interpretation of the taxpayer to be applied as an aid in the interpretation of a statute.

1.3. **Problem statement**

The Zimbabwean High Court made a ruling in respect of the term 'received by' on stolen amounts. It concluded that a receipt is determined by the passing of rights. According to the court, proceeds from embezzlement cannot be taxed because no rights can ever be passed to an embezzler on his act of stealing. The courts came to the conclusion that a person is taxable according to legal rights and obligations.

The Supreme Court of Appeal in the MP Finance case did not consult other jurisdictions that may have a persuasive influence on our jurisdiction. The decision in the MP Finance case is not clear as to how the literal rule and the subjective intention of the taxpayer is related in the interpretation of a fiscal statute.

Questions arise as to whether the term 'received by' refers to rights in the form of entitlement or just a mere holding of an amount with the intention of benefiting from it? Another question is whether the legislature intended proceeds from illegal activities, such as theft and embezzlement, to be subject to tax under the Act. Is the term 'received by' clear and unambiguous such that stolen amounts could be included in the gross income of a taxpayer?

The current legal position, however, is that the term 'received by' is interpreted subjectively when determining the tax liability of an illegal scheme with the result that a person who steals an amount is taxable if he regards such an amount to be his. This position leaves more questions. Firstly, does this mean an enterprise that is engaged in fraudulent activities is entitled to deductions on expenditure utilized in the production of that illegal income? Secondly, since taxation of stolen amounts reduces any amounts recoverable by the investors of pyramid schemes, what relief does the Act



provide to the innocent investors who will be subject to tax on fictitious interest promised by these schemes?

It is submitted that interpreting the term 'received by' with reference to a subjective intention of the taxpayer is not the proper test to determine a person's liability for taxation. It is also submitted that the common law rules, property rights and obligations should apply in determining the tax liability of illegal schemes and that the subjective approach was adopted to subject stolen amounts under the Act but it does not prescribe that they be taxed.

1.4. Research objectives

- To study the term 'received by' in the definition of gross income and determine whether it should be interpreted with reference to a subjective intention of the taxpayer.
- To study the facts of the MP Finance case⁶ to understand the principles applied by the court in determining the term 'received by'. This will be achieved by studying the literal rule of statutory interpretation in an endeavour to understand its relationship with the subjective intention of the taxpayer in the interpretation of a fiscal statute.
- To understand whether the term 'receipt' encompasses a thin test; that is, a mere claim to an amount for the purpose of deriving a benefit as opposed to a reference to property rights and obligations.
- To determine whether there is a need to provide innocent investors in a pyramid scheme a deduction for their losses incurred with their investment.
- To determine whether illegal schemes are entitled to a deduction under section 11

 (a) general deduction formula and section 23(g), now that amounts produced by theft are included under gross income.

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⁶ Geldenhuys v Commissioner for Inland Revenue, 14 SATC 419, at 431.



1.5. Importance and benefit of the study

There is a debate over the interpretation of the word 'received by'.

Prior the issue of stolen amounts, the definition of 'receipt' was regarded as settled in law through the application of rights and obligations, and so the reasoning behind the SCA ruling in the MP Finance case⁷ needs to be clearly understood. There is a need to determine why the court interpreted the term subjectively especially when there was the question whether stolen amounts could be taxable. There have been many court cases in the lower courts before the MP Finance case⁸, expressing conflicting views on whether one should be entitled to an amount or a mere claim to an amount for his own benefit without regard to property rights and interests. The Supreme Court of Appeal in the MP Finance case⁹ ruled contrary to the views of other jurisdictions, and it is therefore pertinent to analyse why the court rejected an objective test that focuses on rights and obligations and has been long standing in our law, in favour of a subjective test.

In a developing country where there is high unemployment and low growth in the gross domestic product, one would assume that the government would encourage growth in the private sector.¹⁰ There is therefore a need to explore all available avenues for investors misled in fraudulent pyramid schemes where they not only lose their capital investment but are also faced with a direct tax burden on income derived from the investment that must be first be subjected to tax in the hands of the scheme.¹¹

⁷ Geldenhuys v Commissioner for Inland Revenue, 14 SATC 419.

⁸ *Ibid*.

⁹ Ibid.

¹⁰ Sacks, J. 2010. *Tax implications for Ponzi scheme investors*. Money webs TAX BREAKS, 13 May 2010. [Online] Available at

http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page259?oid=48546&sn=Detail

¹¹ Ibid.



1.6. **Research design**

The research design consists of two parts:

Firstly, it will be necessary to highlight how the courts have interpreted the term 'received by' with regard to both legal and illegal transactions.

Secondly, the implications of the MP Finance case¹² will be analysed. This will prove that the subjective approach was only introduced as a measure and not as a requirement to include stolen amounts under the Act.

To support this assertion, the literal rule and the subjective intention will be separated. This will expose the preconceived notions behind those who support the subjective approach. The true intention of the legislature is analysed by following, step by step, the rules of statutory interpretation. Secondly, the implications of the ruling in the MP Finance case will be analysed. Issues that will be addressed will be to see if illegal schemes are eligible to deduct expenditure and losses incurred in the production of their illegal income, and the impact of the decision on the innocent investors.

1.7. Structure of the research report

The dissertation will consist of six chapters:

· Chapter One.

The problems which led to the study of the principles applied in the MP Finance case¹³ were discussed. The objectives and limitations of the study were set out and the importance of the study considered. The research design and methodology of the study were also explained.

•	Chapter '	Two.
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¹² Ibid.

¹³ Geldenhuys v Commissioner for Inland Revenue, 14 SATC 419.



A case study is undertaken to highlight how the courts interpreted the term 'received by' for both legal and illegal proceeds. This will clearly show the circumstances under which a subjective approach was adopted, and the conflicts that arose between the courts as a result. A literature study is conducted to analyse the facts, arguments and reasoning of the MP Finance case¹⁴.

Chapter Three.

The rules of statutory interpretation are studied in order to understand the relationship between the literal rule and the subjective interpretation. There is a need to understand whether the subjective interpretation of the taxpayer can be used as an aid or tool of interpretation. The term 'received by' is read in its context in an attempt to determine the true intention of the legislature, rather than employing a strict interpretation of the term. It is necessary to understand what must be received by a taxpayer so that a tax liability is triggered. An attempt is made to arrive at the proper interpretation by analysing the context of the wording in the definition of gross income.

Chapter Four.

The interpretation by other jurisdictions such the United States, Australia and New Zealand are examined. These countries have adopted the subjective interpretation in their own concept, known as the doctrine of claim of right, which is similar to the approach adopted by the Supreme Court of Appeal in the MP Finance case. This doctrine was adopted in their Acts specifically to subject stolen amounts to income tax. The chapter focuses on whether the foreign concept should have been adopted in light of our own Act.

· Chapter Five.

Chapter Six.

An analysis will be conducted to understand whether pyramid schemes can deduct expenses in terms of the Income Tax Act now that stolen amounts are regarded as income under the Act.

¹⁴ Ibid.



An analysis is conducted to study the tax consequences of a Ponzi scheme investor. The focus will be on whether investors can deduct losses incurred with their investments. In this chapter other jurisdictions are studied and consulted on how they treat investors who lose their investment money through Ponzi schemes.

· Chapter Seven.

Chapter 7 provides the conclusion to the research, and also suggests areas for further research.

1.8. Conclusion

This chapter has set out the problem statement, the research objectives and methodology to be used, as well as providing the anticipated structure of the dissertation.



CHAPTER 2. LITERATURE REVIEW

2.1. The definition of 'gross income'

Gross income in relation to a year of assessment is defined in section 1 of the Income Tax Act¹⁵ as:

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

The starting point to calculate a persons' tax liability is to determine his gross income. ¹⁶ This definition is central to the entire tax system. ¹⁷ The meaning of the phrase 'received by' or 'accrued to' or 'in favour of' a person is not explained in the Act. The courts are therefore often required to interpret the meaning of the terms, based on the specific set of facts before them. ¹⁸

It is not profits but receipts and accruals that are included in gross income. There must be either a receipt or an accrual, and in the absence of special provisions, when a person neither receives anything nor has anything accrued to him, there can be no amount to be included in his gross income.¹⁹ The core issue is to understand how the courts have determined what constitutes a receipt and whether legality or illegality of an amount affects the nature of a receipt.

¹⁶ Williams, R.C. (2003). Income Tax and Capital Gains in South African Law and Practice. p 26.

¹⁵ Income Tax Act 58 of 1962.

¹⁷ De Koker, A.P. (2010). Silke on South African Income Tax 2010, par 2.0.

¹⁸ Huxham, K., Haupt, P. (2007). Notes on South African Income Tax, p10.

¹⁹ De Koker, A.P. (2010). Silke on South African Income Tax 2010, par 2.1.



2.2. The meaning of 'received' on legal receipts

The interpretation of the word 'received' in the definition of gross income has not given rise to difficulty²⁰ on legal receipts. In the case of Geldenhuys v CIR,²¹ it was decided it in a judgment delivered by Justice Steyn that the expression 'received by' means that money must be received by the taxpayer in such circumstances that he becomes 'entitled to' it. In a separate judgment delivered by A.J. Herbstein, the word 'received' was interpreted to mean received by a taxpayer on his own behalf and for his own benefit.

The case involves a woman who acquired a usufruct over the assets (livestock) of the estate with assets vesting in her children, the dominium holders. It was held that the usufructuary, being the taxpayer, was not entitled to the amount received on the realization of the assets subject to the usufruct. It remained the property of the remainder man. In deciding this, the court paid due regard to the underlying common law obligatory and property rights of the usufructuary.²² A person should not be subjected to tax on amounts received by him for the benefit of another. Simply put, the amount has to be the taxpayers' own amount to deal with as he pleases.

In the Supreme Court of Appeal in CIR v Genn,²³ the courts acknowledged ownership and entitlement to form part of a receipt. It was held that an amount was not received for purposes of gross income if there was a legal obligation upon receipt to pay the amount to somebody else. The court used an example of a farmer who borrowed a tractor from someone else and said that from the very moment that this tractor is delivered to the farmer, he is under an obligation to return it to the owner. The tractor is not received by the farmer for his own benefit to use as he pleases. It is for this reason that he will not be liable to pay income tax in respect of this receipt.

²³ Commissioner for Inland Revenue v Genn 1955 3 SA 293.

²⁰ Williams, R.C. (2001), par 4.1.2 the meaning of received, 77.

²¹ Geldenhuys v Commissioner for Inland Revenue 1947 3 SA 256.

²² Muller (2007) 17 Mercantile Law Journal, 171.



The court said,

'It is certainly not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance money is obtained and banked by someone as agent or trustee for another, the farmer has not received his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes that if what is borrowed is consumable there is in law a change of ownership in the actual thing borrowed'.²⁴

In the Brookes Lemos Ltd v CIR²⁵ a taxpayer in the wholesale trade required a customer to pay a deposit on a container, to be refunded when the empty container was returned. The court held that the deposits were beneficially received for purposes of gross income because there was no absolute obligation on a customer to return a container. The deposit received by the taxpayer had been beneficially received by them and hence was taxable in their hands. The basis of the decision was that the taxpayer had not received the deposit in trust and that consequently the amounts were received. In other words, the taxpayer had not held the amounts on behalf of another person. The courts approach was therefore the principle of entitlement.

In CIR v Witswatersrand Association Racing clubs, ²⁶ an association consisting of the representatives of regional racing clubs, held a horse racing event in aid of charity. The money so raised, although duly paid to the charity organizations, was taxed in the hands of the association, being income beneficially received by the association. According to the findings of the court, the race meeting was conducted by the association as principal, and not as agent, and therefore was income taxable in its hands. Counsel for the association argued that an amount is beneficially 'received by' the taxpayer only if his right thereto is absolute and under no restriction, contractual or otherwise, as to its disposition use or enjoyment.²⁷

²⁴ Commissioner for Inland Revenue v Genn 1955 3 SA 293, at 301.

²⁵ Brookes Lemos v Commissioner for Inland Revenue 1947 2 SA 976.

²⁶ Commissioner for Inland Revenue v Witwatersrand racing club 1960 3 SA 291.

²⁷ Commissioner for Inland Revenue v Witwatersrand racing club 1960 3 SA 291, at 293.



The attitude of the court was that unless the association had received the money *qua* agent, *stricto sensu*, this money was received by beneficially and was therefore taxable in its hands. The fact that the association had organized the race meeting with the explicit intention of paying over the funds which it raised to charities, the fact that it received the money with this purpose, and the fact that it duly paid over the money, all of this, for purposes of tax law were regarded as irrelevant. A mere moral restriction as to the disposition, use or enjoyment of an amount received does not destroy the beneficial character of the receipt. The courts' approach was the determination of entitlement to the amount.

In Rishworth v SIR²⁸ the taxpayers' wife had executed an agreement of cession, granting the cessionary the sum of £50 per month out of the rental payable to her under a certain base. This sum was to be paid directly to the cessionary. The issue was whether the rental, which the taxpayer's wife had ceded, continued to form part of her gross income; that is, did the cession take effect only after the rental had accrued to the taxpayer? The court held that the wording of the deed meant that the taxpayer ceded the right to claim rent as and when it because payable to her. This indicates a monthly accrual to her upon which the cession would operate. This decision accepts the principle that a taxpayer can antecedently divest himself of the right to income, with the result that the income thereafter belongs to someone else. In this case the taxpayer failed to achieve an antecedent cession because the particular words used in the contract had the result that the cession took effect only after each month's rent had accrued to the taxpayer. It is implicit in the judgment that a different form of words could have achieved the taxpayers' objective.²⁹

In SIR v Smant³⁰ the taxpayer disposed of shares and ceded his right to receive future payments in respect of such shares, to the purchaser of the shares. Although the payments were then made to the taxpayer, such payments were indeed paid over to the purchaser by the taxpayer. The question was whether or not the taxpayer 'received' the payments for the purposes of gross income.

²⁸ Rishworth v Secretary for Inland Revenue 1964 4 SA 493.

²⁹ Williams, R.C. (2001). Income Tax & Capital Gains in South Africa: Cases & Materials, p.136.

³⁰ Secretary for Inland Revenue v Smant 1973 3 SA 754 (AD).



The majority of the judges held that the cession divested the taxpayer of his right to receive future payment before they accrued. Due to the fact that the taxpayer was obliged to transmit the payment, he did not receive it for his own benefit. Money received by an agent on behalf of a principal, or for that matter any person merely receiving money *en route* to the ultimate beneficiary, should not be regarded as having been received for the purposes of the definition of gross income.

In C. SARS v Cape Consumers (Pvt) Ltd.,³¹ Cape Consumers (Pvt) Ltd traded as a mutual buying organization. Acting on behalf of its members, the taxpayers would purchase goods from suppliers at a discounted price and the relevant member of the taxpayer company would then pay the taxpayer the full undiscounted purchase price of the goods purchased on the members' behalf. After paying the suppliers for the goods, and paying its own operational expenses, the taxpayer transferred the surplus to the buyers aid fund. The taxpayers' articles of association provided that amounts transferred to the buyers' reserve fund were held for the benefit of the buyers. The issue was whether the amounts transferred by the taxpayer to the buyers' reserve fund had been beneficially received by the taxpayer such that these amounts formed part of the gross amounts of the taxpayer.

The court held that amounts transferred by the taxpayer, on behalf of its customers, to a buyers' reserve fund, were held for the benefit of the buyers. The taxpayer was obliged to credit the income to the buyers' reserve fund. For this reason, the taxpayer did not have a legal entitlement to such income which was necessary for such amounts to have been received by or to have accrued to the taxpayer.

2.3. The meaning of 'received' on illegal proceeds

It will be shown that the root of the problem, in the cases that involve stolen amounts, is whether these amounts are taxable. The courts have followed an objective approach in some cases, and a subjective approach in others. It remains a highly controversial issue whether or not such proceeds should be subject to income tax.³²

³² Classen, L.G. (2007). Legality & Income Tax, 19 SA Mercantile Law Journal 534.

³¹Commissioner for SARS v Cape Consumers (Pvt) Ltd 1999 4 SA 1213 (C).



The Supreme Court, as far back as 1918 in CIR v Delagoa Bay Cigarette Ltd.,³³ dealt with a case in which a company sold cigarettes that were worth sixpence at a price of ten shillings. Each pack of cigarettes sold contained a lucky number. An advertisement was placed in each pack which stated that two thirds of the income earned from the sale of these cigarettes would be drawn. The company paid two distributions, or prizes, and was then prosecuted for the illegal running of a lottery. The court held that the legal or illegal nature of the source of income was not decisive in determining its tax liability.

The court considered the phrase 'received by' or 'accrued to' or 'in favour of' a person in order to determine whether it constituted income. The Act did not differentiate between legal or illegal reasons for income and neither should a court. It introduced a principle that in determining whether an amount is income or not, no account must be taken of the fact that the activity involved is illegal, immoral or *ultra vires;* in other words, it is immaterial for income tax purposes whether or not the business carried on by the taxpayer is in fact illegal or legal.³⁴ The court followed a simple approach without any technical or linguistic analysis of the phrases concerned.³⁵

One of the cases that has been adopted by South African courts is the Zimbabwean case COT v G.³⁶ The taxpayer occupied a responsible government position and money was given to him by the government to be used for certain specific purposes. Over a period of some years he stole some \$58 000 of the funds given to him. The taxpayer was convicted of theft and sentenced to imprisonment; part of which was suspended on condition of repayment. The whole amount was in fact repaid. The Commissioner included this amount in his gross income and also subjected the taxpayer to penalties. The taxpayer appealed successfully to the special court on the grounds that the amounts stolen had not been received by him and an appeal to the Appellate Division of the High Court of Zimbabwe held that 'received by' means received by the taxpayer on his own behalf and for his own benefit.

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³³Commissioner for Inland Revenue v Delagoa Bay Cigarette1919 TPD 391.

³⁴ Commissioner for Inland Revenue v Delagoa Bay Cigarette 1918 TPD 391, at 394.

³⁵ Classen, L.G. (2007) Legality & Income Tax, 19 SA Mercantile Law Journal 540.

³⁶Commissioner of Taxes v G 1981 (4) SA 167.



Whether or not the taxpayer received the money on his own behalf and for his own benefit depended not only on his own intentions but also on the intention of the person who paid the money to him.

The government never intended that any of the money paid to the taxpayer should be his to deal with as he liked. It was all paid to him to be applied to a specific government purpose. Accordingly, at no time did he receive it on his own behalf and for his own benefit. Stolen money does not constitute gross income in the hands of the thief because of the fact that the money never became the property of the thief, despite his own intentions.

In ITC 1545,³⁷ the taxpayer earned illegal profits in various ways. He derived profits from the purchase and sale of stolen diamonds and he was aware that the diamonds he had purchased and sold were stolen, and that his conduct amounted to theft. The court distinguished the facts from COT v G case in that it was not merely a taking by a thief. The taxpayer was also involved in a scheme where he, through his company, sold milk cultures to members of the public ('the growers'). They used 'activators' to grow a milk culture which they then denied ('the crop') and were entitled to sell back to the company. The taxpayer, in his personal capacity, participated in the scheme as a grower. The profits so denied by him were taxed by the Receiver of Revenue. The court stated that an amount will be included as gross income if it is 'received by or accrued to' the taxpayer. The use of the words 'or is' indicates the implication that there may be a receipt without an accrual. The proceeds of the void sales could clearly not have been regarded as having been accrued to the growers due to the fact that they were not entitled to the payment.

The court then accepted that the meaning of 'received' implies a receipt by the taxpayer for his own benefit, although it could never have been intended to include an amount received on behalf of someone else. The court held that an amount received by a taxpayer for his own benefit in pursuance of a void transaction should constitute an amount received within the ordinary literal meaning of that word and therefore be included the taxpayers' earnings in his gross income.

³⁷ITC 1545 1992 54 SATC 464.



In 1996 the special court in ITC 1624³⁸ was faced with a situation where a taxpayer fraudulently overcharged its customers for services rendered. The court held that when a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent, or for that matter negligent, misrepresentation to a customer, it receives that money and has intended to receive it as part of its business income and in the course of its business.

In that case a close corporation was carrying on a business as a customs clearing and freight forwarding agent. It rendered services to one of its customers A. Amongst other things, it made payment to a partner for certain wharfage fees on behalf of A and was entitled to recover those fees from A. But it fraudulently overstated the wharfage fees disbursed by it, with the result that it recovered more from A then it should have. In its income statement for the relevant year it included the over recovered amount in its figure for fees and disbursements recovered, but also included the same amount in its figure for fees and disbursements paid, thus escaping tax on the relevant amount. When the irregularity was reported to the Commissioner and A, the customer, A took action for the recovery of the amount overpaid, but its claim had not yet been settled at the time the case was heard and it appeared that the reason for the delay may have been that the amount that could be recovered was not finally settled. The Commissioner, for his part, assessed the taxpayer on the basis that it was not entitled to deduct the amount.

The court held that if the money is paid to an agent, in the broad sense, for the purpose of being paid by him to another for the payer's benefit so that the agent is in essence a conduit or trustee, the effect of the contract is that the money has not been received by the agent for his own benefit and it has also not been received as a reward or remuneration for services rendered, and that applies to the monies legitimately recovered by the taxpayer for disbursements made to others. Also, if a dishonest attorney recovered from his or her client a sum for witness's fee and corruptly negotiated with the witnesses 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

³⁸ITC 1624 1996 59 SATC 373.



would apply to the disputed sum obtained by the taxpayer; in this case by over reading its client.

In ITC 1792,³⁹ a stock broker (the taxpayer) who acted for 'M' became involved in a syndicate with dealers or portfolio of managers employed by 'M' with the object of manipulating certain share transactions. Generally the syndicate knew beforehand which shares 'M' had intended to purchase, and the syndicate, with this knowledge, bought shares in the name of another entity, for which an account in the taxpayers stock broking firm had been opened, 'warehoused' the shares, and resold them to 'M' at a profit. The taxpayer was convicted of fraud and was sentenced to imprisonment, but had made full restitution to 'M' together with interest. The court distinguished the facts of this case from COT v G as there was no unilateral taking. The court then referred with approval to the cases of Geldenhuys, Genn, Cape Consumers and Smart (Supra) which followed the entitlement approach as discussed above, and the court consequently disregarded the taxpayer's intention to benefit from the ill-gotten gains. It was concluded that the taxpayer had not 'received' the profits on his own behalf and for his own benefit because the profits did not belong to him.

In ITC 1810⁴⁰the taxpayer invested money in a pyramid scheme. The scheme collapsed and the taxpayer submitted a claim for interest against the insolvent estate. SARS included certain amounts received by the taxpayer's income tax assessments. As any interest paid by the scheme operators would have qualified as dispositions without value and were voidable in terms of insolvency legislation, the court concluded that the taxpayer never had an unconditional agent to claim interest from the scheme operators. The court held that 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 the scheme to taxpayers those payments of interest would have been dispositions without value and such disposition may be set aside by a court application.

³⁹ITC 1792 67 SATC 236.

⁴⁰ITC 1810 68 SATC 189.



That, as was held by Conradie JA, in Fourie NO and Others v Edeling NO and others, ⁴¹that a promise to reward investors with returns paid by the pyramid scheme was a mere nullity and any payment of a profit or interest would be a disposition not made for value, and consequently, the taxpayer never had an unconditional right to claim interest from the scheme. The court never got to the conclusion that it could ever have been the intention of the legislature to have a person taxed on an income that he never got or if he got it, would lose it in terms of other legislation.

2.4. MP Finance Group CC v C. SARS

The dispute whether the term 'received by' should be interpreted objectively or subjectively finally reached the superior courts in the case MP Finance Group CC v C. SARS. This case involved an illegal investment enterprise, commonly called a pyramid scheme, and the scheme had been conducted by way of successively created entities, incorporated and unincorporated which were all eventually insolvent, and by an order made by the High Court, the original entities were consolidated into a single entity, being the Taxpayer for purposes of the relevant tax assessments and was represented by the joint liquidators of the various entities.

During the 2000, 2001 and 2002 years of assessments, one Maritjie Prinsloo operated an illegal and fraudulent investment enterprise, i.e. a pyramid scheme, through various entities with the aid of family and employees, as well as so-called agents who solicited and transmitted investors' deposits in return for commission. She controlled the various entities in the names of the scheme and procured a range of convincing looking documentation issued to investors when they made deposits. This readily parted investors from their money by promising irresistible but unsustainable returns on various forms of ostensible investment, and it paid such returns for a while before finally collapsing owing many millions.

⁴¹ Fourie v Edeling 2006 4 All SA 393 (SCA).



2.5. **Taxpayers' arguments**

The taxpayer relied on a passage in the judgment of the Supreme Court of Appeal pertaining to the same scheme in Fourie NO v Edeling⁴² in which the question was whether repayments to investors were recoverable by the liquidators, and held that because the scheme was liable in law immediately to refund the deposits, there was no basis on which it could be said that the deposits were received within the meaning of the Act, and they were consequently not subject to tax.

2.6. The decision of the court

The court's judgment in the matter of Fourie v Edeling does not assist the taxpayer as that case dealt with the relationship between investor and scheme, and the present case scheme and the fiscus; moreover, even if the scheme was legally obliged 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; that is, the sole question between the scheme and the fiscus was whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Income Tax Act, and they unquestionably 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.

⁴² Fourie v Edeling 2006 4 All SA 393 (SCA).



CHAPTER 3. ACCRUAL, RECEIPTS, ENTITLEMENT

3.1. Introduction

There are no special deeming provisions in the Income Tax Act relating to the taxability of the proceeds of illegal activity. To be taxable, the enquiry should proceed on the basis of whether its proceeds fall within the ambit of gross income, as defined in section 1 of the Act.⁴³ In determining whether proceeds from all illegal activities fall within the ambit of the definition of gross income, the courts have included several extraneous considerations into account; for example, South African Roman-Dutch common law principles in regard to contract, agency and the ownership of goods.⁴⁴ These courts based their decisions on the objective approach; that is, property rights and obligations in determining a receipt.

However, these decisions were reversed by the Supreme Court in the MP Finance Group CC case which determined that the essential element of a receipt is the intention of the taxpayer to hold an amount with the purpose of deriving a benefit for himself. In other words, a person receives an amount if he claims a right to it, regardless of whether he is entitled to it or not. There is now no room to distinguish between proceeds arising from illegal activities, and the principle in this case is a catch-all decision.⁴⁵

Before this decision the concept of 'receipt' was linked to the underlying legal entitlement to the amount received. An obligation to repay or redeliver was indicative of the fact that the amount was not received by the recipient for purposes of gross income. According to the objective approach, any underlying obligation to repay or redeliver, either based on a contractual or delictual obligation, or for that matter any other action, in terms of a statutory or common law should indicate that the amount is not received for purposes of gross income.

44 Ibid.

⁴³ Goldswain, G. (2008). Tax Planning, 143.

⁴⁵ Goldswain, G. (2008). Tax Planning, 146.



The main question is, therefore, whether a receipt under the Income Tax Act should consider property rights or a mere claim of a right to an amount.

3.2. The jurisprudence behind the subjective approach

The Supreme Court in Geldenhuys v CIR discovered that the meaning of the term 'received by', in a literal interpretation, would mean that any person who has engaged in an activity during the year of assessment and has disposed of any stock in that year will be liable to tax on the proceeds of such stock, and ownership would appear to be irrelevant. In simple terms, it discovered that, if one merely holds an amount in his hands even when he derives no benefit, he would be liable to tax even when he was involved in the transaction in a fiduciary capacity. The court felt that it would be absurd to adopt a literal interpretation as it would subject every kind of a receipt to tax and decided to depart from this rule in the belief that the Legislature intended that one had to be entitled to an amount. According to the Supreme Court of Appeal in the MP Finance v C. SARS,

'The amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Act. In other words, it does not matter for present purposes that the scheme was not entitled...to retain the money'.⁴⁷

In this case the court felt that if a person accepts an amount with the intention of retaining it for his benefit, then he has received it, regardless of whether he is entitled to an amount or not. So the court in Geldenhuys v CIR believed that a person must have a right to an amount, whilst the court in the MP Finance case believed that if one claims a right to an amount, regardless of the fact that he is not entitled to it, he is taxable under receipt. Answers to these distinct interpretations by the two courts may be found by understanding the pre-conceived notions or the inarticulate major premise

⁴⁶ Geldenhuys v Commissioner for Inland Revenue (1947) 14 SATC 419, at 433.

⁴⁷ MP Finance v Commissioner for SARS 69 SATC 141, at 45



of the presiding judges. The views of those who support the subjective approach may outline the pre-conceived notions of the court.

Muller (2007) who supports a subjective interpretation on the term 'received by' says that,

'by following the subjective approach all illegal income will fall into the tax net if the taxpayer intends to benefit from proceeds except where the taxpayer received the income as an agent (in the broad sense) on behalf of another. This approach will also be consistent with public policy. Surely it is not in the interest of public policy that a trader who cheats his customer in the course of his business should be subject to income tax while one who actually steals from them should enjoy exemption from income tax. If the subjective approach was followed in COT v G the court may well have found that the thief indeed received the stolen property' 48.

It is most likely that the subjective intention has been adopted as a tool to ensure equity between law abiding citizens and those who engaged in illicit activities such as theft and embezzlement. This is because those who engage in illicit activities stand to benefit more financially because they could not be liable to tax by virtue of entitlement. The real reason for a reference to the subjective approach by the courts could be for public policy reasons, and the desire to ensure that a thief does not benefit from stealing. This reasoning makes a lot of sense in understanding why the subjective approach was only applied when the court was determining the taxability of illegal amounts. At no point did the court ever introduce this approach in determining legal activities.

It is clear that entitlement denied the Commissioner the right to tax certain illegal proceeds and there are courts that sympathised with him and felt that every ordinary citizen must be subject to tax regardless of the source of proceeds. The only way possible was to replace entitlement with an approach that accommodated all proceeds from whatever source or nature within the Act. In order to really understand whether stolen amounts are taxable, the literal rule must be studied.

⁴⁸Muller, E. (2007). The taxation of illegal receipts. 17 Obiter, vol. 28 Issue 1, 177.



This will provide insight on how the subjective intention of the taxpayer is applicable.

3.3. Interpretation of statutes; the literal rule

Under the literal rule of interpretation, the object is to ascertain the intention which the Legislature meant to express from the language which it has employed. By far the most important rule to guide the courts in arriving at that intention is to take the language of the instrument as a whole, and where words are clear and unambiguous, to place upon them their grammatical construction and give them their ordinary effect. 49

When to give the plain words of the statute their ordinary meaning would lead to absurdity so glaring that it could never have been contemplated by the Legislature or where it would lead to a result contrary to the intention of the Legislature, as shown by the context or by such other considerations as the court is justified in taking into account, the court may depart from the ordinary effect of the words to the extent necessary to remove the absurdity and to give effect to the true intention of the legislature. 50 The primary rule of interpretation is looking at the plain meaning of the words if they are ambiguous, vague or misleading, or if such a strict literal approach would yield absurd results, the court may deviate from the literal meaning to avoid such an absurdity.51

The subjective approach is problematic on the following reasons, firstly the Supreme Court of Appeal in the MP Finance Group v C.SARS case professed that its findings were according to the literal rule of interpretation. However, it is clear that this rule or its aids or maxims, does not include subjectivity. Nowhere is the subjective approach part of the literal rule of interpretation. On close analysis it becomes clear that the court camouflaged the subjective approach as an influential concept that could interpret a statute under the literal rule. What is believed to be a literal interpretation applied by the court in the MP Finance case is in fact not a literal interpretation at all, but rather a common law principle of subjectivity used in criminal and delict law to determine

⁴⁹ Ebrahim v Minister of the Interior 1977 1 SA 665, at 680.

⁵⁰ Venter v Rex (1907) TS 911, at 915.

⁵¹ Botha, C. (2005). Statutory Interpretation, 4th ed., 11.



liability, fault or guilt on an individual. This principle was employed to subjugate illegal activities to be bound by tax legislation that would have otherwise escaped taxation. The literal rule interprets a wording of a statutory provision whereas the subjective intention interprets a persons' mind when determining the commission of an illegal act. The literal rule therefore does not interpret how a person thinks but the true meaning of a word.

No rule of statutory interpretation was applied by the court. The reference to a subjective intention of a taxpayer is not an aid to the literal rule of interpretation and was likely adopted as a means to subject those involved in the production of illegal income such as theft under the Income Tax Act. The adoption of the subjective intention is vindictive and punitive in nature. The law of taxation is not punitive. However, it allows the subjective intention for purposes of determining tax evasion which is enforceable under criminal law and also to establish impermissible tax avoidance by establishing wrongfulness by a taxpayer by adopting the common law subjective approach in statute. The concept is applicable in tax when determining whether there has been tax avoidance and evasion, but should not extend in establishing tax liability under a receipt.

Also, there seems to be a desire to enforce public policy on the receipt of illicit proceeds; however, the concept of mores has no place in tax, because tax is a creature of statute. Public policy can only be enforced if it is required by statute. Public policy is a measure to prevent enforceability of illegal or immoral transactions but does not extend to subjecting a person to income tax unless it is so specifically stated. The subjective approach has only been contentious on illegal receipts and this indicates that it was applied for the purpose of fulfilling pre-conceived ideas that promote equality between ordinary law abiding citizens and transgressors. The connection between the use of the subjective approach by the courts and illegal transactions is reflective of the desperation to bind illegal proceeds within the tax law of South Africa and the only possible way would be applying the common law subjective approach. The courts in South Africa have previously rejected uncommon concepts in the interpretation of a statute.



As per Rowlett J, Cape Brandy Syndicate v IR Comrs:

'In a taxing Act one has to look merely at what was clearly said. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used'.⁵²

The Cape Brandy case made it specifically clear when interpreting a tax statute, that if a certain class of people is subject to tax but another category of persons is not subject to tax, then the court has no duty to enforce taxation on the category of persons that are not taxable, even if there is a clear perceived injustice to those who are subject to tax. It states that no presumptions or implications should be adopted to enforce equity; instead the ordinary words of a statute that must be interpreted as it is. Therefore it is crucial to understand that no concept foreign to the interpretation of a tax statute must be adopted in order to arrive at the intention of the legislature.

A reference to the subjective intention of the taxpayer does not avoid absurdity because an agent who steals an amount is regarded to have received, and at the same time the same amount is regarded to have accrued to the principal by entitlement. Therefore a usufruct who sells flocks on behalf of a dominium will be taxed under a receipt if he steals the proceeds of the sale, and the bare dominium will be liable to income tax on those amounts on the basis of an accrual because he is entitled to those amounts.

So a consideration of the above possibilities leads one to doubt whether such a literal interpretation or construction can be correct in the search for an alternative construction which avoids these hardships and absurdities.⁵³ The rule in statutory interpretation is clear, that if the ordinary grammatical meaning of the word leads to an absurdity, then the court should interpret the word in its context, and where absurdities are still apparent, it must apply the purposive rule.

Once a literal interpretation leads to an absurdity, the court in the Glen Anil Development v SIR said that,

53 Geldenhuys v Commissioner for Inland Revenue 14 SATC 419, at 433.

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⁵² Cape Brandy Syndicate v IR Comms12 TC, 358.[1921] 1 KB 64, at 71.



'apart from the rule that in a case of an ambiguity a fiscal provision should be construed contra fiscum, which is but a specific application of the general rule that all legislation imposing a burden upon the subject, there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation. Even in the interpretation of fiscal legislation the true intention of the legislature is of paramount importance and decisive'.⁵⁴

The Court in Commissioner for SARS v Airworld CC and Another, ⁵⁵ the court found that a word can even have more than one meaning. It said that,

'It is by no means a novel situation when it comes to the interpretation of a language. But the question is whether the word properly considered in its context, is never the less ambiguous. Most of the rules of interpretation have been devised for the purpose of resolving apparent ambiguity and arriving at an interpretation which accords as well as possible both with the language which the Legislature has used and with the apparent intention with which the Legislature has used it. In recent years courts have placed emphasis on the purpose with which Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose (which is usually clear or discernible) is used, in conjunction with the appropriate meaning of the language of the provision as a guide to ascertain the legislators' intention.'56

According to the Glen Anil case, there is no reason why the term 'received by' should be subjected to a special treatment by adopting the subjective approach which is not applicable in the interpretation of other legislation, and thereby imposing a burden upon the subject who otherwise should not have been taxable. The *contra fiscum* rule must apply if the ordinary wording does not yield the intention of the legislature. SARS v Airworld CC elaborates further that, where there is ambiguity in interpreting a word then the courts must consider the word in its proper context. It is not uncommon to apply the subjective approach in the interpretation of a statute. However the literal rule does not

⁵⁶ Commissioner for SARS v Airworld (2008) 70 SATC 48, at 60I - 61A.

⁵⁴ Glen Anil Development v Secretary for Inland Revenue (1975) 37 SATC 319, at 334

⁵⁵ Commissioner for SARS v Airworld (2008) 70 SATC 48.



provide for such an approach. The purposive rule is subjective but only focuses on the intention of the legislature and not the taxpayer.

The purposive rule must only be adopted if the word is nevertheless ambiguous after the proper context fails to avert an absurdity. It is therefore necessary to understand whether the context of the wording in the definition of gross income has any effect in arriving at the true intention of the legislature.

3.3.1 The context of received by, receipt of, an amount

Lonrho v Salisbury Municipality⁵⁷Beadle CJ held that,

'when in a technical statute ... the legislation uses words which ...have been recognised as having a specialised technical meaning, it must be assumed that the legislation intended to use the words in their recognised technical sense and not in their popular sense, unless of course it appears from the context in which the words are used that the legislation intended to depart from the proper technical meaning'.

Not only must the words of a statute be interpreted according to their ordinary meaning but also their context.⁵⁸ Gross income in relation to a year of assessment is defined in section 1 of the Income Tax Act⁵⁹ as:

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

Under gross income, the subject of a receipt is an amount. What is taxable is an amount that has been received by or accrued to a taxpayer. So therefore one must receive an amount for it to become taxable under gross income. It is of critical importance therefore to understand what an amount is, as defined by the courts.

⁵⁷ Lonhro v Salisbury Municipality 1970 (4) SA 1, at 4.

⁵⁸ Cochram, G.M. (1983). Interpretation of statutes, 2nd ed., 53.

⁵⁹ Income Tax Act 58 of 1962.



In Lategan v CIR, Watermeyer CJ, held that,

'even without the words, 'whether in cash or otherwise', the definition of gross income would include, by virtue of the term 'amount' not only money, but also the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a monetary value'. 60

It does not matter that a person receives cash or other forms of payment; what matters is the value of the proprietary interest. An amount therefore includes property interests. The court in Cactus Investments Ltd v CIR⁶¹ later expanded on the word 'amount'. Hefer J.A. said it includes

'Not only income actually received, but also rights of a non-capital nature which accrued during the relevant year of assessment and are capable of being valued in money⁶²

The court in this instance included 'rights' that are capable of being valued in money. An amount is a property interest or right that has been received by a taxpayer, whether corporeal or incorporeal. So a taxpayer is taxable not when he receives, but when he receives a right, and not when he claims a right that he does not possess in a property. The significance of the definition of an amount is that it indicates that liability to tax in South Africa is determined by property law and obligations.

The Court in Geldenhuys v CIR did not adopt a contextual approach; however, it arrived at the same conclusion by adopting a Golden Rule or purposive approach. A strict literal interpretation of the term 'receipt' would never yield a proper answer if the context is not appreciated and absurdities would be unavoidable. The proper approach under the context of the wording leads to a simple conclusion that a receipt must be determined in accordance with property rights and obligations; hence the law of obligations must take precedence in determining liability.

⁶¹ Cactus Investments Ltd v Commissioner for Inland Revenue 1999 1 SA 315.

⁶² Cactus Investments Ltd v Commissioner for Inland Revenue 1999 (1) SA 315, at 319G-H.

⁶⁰ Lategan v Commissioner for Inland Revenue1926 CPD 203, at 208-209.



3.4. The relationship between accrual and receipt

The tax court, whilst supporting the interpretation of a receipt with reference to the subjective intention of the taxpayer in ITC 1545, said that situations may arise where an amount is received but not yet accrued. It said that a person can receive a salary prior to earning it. If this proposition is correct, this means that a person could be taxable on a claim of a right to an amount; that is, if he subjectively intends to retain the amount for his own benefit as is held proposed by the MP Finance case. The fundamental question therefore is, can a person receive an amount that does not accrue to him? The answer to this question can be found by determining the relationship between a receipt and an accrual.

The concept of accrual was determined in Lategan v CIR. The principle established is that an amount of gross income accrues to a taxpayer in the year of assessment in which he acquires the right to claim payment in future, and not in the year of assessment in which he eventually is entitled to claim payment. That is, as soon as amount becomes unconditionally and uncontigently due to a taxpayer; it must be recognized as income. In an accrual a person does not become entitled to a right to claim payment of the debt in the year of assessment, but acquires a right to claim payment of the debt in future. The meaning of the words 'accrued to' means 'entitled to' and an amount accrues to a taxpayer irrespective of the fact that an amount may only be due and payable in a later year of assessment.

In CIR v Delfos, dissensus prevailed in respect of the meaning of the concept 'accrued to'. The court held that 'accrued to' meant that an amount should be due and payable, notwithstanding vested rights. The court also said that the Commissioner may regard as gross income all amounts actually received during the year of assessment, whenever they may have originally accrued, and also all amounts accruing during a year of assessment⁶⁵ whenever they may be received. The court connotes an existing relationship between an accrual and receipt.

⁶³ De Koker, A.P. (2010), at 2.7. Lategan Principle.

⁶⁴ Lategan v Commissioner for Inland Revenue 2 SATC 16, at 25.

⁶⁵ Commissioner for Inland Revenue v Delfos 6 SATC 92, at 112.



In the Appellate Division in CIR v Peoples Stores,⁶⁷ the court unanimously ruled that interpretation according to the Lategan case reflected the law correctly. It said that,

'no more is required for an accrual in terms of the definition of gross income than that the person concerned has become entitled to an amount in question...the pith of the supporting reasoning is that any right acquired by the taxpayer during the year of assessment and to which a money value can be attached forms part of gross income irrespective of whether it is immediately enforceable or not but that its value is affected if it is not immediately enforceable.⁶⁸

Accrual connotes an entitlement to an amount without possession or physical control of an amount; at this point the amount or right to the amount must be immediately enforceable, whilst a receipt connotes a physical control of the funds with an unconditional entitlement. This is supported by the CIR v Genn that says,

'It is not every physical control of over money or money's worth that constitutes a receipt...unless there is in law a change of ownership... ⁶⁹

According to case law, the fundamental similarity between an accrual and a receipt is entitlement. The only difference that determines whether there is a receipt or an accrual on an entitlement is the existence or absence of a possession or physical control of an amount.

An accrual is a performance of an obligation that gives rise to a right to claim an amount. If an employee uses his wits and labour first before he is in physical possession of an amount, he becomes entitled (accrue) to a right to receive an amount. If the employee is in physical control of an amount first before he performs his obligation, he cannot have received the amount because he derives no absolute right (entitlement) to the amount.

⁶⁶ De Koker, A.P. (2010). At 2.3, Levy of tax on both receipts and accruals.

⁶⁷ Commissioner for Inland Revenue v Peoples Stores 1990 (2) SA 353.

⁶⁸⁶⁸ Commissioner for Inland Revenue v Peoples Stores 1990 (2) SA 353, at 365A-B.

⁶⁹ Supra fn. 27.



This is because of the fact that the employer has a right of action against the employee if he fails to perform his obligation. Therefore the employee derives no entitlement by the mere physical control of the amount, nor does he derive a right to claim the amount. It is at the moment the employee accrues the amount in his control, that is, when he performs his obligation that gives rise to a right to claim the amount, i.e. when he becomes entitled to the amount and receives under the Income Tax Act. Since a prior receipt by an employee of his salary is an advance payment, the law of advanced determines whether indeed obligations give rise to a receipt. In Brookes Lemos Ltd v CIR, ⁷⁰ the facts of which were stated earlier in Chapter two, the court said,

'The taxpayer was not a trustee holding the deposits account of the customer as security for the return of the bottles. Even if the relationship between customer and company could in common parlance, be loosely so described it was not such in law. There was no obligation to return the container vesting on the customer and the deposit was not a security in nature of a pledge given to secure performance of such an obligation. ⁷¹

The law of advanced payments confirms the importance of obligations when determining a receipt. If a holder of an amount has no corresponding obligation to fulfil, then a receipt is triggered under the Act. Impliedly the court means that where there is an existing obligation to be performed by a taxpayer then he has not received and is not yet entitled to the amount until his obligations are fulfilled.

A trader who sells goods or who provides services is not liable to tax in the year of assessment that he receives an amount as an advance payment for the purchase of goods or services that will be delivered in the next year of assessment. If he delivers the next year of assessment he receives the moment his corresponding obligation has been satisfied that is in the next year of assessment. The simple answer to the question raised in ITC 1545 is that if a person cannot receive an amount he does not accrue, that is, an amount that he does not derive a *bona fide* right to claim the amount. A mere possession of an amount does not amount to a tax liability until he derives an absolute right over the amount.

⁷⁰ Supra fn. 28.

⁷¹Brookes Lemos v Commissioner for Inland Revenue 1947 2 SA 976, at 886.



3.5. Entitlement by a unilateral taking

Fieldsend CJ delivered a judgment in COT v G, and made the following remarks,

'I can see no warrant on the face of the statute for construing the word, 'received' in any but its ordinary meaning. To extend it to cover a unilateral taking such as theft, which in any event confers no right upon the taker to the things taken would be to give the word a meaning that could not be justified on any rational construction of the Act as a whole. In short a thief takes, he does not receive.⁷² The intention of the taker cannot of itself result in him receiving the thing in his own right. He can only receive the thing in his own right if the giver intends that result as well'.⁷³

Classen⁷⁴ observed that The Oxford English Dictionary⁷⁵describes 'receive' as,

to take or accept (a person) in some capacity; to take for, regard as ...; to make use of, to have (a thing) given or handed to oneself; to get from another or others...; to have (some quality, attribute, or property) given, bestowed, conferred or impressed...; to take, accept or get, in various senses;... an act of taking; definite amount taken.'

He says that

'The description of the verb in this dictionary included the act of taking which indicates that the analysis in COT v G, in terms of which it was held that a taxpayer had to be entitled to an amount in order to receive it, contained certain shortfalls. The court was incorrect to find an Act of taking could not form part of the meaning of receipt as is evident from the definition referred to.

⁷² Commissioner of Taxes v G 43 SATC 159, at 162.

⁷³ Commissioner of Taxes v G 43 SATC 159, at 163.

⁷⁴ Classen, L.G. (2007). 19 SA Mercantile Law Journal, at 551.

⁷⁵ http://www.dictionary.oed.com, visited on 12 July 2007.



The dictum in Geldenhuys v CIR which stated that an amount must be received in such circumstances that a person becomes entitled to it; may also be regarded as incorrect, if a strict linguistic approach is followed⁷⁶.

The court in COT v G appreciated that a taking by a thief could not be included as a receipt because such a taking confers no right upon such a taker (thief) and therefore it is not a receipt of gross income. It is submitted that it is no authority for determining that a receipt can only be passed between two people but it addressed how to determine the passing of rights between two people; a taker and a giver, as an example. The court based its decision on the necessity of the passing of a right where two people are concerned, and that where an individual engages in an activity, then the test for a receipt is whether he derived a right.

Under our common law a person can receive a right on an object on a unilateral taking through occupation. Occupation is defined as taking of a possession by a person of an unowned thing, such as, a corporeal nature, within the sphere of private law which is not in the ownership of any other person with the intention of becoming its owner.⁷⁷ Common law examples of things that qualify as unowned things and that are consequently susceptible to occupation among other things are wild animals, things belonging to an enemy, and things abandoned by their owners.⁷⁸

A person who discovers treasure that is unclaimed by someone else can be taxed on its monetary value by virtue of occupation if he intends to own the treasure, because occupation amounts to a transfer of real rights to the occupant. A taker can receive if he derives a right through an occupation. An interpretation of term 'received by' should be read in the context of property rights as opposed to a strict literal interpretation. The court can interpret the word 'receive' in a strict sense; however, one should bear in mind that its interpretation must be read in the context of receiving a property right. Therefore if a person takes an amount in such circumstances that he becomes entitled, then he has received. If he takes an amount in such circumstances that he infringes the property right of another, he has not received.

⁷⁶ Classen, L.G. (2007) 19 SA Mercantile Law Journal, at 551.

⁷⁷ Van der Linden Koopmans Handbook 1.2.1.

⁷⁸ Van Zyl Roman Private Law 152-154.



3.6. Illegal activities that constitute a receipt

One of the major issues in our tax law is whether illegal is taxable. The Supreme Court of Appeal held in CIR v Delagoa Bay Cigarette Ltd that, in determining whether an amount is income or not, no account must be taken of the fact that the activity involved is illegal, immoral or *ultra vires*. In other words, it is immaterial for income tax purposes whether or not the business carried on by a taxpayer is in fact illegal.⁷⁹

It is submitted that COT v G is no authority that illegal transactions are not taxable but that a right must be transferable for an amount to be taxable. In light of this it is submitted that since the broad distinguishing characteristic for a receipt is a property right, illicit gambling, drug dealing, and prostitution have no prior abuse of property rights. Whereas in the case of most forms of poaching, theft, fraud and embezzlement, there are clear prior property rights that the criminal intends to defeat by his or her actions, ⁸⁰ and such transactions do not result in the transfer of any rights to the taker.

Therefore if Person X, a drug dealer, sells 100 kg of cocaine to Y, the drug user, for R100 000, Person X is taxable because there is no unilateral act of stealing. The two parties are a consensus which transfers entitlement and therefore trigger a receipt in terms of the Income Tax Act. It is submitted that not all illegal receipts are taxable. Property rights in the form of an entitlement determine illegal proceeds that are taxable under the Act. It is submitted that the Supreme Court of Appeals decision in CIR v Delagoa Bay Cigarette Ltd was correct.

Though these submissions seem to stem from a firm foundation; however, it is submitted that illegal income should not be taxed for the simple reason that criminals have no legal or moral entitlement to the proceeds of their crimes⁸¹ because they are earned through the harm, suffering and human misery of others.⁸²

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⁷⁹ Commissioner for Inland Revenue v Delagoa Bay Cigarette 1918 TPD 391, at 394.

⁸⁰ Gupta, R, (2008). Journal of the Australian Tax Teachers Association, vol. 3 no. 2, 15.

⁸¹ Black, C.M. (2005). 20 ATF, 437.

⁸² Williams, D. (March 2002). Commonwealth Parliamentary Debates, House of Representatives 1112.



It is highly unlikely, therefore, that that illegal income is taxable because entitlement evolves from legal rights and obligations, and criminals are in breach of their obligations which they must honour in their communities and therefore do not have an entitlement to their illegal proceeds that arise from prostitution and drug trafficking.



CHAPTER 4. SUBJECTIVE INTENTION

4.1. Reference to the subjective intention of the taxpayer; foreign jurisdictions

The Income Tax legislation in the United States at one stage made specific reference to the legality of the business for purposes of determining income tax.⁸³ The Tax Act of 1913 (US) ch 16, 8II B 38 Stat 114, 167 stated the following:

'The net income of a taxable person shall include gains, profits and income... from...the transaction of any lawful business carried on for gain or profit or gains or profits and income derived from any source whatever...'

This statute was amended in 1916 to omit the term 'lawful' from the section. In interpreting the intent behind this amendment, the US Supreme Court stated the following:

'This revealed we think the obvious of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest labourer taxed and gains of the dishonest immune'.⁸⁴

The relevant amended section, as it stood in James v United States⁸⁵was section 22 of the Internal Revenue Code 1939 (US), which has been carried into the current Internal Reserve Code (US) as section 61 now reads as follows:

'Gross Income defined.

General definition; Except as otherwise provided in this subtitle, gross income means all income from whatever source derived; including (but not limited to) the following items....'.

⁸³ Black, C.K. (2005). 20 Australian Tax Forum 456.

⁸⁴ Commissioner for Inland Revenue v AKON (1990) STC 497, 506.

⁸⁵ James v US 366 US 213, 218 (1961).



The courts in the United States considered the Income Tax treatment of funds obtained through illegal acts and developed the claim of right doctrine as a basis for assessing a holder of such amounts as income. The decision of the Supreme Court in James v US⁸⁶ provides authority for this approach. The taxpayer was a Union official who embezzled funds from his employer union and an insurance company. Having not disclosed such amounts in his tax returns for the relevant years, he was convicted of tax evasion and given a custodial sentence. In a majority decision the court decided that,

'Income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition.⁸⁷

The court simply meant that a person is taxable if he regards proceeds in his control to be his, regardless of existing obligations to repay the amount. The lead opinion in James v US proceeded to develop a rule for such cases, based on a holding that the language of the Internal Revenue Code; 'all income from whatever source derived'⁸⁸ encompasses all accessions to wealth, clearly realized and over which the taxpayers have complete dominion. ⁸⁹

The legislature in the United States paved the way for the determination of taxable income by virtue of the subjective intention of the taxpayer, disregarding in clear and unambiguous fashion, the need to determine taxability of proceeds by legality or property rights. It provided a thin test that should be applied to determine income tax liability. What is only required is a claim to an amount by a taxpayer regardless of obligations to repay, and not a right to claim an amount. This is what is now known as the doctrine of 'claim of right' in the North American jurisdictions.

⁸⁶ James v US 366 US 213 (1961).

⁸⁷ James v US, 366 US 213, 219 (1961).

⁸⁸ Section 61 Internal Revenue Code.

⁸⁹ James v US, 366 US 213,219 (1961).



4.2. The doctrine of claim of right in New Zealand

The doctrine of claim of right was then adopted by the Australian High Court in A Taxpayer v CIR. 90 An accountant systematically embezzled over \$2 million from his employer, which he used to speculate in the futures market. Unfortunately his future trading was not successful and he made losses. The Commissioner assessed him on funds stolen and income from his trading activities. The court considered that in equity constructive trust arises at the time the thief commits the act that obligates him or her to account to the rightful owner of the property. This equitable remedy ensures that the thief does not acquire beneficial ownership of the property stolen. In the simple case of theft, a thief has no fiduciary duty as compared with a case of embezzlement where there is existence of fiduciary duty on the part of the embezzler which results in a constructive trust.

In reaching his decision Morris J said,

'The respondent (taxpayer) was under an obligation to return the stolen money. For the monies that he did no question of taxation arises. 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 money for his own account. He is obliged to return 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 taxpayer regarded the money as his own to use for his purposes as he chose. I therefore, conclude that the stolen monies constitute income and are assessable for income tax'.91

The court based its decision on Canadian and American decisions on the doctrine of claim of right. The doctrine of claim of right would allow the Commissioner to ignore any issues of restitution or constructive trust and to tax the funds stolen as a gain to the

⁹⁰ A Taxpayer v Commissioner for Inland Revenue 17 NZTC 12, 574.

⁹¹ Commissioner for Inland Revenue v A Taxpayer 17 NZTC 12, 574, 578.



thief. However, the Court of Appeal⁹²decided in favour of the taxpayer. The court rejected any reliance upon the North American cases. It rejected any reliance upon the economic reality of the situation, and based its decision upon the application of property and trust concepts. Referring to Arthur Murray (NSW) Pvt Ltd v COT⁹³ the majority of the court said

'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 the re-characterization or different characterization 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 the taxpayer. Taxation by economic equivalence is impermissible'. 94

A closer analysis of the Supreme Court ruling in the MP Finance v C. SARS leads one to arrive at a simple conclusion that the decision has its influences from the foreign concept of the claim of right in the Canadian and North American jurisdiction. The Australian Courts were interpreting the term 'gain' in their gross income, as opposed to the term 'received by' in the South African Income Tax Act.

However, legal rights and obligations are the basis of their tax law; the same that should apply in our Act if the term is read in its proper context. The Appeal Court in A Taxpayer v CIR held that no one would seriously contend that a sum borrowed is a taxable gain; economically the sum is a gain but it is subject to the counter balancing obligation to repay the sum which is a gain for income tax purposes.⁹⁵

⁹² Commissioner for Inland Revenue v Taxpayer (1997) 18 NZTC 13, 350 (CA).

⁹³ Arthur Murray (NSW) v Commissioner of Taxes (1965) 114 CLR 314.

⁹⁴ Commissioner for Inland Revenue v Taxpayer (1997) 18 NZTC 13, 350 (CA).

⁹⁵ A Taxpayer v Commissioner for Inland Revenue (1997) NZTC 13, 350 (CA).



Australian authorities submit that it is the passing of ownership that determines, in part, whether a receipt is taxable, as the approach in A Taxpayer confirms, and proceeds of drug trafficking, gambling can be seen to be beneficially derived by the taxpayer and thus taxable; whereas proceeds of burglary or embezzlement are not beneficially derived, as a result of constructive trust and the right of restitution, and therefore not taxable. Consequently, the application of ordinary concepts of property rights is a component in determining whether or not a taxpayer has received. It is submitted that this offers a more consistent test to determining which taxable activities give rise to taxable income.

The Appeals Court decision in A Taxpayer v CIR was met by a swift legislative amendment. In 1998, the Income Tax Act (New Zealand) was amended to include a new section, CD6, which has the effect of including as income the proceeds of certain crimes such as embezzlement and theft.⁹⁷ The new provision achieves this result by including amounts in gross income where the taxpayer has possession or control over the property and disregards any constructive trust and right of restitution. In section 106 of the Income Tax Act 1994 (NZ) CD6, gross income derives from certain property.

'The gross income of a person is deemed to include an amount equal to the market value of property the possession or control of which that person detained without claim of right.

Subsection (1) applies notwithstanding the existence of any constructive trust of which the person is the trustee...'

Amendments were also made to provide a corresponding deduction where amounts are later returned to the beneficiary.⁹⁸

Under the claims of right doctrine as developed, income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition.⁹⁹

⁹⁶ Gupta, R. (2008). Journal of the Australian Tax Teachers Association, Vol. 3 no. 2, 117.

⁹⁷ Black, C.M. (2005). Australian Tax Forum, 20, 456.

⁹⁸ Income T0061 Act 1994 (NZ) DJ 18.



It is unfortunate that the doctrine of claim of right stands as the interpretation of the term 'received by' in the South African Income Tax Act. The gross income provision is not wide enough to be interpreted by such a foreign concept. It is clear that the legislative provisions on gross income require a re-characterization that would include proceeds from embezzlement and theft. Legal rights and obligations must prevail in the interpretation of the term 'received by' in gross income.

In the absence of an amendment that introduces the doctrine of claim of right, the subjective approach must not be applied, and it is not the duty of the court to introduce the concept when statute does not expressly state its existence. Amendments in New Zealand and the United States of America's Income Acts must be adopted by Legislature in South Africa as there is a growing sentiment that a business carrying on unlawful activities should not be exempt from taxes.

⁹⁹ Wolfe, S. (1996). Recovery from Hedper: The pain from additions to tax is not the sting of punishment. Hofstra Law Review, 15, 161, 167.



CHAPTER 5. PONZI SCHEME TAX IMPLICATIONS

5.1. Tax implications for Ponzi schemes: deductions for illegal schemes

Now that illegal pyramid schemes are regarded as taxpayers under the Income Tax Act, the crucial question is whether they are entitled to a deduction under the general deduction provisions. The Appellate Division of the Supreme Court in CIR v Sub Nigel, 100 Centilivres, JA said,

'The court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act, Regard, therefore must be had to the Act and the Act alone in order to ascertain whether the deductions sought to be made are ... permissible'.

Most deductions are allowed by virtue of the so called general deduction formula sanctioned by section 11(a) of the Income Tax Act, which sets out what may be deducted, also known as the positive test, and section 23 (g) which stipulates what may not be deducted, also known as the negative test. 101

Section 11(a) of the Income Tax Act provides as follows,

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

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

100 Commissioner for Inland Revenue v Sub Nigel 1948 (4) SA 580. ¹⁰¹ Stiglingh et al. (2009). Silke, South African Income Tax Law 2009, at 7.1. General

deductions, 91.



Section 23 (g) of the Income Tax Act says that,

'No deductions shall in any case be made in respect of the following matters namely, any moneys, claimed as a deduction from income derived from trade to the extent to which such moneys were not laid out or expended for the purposes of trade'.

If a Ponzi scheme requires a deduction of expenses incurred in the production of its income, such as salaries of its employees or interest paid to the fortunate investors, it must satisfy the requirements of both sub-sections; namely that expenditure must be in the production of income and also that the scheme must have been carrying on a trade. Any expense that is a necessary concomitant to the production of income is deductible. However, the court made exceptions to this rule. Watermeyer AJP in Port Elizabeth Electric Tramway Co Ltd v CIR said,

'All expenses attached to the performance of a business operation bone fide performed for the purpose of earning income are deductible whether such expenses are necessary for the performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it...If the act done is illegal or negligent and the attended expense is occasioned by the unlawfulness or possibly the negligence of the act then probably it would not be deductible'.¹⁰²

This position was adopted in the case of Jeffe Company v CIR;¹⁰³ the case involved the deduction of legal expenses incurred by the company after its employees worked negligently. The court found out that the damages paid to a workman who had been killed when a cantilever hood that was being erected fell on him as a result of negligence on the part of the taxpayer, were not deductible. The court, however, did not find that damages arising from negligence cannot ever be deductible, but merely that in the case where there was an absence of evidence to suggest that the negligent act in question was an inevitable part of the trading operations of a reinforced concrete

¹⁰² Port Elizabeth Tramway v Commissioner for Inland Revenue 8 SATC 13, at 17.

¹⁰³ Jeffe & Co. v Commissioner for Inland Revenue 13 SATC 354.



However such a contention was clearly rejected in C. SARS v Thor engineer. Chemicals SA (Pty)¹⁰⁴ where the court held that,

'Jeffe's case is no authority that expenses are deductible only in the absence of unlawfulness and negligence'.

Unlawfulness is therefore not grounds to disallow a deduction. What is required is for a taxpayer to prove that his expenses were a necessary concomitant to the production of income, regardless of its illegality. If the payment of salaries to the employees and interests paid to the investors was a necessary concomitant to the production of illegal income, it must be deducted since the proceeds derived from the expenses are taxable. However, though a taxpayer may be entitled to a deduction on amounts included in its gross income, public policy could prevent a deduction. The courts have relied on public policy to disallow the deduction of fines imposed on criminal activities.

In ITC 1490¹⁰⁵ Melamet J said,

'... I will prefer to base my conclusion on the basis that to allow fines imposed for an infraction of the law to be deducted as an expense in terms of section 11(a) and section 23 (g) of the Income Tax Act could be contrary to public policy, in that it would frustrate the legislative intent and allow a punishment imposed to the diminished or lightened'. 106

The case was decided before section 23(o) of the Income Tax Act was enacted, which prohibits expenditure incurred in respect of lawful activities. These activities are limited to only those that deal with the prevention and combating of corrupt activities. Fines and penalties imposed as a result of unlawful activities, even if carried out in any country, may also not be deducted. 107

¹⁰⁴ Commissioner for SARS v Thor Chemicals SA 62 SATC 208.

¹⁰⁵ ITC 1490 (1990) 53 SATC 108.

¹⁰⁶ ITC 1490 (1990) 53 SATC 108, at 113-114.

¹⁰⁷ Woellener, R.H. et al. (2003). Australian Tax Law ,13th ed, 721.



Section 23 says,

'No deduction shall in any case be made in respect of the following matters namely ...

(o) Any expenditure incurred

- (i) where the payment of that expenditure or the agreement or after to make that payment constitutes an activity contemplated in chapter 2 of the Prevention and Combating of Corruption Act, 2004, Act No 12 of 2004 or
- (ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or any other country if that activity would be unlawful had it been carried out in the Republic'. ¹⁰⁸

The policy behind the enactment of this provision is that a penalty is imposed as a punishment and therefore a taxpayer should not indirectly benefit from paying a penalty by gaining a tax deduction. This was confirmed by the decision in ITC 1490. Fines and penalties are punitive but not expenses of an illegal activity. There is nothing punitive about expenditure of an illegal enterprise therefore they should be allowed to stand as a deduction.

It is uncertain whether expenses incurred for purposes of producing illegal income are deductible in South Africa but case law holds that in the case of expenses unlawfulness or negligence is not a factor that prohibits a deduction. It is highly unlikely that a court would allow deductions on an illegal scheme due to the fact that it will be tasked to make findings on whether salaries on employees and interests paid to early investors of an illegal scheme investors is a necessary concomitant of deriving income for an illegal scheme. However, if a court of law determined the liability of an illegal amount in to the fiscus, there is nothing that should hinder it to allow a corresponding deduction if the ordinary wording of the Act does not prohibit such a deduction.

¹⁰⁸ Section 23(o) Income Tax Act 58 of 1962.



Due to the lack of case law on this subject it is pertinent to understand the findings of foreign jurisdictions that may have persuasive influence with regards to deductions for illegal proceeds.

5.2. Deductions for illegal enterprises in Australia and the United States

5.2.1 Australia

The courts in Australia were faced with an unusual case whereby a taxpayer sought deductions from illegal income. In Commissioner of Taxes v La Rosa, ¹⁰⁹ the tax payer was involved in drug dealing. In 1996 he was sentenced to more than 12 years in prison after pleading guilty to charges relating to the importation and possession of heroin. ¹¹⁰ Following the taxpayer's criminal convictions, his financial affairs came to the Commissioner's attention. He had not lodged income tax returns for the seven years of income ended 30 June 1990 to 30 June 1996 inclusive. Accordingly, the Commissioner issued default notices of assessment on the taxpayer. Included in the assessable income of the taxpayer was \$220 000 that had accumulated from drug dealings and had been buried in the taxpayers backyard and later dug out for an intended drug deal in May 1995. The \$220 000 was subsequently stolen from the taxpayer during that intended drug purchase.

The Administrative Appeals Tribunal (the AAT) considered whether the taxpayer should be entitled to a deduction of the \$220 000 stolen during the intended drug purchase. The AAT characterized the losses as one incurred in the process of gaining or producing assessable income. It was lost during a robbery connected with a drug purchase operation directly connected with the taxpayer's illicit drug dealing business. The occasion of the loss was that theft of money intended to be applied in connection with the purchase of trading stock for the taxpayer's business as a dealer in drugs. It did not matter that the drug dealing business was illegal, therefore the \$220 000 was allowed as a deduction during the year ended 30 June 1995.

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¹⁰⁹ Commissioner of Taxes v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003).

¹¹⁰ La Rosa v Queen (1999) 105 A Crim R 362,363.



The Commissioner appealed the AAT's decision to allow the taxpayer to deduct the stolen funds. Nicholson J dismissed the Commissioners' grounds of appeal that deduction should only be available for legitimate activities.

He said,

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

The Commissioner also submitted that the stolen funds were not deductible on public policy grounds. The Commissioner submitted that the policy of the law is not served by allowing a deduction to the taxpayer for a payment or loss of funds in acquiring or attempting to acquire a substantial amount of prohibited drugs through a drug dealing. In particular, the commissioner relied on Mayne Nickless Ltd v Federal COT¹¹¹ which stood for the principle that the court will not allow a person to benefit from their wrong doing. Nicholson J accepted that deductions may be limited by public policy considerations. However, he held that none of the authorities relied on by the Commissioner supported the more general proposition that expenditure (other than fines and penalties) which has the requisite nexus with the business operations are unlawful and involve breaches of the criminal law.

He thus adopted a literal approach and held that the public policy argument of the Commissioner could not succeed. The Commissioner appealed the decision of the Nicholson J to the Full Federal Court and contended that the deductions should not be allowed. Again the Commissioner's main submission was that the taxpayer's loss arose from conducting illegal business activities and thus, allowing a deduction for such a loss would be contrary to the public policy.

Hely J. accepted that the Administrative Appeals Tribunal had made a correct characterization of the \$220 000 loss. Hely J. held that there were sufficient reasons

^{111 [1984]} VR 863.



between the loss and the business operations for the taxpayer. ¹¹² He accepted that the risk that losses of that type would be sustained was inherent in the activities under consideration.

Carr J concurred, and held that since illegal income had been interpreted literally, section 51(1) of the Income Tax Assessment Act for deductions also called for a literal interpretation, and as such the usual principles should be applied to allow the loss of \$220 000 as a deduction. Adopting the literal approach to statutory interpretation, Carr J acknowledged that the criminality of the occasion of the outgoing must be irrelevant.¹¹³

The Commissioner argued that the policy of the law is not served by allowing a deduction to the taxpayer under the Income Tax Assessment Act. If allowed, the deduction would be given for an outgoing or loss that is clearly or sharply prohibited by the declared criminal law. However, the court unanimously dismissed the submission on the grounds that allowing for such a deduction does not frustrate the operation of the criminal law, nor will any sanction imposed by that law be diluted by the allowance of the deduction for business expenses or losses. The court held that the policy of the law does not disentitle the taxpayer to a deduction in relation to the \$220 000.

Hely J. stated,

'The purpose of the Income Tax Assessment Act is to tax taxable income, not to punish wrongdoing. The language ss17, 25, 48 and 51, is indifferent as to whether the income, loss or outgoing in question has its source in lawful and unlawful activity...There should not be a higher burden of taxation imposed on those whose business activities are unlawful than that imposed in relation to lawful business activities. Punishment for those who engage in unlawful

¹¹² Commissioner of Taxes v Jones (2002) 117 FCR 95, 98.

¹¹³ SiskaLundi (2008). RLJ Article 7, Vol. 13, issue 1, 119-121.

¹¹⁴ Commissioner of Taxes v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003), para 48.

¹¹⁵ Per Carr J, para 8, per Hely J, para 58; Commissioner of Taxes v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003).



activities is imposed by the criminal law and not by laws in relation to income ax.

The Full Federal Court therefore rejected the taxpayer's public policy submission and allowed the deduction.

5.2.2 United States

In the United States the Internal Revenue Code s162, (similar to our Income Tax Act) allows to be deducted, all the ordinary and necessary expenses paid. The court in the case of New Colonial Ice Company v Helvering (1934) ruled that the tax deductibility of expenses depends merely on legislative grace. This legislative grace approach means that all exclusions from gross income and every deduction can be viewed as a present from Congress. Thus a deduction is precluded on a tax return unless a specific provision in the tax law allows it; therefore the rule on deductions is summarized as none unless specified.

However, while section 162 does not allow taxpayers deductions for bribes to public officials, illegal kickbacks and fines, based on the case of The Commissioner v Sullivan, all of the usual expenses incurred in the operation of an illegal business are deductible for tax purposes. Taxpayers owning an operating illegal gambling establishment incur various expenses to sustain such an activity. These expenses can include criminal fines, depreciation on equipment, illegal bribes, illegal kickbacks, interests, insurance, and pay-offs to law enforcement officials, rents, utilities and wages.

For such a business enterprise, every one of the usual expenses depreciation on equipment, rent, insurance, interest, utilities, and wages qualifies as a valid deduction. The other deductions are not permitted because section 162 does not allow taxpayer's deductions for bribes to public officials, illegal kickbacks, fines and other expenses. Section 280E¹¹⁷ provides an exception for expenses incurred in the illegal trafficking of

¹¹⁶¹¹⁶ Par 55, per Carr J, para 9; Commissioner of Taxes v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003).

¹¹⁷ United States Internal Revenue Code.



drugs. No deduction is available for drug dealers regarding necessary and ordinary expenses incurred in such commerce.

An illegal scheme could actually qualify for deduction under section 11(a) of the South African Income Tax Act if the approach by other jurisdictions is followed.

If the courts adopted a literal approach in determining the liability of an illegal enterprise to taxation on its proceeds, it should not find an absurdity by applying the same approach when considering whether these schemes should be entitled to a deduction. There should not be a higher burden of taxation imposed on those whose business activities are unlawful than that imposed in relation to lawful business activities.

Punishment for those who engage in unlawful activities is imposed by the criminal law and not by laws in relation to income tax. It must be recognized that public policy disallows a deduction only in relation to fines and penalties on criminal activities because they are punitive, and that in no way includes any other expenditure that produces illegal income because they are not punitive expenses payable to the State.

5.3. For the purpose of trade, section 23 (g)

The negative portion of the so called 'general deduction formula' contained in section 23 (g) prohibits as a deduction 'any monies' claimed as a deduction from income derived from trade, to the extent to which such monies were laid out or expended wholly or exclusively for the purposes of trade. As already pointed out, section 23 (g) must be read together with section 11 (a) when the deductibility of an amount is being ascertained. Expenditure incurred that is referred to in section 11 (a) may be claimed as a deduction only against income as defined from the carrying of any trade. Whether a taxpayer is or is not carrying on any trade is a question of law to be decided on the facts of each case.

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¹¹⁸ Par 55 per Carr J, Para 9; Commissioner of Taxes v La Rosa (2002) 50 ATR 450, [2003] FCAFC (5 June 2003).

¹¹⁹ ITC 1490 (1990) 53 SATC 108.

¹²⁰ De Koker, A.P. (2010). Silke: South African Income Tax, par 7.10C, General deduction formula.



In Burgess v CIR¹²¹ the principles that the definition of trade should be given a wide interpretation was described as well established. It was also pointed out that the definition is not necessarily exhaustive.

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 $^{^{\}rm 121}$ Burgess v Commissioner of Inland Revenue 1993 4 SA 161.



According to Stiglingh et al., (2009), 122

What the Act requires before a section 11(a) deduction can be claimed is the carrying on of a trade. To fulfil this requirement the principle features of the specific trade that will have to be examined for example, is there continuity of the activities? If so the trade way be said to be carrying on the trade. Is the long term objective of the trade to generate a profit? If so such trade may constitute the carrying on of a trade¹²³ the principle of continuity may result in the denial of deductions against rental income earned from a single residential property.¹²⁴

In spite of its wide meaning, the term 'trade' does not include all activities that might produce income; for example in the form of interest, dividends, and annuities or pensions; what is called passive income.¹²⁵ Carrying on of a trade involves an 'active step'; that means something more than watching existing investments that are not income producing and are not intended or expected to be so.¹²⁶ The mere retention of investments, even if acquired when a trade was carried out, does not imply a continuance of trade.

It seems therefore that as long as there is continuity in a business with the intent to earn income, it would be sufficient for a trade to be established as long as income is active not passive. Amounts derived by a Ponzi scheme are not passive since they are usually successively created entities, have cleverly constructed, convincing looking documentation, and agents that solicit investors. It is uncertain whether an illegal business would qualify as a trade under South African law. But the starting point must be the definition of a trade under section 1 of the Act.

The term trade has a very wide meaning:

¹²⁵ Supra fn. 121

¹²² Stiglingh et al. (2009) Silke: South African Income Tax, at 92.

¹²³ ITC 1529 (54 SATC) 252.

¹²⁴ Supra fn. 121.

¹²⁶ ITC 1476 (1989) 52 SATC 141.



'every profession, trade, business, employment, calling, occupation or routine including the letting of any property and the use of and the granting of permission to use any Patent as defined in the Patent Act or any design as defined in the Designs Act or any other property which is of the similar nature.'

The definition of trade includes a business and it is necessary to understand how other jurisdictions have defined it. In the New Zealand and Australian Courts, Richardson J in Grieve v CIR¹²⁷ said.

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

It may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those which are characteristic of ordinary trade in the line of business in which the venture was conducted. However in the end it is the character and the circumstances of the particular venture which are crucial. Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably or because the taxpayer derived personal satisfaction from the venture nor because that business is illegal'.¹²⁸

If the above approach by the Australian and New Zealand Courts is adopted, an illegal enterprise qualifies as a business which is sufficient to constitute a trade under South African law because a business is a Trade under section 1 of the Act.

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¹²⁷ Grieve v Commissioner for Inland Revenue 1984 6 NZTC 61, 682.

¹²⁸ Grieve v Commissioner for Inland Revenue 1984 6 NZTC 61, 682, 1,691.



In the United Kingdom, the tax legislation is based upon taxation of the profits of trade and in determining whether an illegal business constitutes a trade, Lord Denning¹²⁹said,

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

The above judgment is self-contradictory. It recognizes that legality is not an essential characteristic of a trade, but denies that burglary is not a trade even though all the characters of a trade are present. If illegality does not detract from an adventure to be a trade then what factor hinders burglary form constituting a trade apart from illegality? It is as much as determining that a group of sportspersons venturing in football activities have all the essential characteristics of engaging in a trade, however they cannot be regarded as engaging in a trade but engaging in football. If all the essential characteristics of a trade are present, the adventure should therefore stand as a trade. The negativity of the adventure, i.e. its illegal nature, affected the courts determination yet it had clearly denied that a trade could be affected by its illegality.

It should be noted, however, that in Britain that not all illegal activities are disregarded as a trade. As long as there are legal parallels to illegal activity, then the illegal activity constitutes a trade. Theft is, of its very nature, illegal, and would never be considered a trade, whereas some illegal activities such as reselling of stolen gems ¹³¹ or the selling of liquor could be pursued legitimately.

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¹²⁹ Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd 1963 AC 1020.

¹³⁰ Gupta, R. (2005) Journal of the Australian Tax Teachers Association, vol. 3 No. 2, 105.

¹³¹ Lindsay v IR Comms [1932] 18 TC 43.



By this approach illegality goes to the root of the transaction; that it is incapable of being a trade under any circumstances whatsoever, whereas in the example of reselling stolen gems, the illegality may only be an incident of trade, leaving out any consideration of contravention of law.¹³² A legitimate parallel trade, in essence, requires the identification of a parallel legal activity to which the illegal one can be compared to determine assessability; an example is given by Lord Sandson regarding drug trafficking, saying,

'Trafficking in drugs for example is of the nature of trade albeit such trafficking may in circumstances be illegal.' 133

Because there is a legal activity of drug sales, profits from illegal drug dealing can be assessed. Therefore the test of incidental illegality is to identify a similar or identical legal business. If this can be done, the activity is a taxable trade. The test requires that there be a legal parallel that performs a business similar to that of the illegal enterprise. If a person sells stolen gems he is regarded as running a trading operation because there are legal parallels in the form of licensed jewellery shops. The fact that the jewels were stolen does not detract the illegal activity from being classified as a trade.

A Ponzi scheme could qualify if this approach is adopted because there are forms of legal parallels that solicit funds from the public for purposes of investment. The definition of trade uses the word 'EVERY.' This wording is critical; it could mean that anything with the attributes of a trade or business or profession, regardless of illegality, is a trade under the Income Tax Act. Therefore, if illegality does not affect an adventure to be regarded as a 'profession, trade, business, employment, occupation or routine', then a pyramid scheme should be regarded as a trade.

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¹³² Day, K. (1971). The Tax consequences of illegal of trading. British Tax Review, 104, 108.

¹³³ Lindsay v IR Comm [1932] TC 43.

¹³⁴ Gupta, R. (2005). Journal of the Australian Tax Teachers Association. Vol. 3, No. 2, 112.



A fraudulent investment scheme in South Africa could qualify as a trade if the British approach that determines legal parallels is adopted. If the principles that have been laid out to determine a Trade in South Africa are to be followed then what is required among other things is proof that the scheme is active and not passive and that there is continuity. The Australian courts determined that illegality is not a basis for disregarding an illegal activity as a business, and therefore Ponzi schemes should qualify for a deduction provision, positive test and the negative test, in terms of section 23(g).



CHAPTER 6. TREATMENT OF PONZI INVESTORS

6.1. Ponzi scheme investors

A fraudulent scheme is a set up to steal money from the public. The scheme company receives and retains the funds of investors who believe they are investing in a profitable business structure. The scheme company initially makes payments to earlier investors to make the illusion of solvency. The capital raised from new investors is used to pay purported profits and redemption payments to investors. The purported profits are thus all fictitious. Many of the investors re-invest the purported profits and redemption payments received from the scheme company.

Investors of illegal schemes are deemed to have received funds in the form of interest promised by the investment scheme, which in most cases they reinvest. Even though these profits are fictitious, the Supreme Court of Appeal in the MP Finance case has placed a heavy burden on the investors of these schemes because, in addition to the loss suffered from the fraudulent scheme, the investor is now adversely affected by the income tax payable by the scheme for the amount received from the investors¹³⁷ which reduces any amount that may be recoverable and refundable to them. Some of the early investors do recover their principal investment, together with the purported profits promised by the promoter. These investors are faced with the prospect of having to repay the purported profits to the liquidators of the scheme company.¹³⁸

In the AFI Holding Inc¹³⁹ case, an investor had received profits from an investment scheme. The Trustee commenced adversary proceedings against 170 of the scheme's investors to avoid transfers made to them by the scheme.

¹³⁵ Van Doesten, J. (2010). Tax Implication of Ponzi Schemes. The Taxpayer, Jan issue, 6.

¹³⁶ *Ibid*.

¹³⁷ Supra fn. 9.

¹³⁸ Supra fn. 144.

¹³⁹ Case No. 06-55070 and 06-55070, US Court of Appeals, Ninth Circuit, 16 April 2008.



When a Ponzi scheme collapses, the remaining investors lose all, or a substantial portion, of their capital investment. The question that arises is whether such losses qualify for a deduction. In terms of section 11 (a), read together with section 23(g) of the Income Tax Act, expenditure and losses actually incurred in the production of income are deductible provided they are not of the capital nature.

In order for an investor to be entitled to a deduction, the expenditure relating to such investments must form part of the carrying on of a trade, as required by section 23 (g) of the Income Tax Act. Income from these investments arises in the form of interest, and any losses that may arise can only be deducted if the investment is revenue and not of a capital nature. What must be determined is whether the capital lost by an investor is fixed or floating capital. In the case of CIR v George Forest Timber Co, ¹⁴⁰Innes CJ said,

'Capital, it shall be remembered may be either be fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not though it produces fresh wealth it remains intact'.

Whether the amount invested in an illegal scheme is in fixed or floating capital is factual. Similar issues arose in respect of loan transactions in Stone v SIR.¹⁴¹ The taxpayer was a victim of a confident trickster named Kasmai, who was highly thought of and was reputed to be a man of means who made money in the business world. Kasmai approached the taxpayer with a request of financial assistance and produced two contracts which accorded him the right to supply boiler suits and overalls. The taxpayer was promised 20% of the sums loaned. It subsequently transpired that Kasmai perpetrated a fraud and the contracts were forgeries and the taxpayer lost all amounts. In delivering the judgement Colbett AJA said,

'Applying the distinction thus described to the ordinary case of a loan of money, there is no doubt in my opinion that the capital lent constitutes fixed capital. Such capital is not consumed in the very process of income production.

¹⁴⁰ Commissioner for Inland Revenue v George Forest Timber Co. 1924 AD 516, at 524.

¹⁴¹ Stone v Secretary for Inland Revenue 1974 (3) SA 584.



It does not disappear to be replaced by something which when received by the taxpayer forms part of his income. It is true that the lender does not retain ownership in the actual money which passes but in an economic and accounting sense, it remains his capital upon the termination of the loan, it returns to him intact. In the process wealth may be produced for the lender but this takes the form of a consideration usually in the form of interest paid by the borrower for the use of the capital. It does not consist of the augmented proceeds of the capital which itself has disappeared in the process. ¹⁴²

The taxpayer argued that the loan was a revenue loss because it was incurred as part of a profit making scheme. The court dismissed this contention and held that,

'In essence the share of profit is simply a remuneration paid by the borrower for the use of the capital lent. The transaction was in no sense a partnership nor did the appellant (taxpayer) regard it as such. The remuneration was fixed with reference not to the size of the profit but to the amount of the capital advanced'. 143

According to van Dorsten,¹⁴⁴ the reasons for the decision of the Stones case are applicable where capital losses suffered by investors in Ponzi scheme are concerned. The following considerations lead to the conclusion that the capital invested by the investors is in the nature of fixed capital.

- (a). The investment capital is not consumed in the very process of income production and it does not appear to be replaced by something which when received forms part of the investor's income. Before the scheme collapses the capital is returned intact to the investors on the redemption dates.
- (b). The fact that investors are promised a share of the profits to be derived from the transaction which their capital was allegedly designed to finance does not change their investments into profit making schemes.

¹⁴² Stone v Secretary for Inland Revenue 1974 (3) SA 584, at 594-595.

¹⁴³ Stone v Secretary for Inland Revenue 1974 SA 584, at 597.

¹⁴⁴ Van Doesten, J. (2010). The Taxpayer, 6.



The manner in which the profits are made determines whether the scheme is a profit making one, where Ponzi scheme are concerned there are no business operations that make profit. Fictitious profits are made to early investors out of the capital contributed by new investors.

(c). The relationship between the investors and the scheme company cannot be regarded as a partnership. The essentiality of a partnership is that

Each of the partners brings something into the partnership whether it may be money, labour or skill.

The business should be carried on for the joint benefit of the parties.

The objective should be to make profit and

The contract between the parties should be a legitimate one. It is obvious that these essentials are not present in the agreement between the scheme company and the investors of a Ponzi scheme. There has to be a nexus between the investment and the management of the business in order to claim the deduction against the income generated by the taxpayer.145

(d). In order for the investors capital to be regarded as floating or circulating capital it must be made available in the course of a money lending business. In other words the investor must be a money lender, a money lender who was described in Sentra-Oes Kooperatief Bpk v Commissioner for Inland Revenue

'One whose business is lending money at interest, both a bank and a money lender are in the business of dealing in money as their stock in trade'. 146

The Court in Solar Glass Finance Co v CIR¹⁴⁷ determined the circumstances in which losses and expenses on interest can be deducted.

¹⁴⁵ ITC 1814 68 SATC 297.

¹⁴⁶ Sentra-Oes Koopertief v Secretary for Inland Revenue 1995 (3) SA 197, at 209.

¹⁴⁷ Solar Glass Finance v Commissioner for Inland Revenue 1991 (2) SA 257.



The court held that in determining whether losses are of a revenue or capital nature, where the taxpayer's income consisted exclusively of interest earned on monies lent by it in the course of its activities and losses are clearly incurred in the production of such income. If the taxpayer can clearly show that he has been carrying out a business of a money lender or banker, losses incurred as a result of the loans made by him in the course of such business becoming irrecoverable constitute losses of a non-capital nature and are accordingly deductible.

In ITC 1814¹⁴⁸ the question before the court was whether the amount invested had been incurred in the production of income or whether it was of a capital nature. The taxpayer had invested money into a micro lending business, and in addition, had provided a loan to a trust. The court ruled that the taxpayer did not incur the loss in the pursuit of a micro lending business, but the said loss was of a capital nature as his loan did not make him a micro lender, just as a person who invests money in a bank does not become a banker. Moreover, the taxpayer did not in any way become involved in the management and he had no control or say in how his money would be utilized in the business.

There must be a nexus between the investment and the management of the business in order to claim the deduction against the income generated by the taxpayer. Whether or not a taxpayer was carrying out business of a moneylender or banker is in each case a question of fact to be decided in the light of the circumstances of the particular case. Natural persons who make financial investments are adversely affected because of the difficulties of complying with the requirement to be in the business of lending money. It is even more difficult for any investor to prove that they were in partnership with the Ponzi scheme because there are certain requirements that they will have to prove. Furthermore, investors of Ponzi schemes are never part of management of these schemes; neither do they have control or say on how their investments should be utilised.

¹⁴⁸ ITC 1814 68 SATC 297.

¹⁴⁹ Supra fn. 9.

¹⁵⁰ *Ibid*



Capital invested by the investor in the Ponzi scheme is in the nature of fixed capital unless the investor is in the business of money lending. When the scheme collapses and the capital becomes irrecoverable, the losses suffered by the investors who are not money lenders are capital in nature and do not qualify for deductions under section 11 (a) of the Act.

The early investors in the Ponzi scheme who receive and then reinvest purported profits before the scheme collapses will be faced with the situation where they have to pay tax on the amount of purported profits received by them, but will not be allowed to deduct the loss suffered in respect of the reinvested capital. Where purported profits are reinvested as capital, and this capital becomes irrecoverable, the reinvested amount cannot be deducted as a bad debt in relation to the income previously received. Bad debts may be deducted if they are due to the taxpayer, are, or were, included in the taxpayer's income for the previous year of assessment, and have become bad during the year of assessment; therefore a reinvested amount is not a debt due to the investor; it becomes a fixed capital amount and does not qualify for a deduction.

6.2. Treatment of victims of Ponzi schemes in the United States and Australia

6.2.1 United States Approach¹⁵³

The Internal Revenue Service (IRS) published an internal revenue procedure 2009-20 during April 2008. The procedure provides an optional safe harbour treatment for taxpayers that are qualified investors affected by fraudulent schemes. Victims of Ponzi schemes are allowed to deduct losses from Ponzi schemes and similar frauds and losses.

¹⁵¹ Van Doesten, J. (2010). The Taxpayer, 11.

¹⁵² Section 11 of the Income Tax Act & Commissioner Inland Revenue v Peoples Stores 1990(2) 353, at 366.

¹⁵³ Internal Revenue Procedure 2009-2010 USA.



The revenue procedure provides two simplifying assumptions of theft loss and prospect of recovery that taxpayers may utilize to report their investment losses.

First, the revenue procedure provides that the Internal Revenue Service will deem the loss to be the result of theft if the promoter was charged with fraud or embezzlement and there is some evidence of an admission of guilt or a trustee has been appointed to freeze the assets of the scheme. Second, the prospect of recovery limits the amount of the investor's theft or deduction. This revenue procedure provides an optional safe harbour to permit taxpayers to deduct the loss in the year of discovery by deducting 95% of the net investment reduced by the amount of any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance.

A special rule applies to investors that pursue legal recourse against persons other than the promoter, such as the accountant or investment advisers. These investors will compute their deduction under the safe harbour approach by substituting in the formula 75% for the 95%. If future recoveries differ from the loss claimed in the year of discovery, then the qualified investor would have income or additional deductions in the later year. A qualified investor is a United States citizen or resident that generally qualifies to deduct theft losses and did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public. It does not include a person that invested solely in a fund or other entity that invested in the specified fraudulent arrangement. However, the fraud or entity may be a qualified investor within the scope of the procedure. The qualified investors can deduct under code section 165 (c) (3) of the Internal Revenue Code.¹⁵⁴

6.2.2 Australian approach

In Australia investors are provided for the deduction of theft losses under their Income Tax Assessment Act of 1997. Division 25 of the Act sets out some amounts that a taxpayer can deduct.

Sections 24-25 deals with loss by theft and other means, section 24-25 provides that a taxpayer can deduct a loss in respect of money if,

¹⁵⁴ Keebler, R.S. (2007).. Maddoff and other fraudulent schemes; Tax and Planning Implications. CC Whitepaper.

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- (i). The taxpayer discovers the loss in the income year;
- (ii). The loss was caused by theft, stealing, embezzlement, larceny, defalcation or misappropriation by the taxpayer's employee or agent; and
- (iii) The money was included in the tax payer's assessable income for the income year or for an earlier income year.

In Lean v COT¹⁵⁵ the Appeal Court considered the effect of the misappropriation of a substantial sum of money belonging to the taxpayer who sold shares in the USA and transferred the proceeds to a bank in Hong Kong as instructed by his agent. The taxpayer intended to invest the amounts. The question before the court was whether the money in respect of which the taxpayer had incurred a loss, being the money that was transferred to Hong Kong and misappropriated, was money that was included in the assessable income of the taxpayer. The court held that in order to satisfy section 24-25, the money that was included in the taxpayer's assessable income and a subsequent misappropriation.¹⁵⁶ The court held that the money was not included in the assessable income by the taxpayer and it was not the amount misappropriated from the account of the taxpayer and was therefore not deductible.

Other jurisdictions have seen the need to allow deductions to unfortunate investors of fraudulent schemes. In South Africa the Income Tax Act does not provide these deductions. SARS does not feel much empathy towards these investors and this has been the outcome in a number of court cases. ¹⁵⁷ Investors are therefore liable for income tax where he or she receives an amount in excess of his contribution, even if the amount has to be repaid to the liquidator. The Legislature should therefore adopt the approach, either of that of the United States or Australia, to entitle unwary investors a deduction for losses incurred with their investment in order to address the unforeseen and unfortunate circumstances of the investors, especially those who do not qualify as money lenders.

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¹⁵⁵ Lean v Commissioner for Taxes 2010 FCAFC 1.

¹⁵⁶ Lean v Commissioner for Taxes 2010 FCAFC 1, para 20.

¹⁵⁷ Supra fn. 12.



CHAPTER 7. CONCLUSION

To be taxed, fraudulently earned receipts must fall within the ambit of the definition of gross income in section 1 of the Income Tax Act. Receipts from fraudulent transactions comply with most of the requirements of the definition, except possibly for the requirement that an amount must be received within the meaning of this word as used in the definition.¹⁵⁸

An overview of the interpretation of the term 'received by' revealed that when proceeds from legal transactions were determined by the court, they agreed that legal rights and obligation was the yardstick to prove tax liability. This approach was only reversed when the courts were faced with proceeds from an illegal activity, and applied the literal rule with reference to the subjective intention of the taxpayer. The courts were, however, not unanimous; the subjective approach was constantly challenged by those who favoured the objective approach. These courts believed that the wording of the Act did not provide for taxation of stolen amounts and rejected the subjective approach. Since the law of tax is a creature of statute, interpretation of the provisions of the Act is determined by the rules of statutory interpretation. These rules are important in understanding how the literal rule and the subjective intention of a taxpayer are related.

When interpreting a statute, the literal rule is the starting point to arrive at the objective of the Legislature by ascertaining the true meaning of the language employed by Parliament. Where the ordinary wording of a statute leads to an absurdity, then the court must interpret the words in line with the context of the provision. If absurdities are still present, the literal rule will be departed from and the purposive rule will come in to effect.

¹⁵⁸ Warneke, D. (2003). Fraudulent Transactions: Are the Receipts Taxable? Tax Planning, 17, 26.



This predominantly ascertains the true intention of the Legislature. The Supreme Court of Appeal in the MP Finance case professed that it applied its decision through the literal rule. An analysis of the literal rule shows that it focuses on the ordinary wording by applying aids such as a dictionary or by looking at the context of the wording to arrive at the true intention of the legislature.

A literal rule does not involve a subjective approach. The subjective interpretation does not interpret a word but rather interprets the mind of a person. This concept is a common law principle that establishes wrongfulness on an act in criminal law and delict. The subjective approach is useful in determining fault, liability and guilt, but does not apply in determining tax liability. In essence, the court in the MP Finance case applied a principle that establishes guilt and wrongfulness under criminal law and applied the concept in taxation because it is punitive and vindictive. In tax this principle is only acceptable when determining impermissible tax avoidance and tax evasion because there is an element of wrongfulness that has to be established. The definition of gross income is not determined by wrongfulness, but by what the ordinary wording of the Act says.

One of the reasons why the court could have adopted this approach is to ensure equity in taxation. That is, an honest, law abiding citizen should not bear the tax burden whilst a dishonest income earner benefits from his ill-gotten gains by escaping taxation. The courts in South Africa ruled that there is no equity in tax, presumptions or implications¹⁵⁹ but only the language of the Act must determine the true position. The subjective approach is foreign in the interpretation of statutes and there is no reason why the interpretation of a fiscal statute should be subjected to special treatment which is not applicable to other legislation.¹⁶⁰

If the courts were faced with an ambiguity, according to the rules of statutory interpretation, they must seek an answer by interpreting a word in its context. If that fails, then the Purposive must be employed, rather than creating a concept specifically for a purpose of engulfing preconceived notions that are otherwise not supported by the Act. There are clear rules and aids in the interpretation of a statute, and

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¹⁵⁹ Cape Brandy Syndicate IR Comrs, 12 TC, 358. [1921] 1 KB 64, at 71.

¹⁶⁰ Glen Anil Development v Secretary for Inland Revenue (1975) 37 SATC 319, at 334.



interpretation by reference to a subjective interpretation is not among any of the existing methods. Public policy should not be employed by rules of statutory interpretation but should be incorporated in a Taxing Act through a Legislative amendment.

The court in Geldenhuys v CIR recognised that a strict interpretation of the ordinary wording of the term 'received by' would subject any receipt under the Act, even where it is clear that a person acting in a fiduciary capacity does not 'receive' when acting on behalf of his principal. The literal rule accepts that words must be interpreted in their context¹⁶¹. A word can only be clear and unambiguous after taking in to account the context in which it is used. It is therefore not enough to interpret the word 'received' in a strict sense without considering that which must be received under the Income Tax Act. The taxpayer is liable for tax when he receives an amount. An amount was determined as not only money, but also the value of every form of property right¹⁶² and also rights of a non-capital nature.¹⁶³ An amount is a property right, and in interpreting the term 'received by' in its proper context, property law should be applied in the form of legal rights and obligations.

The relationship between an accrual and receipt enlightens one as to what the Legislature intended when it enacted the charging section, i.e. definition of gross income. An accrual involves an entitlement without possession to an amount, whilst on a receipt there has to be a physical control or possession of an amount, coupled with an entitlement. The difference between an accrual and receipt is determined by the existence or absence of a possession. The position therefore is that there has to be an entitlement for a person to be liable under the Act.

This answers the question as to whether a person can receive an amount that does not accrue. An accrual is a performance of an obligation that gives a taxpayer the right to claim an amount. Where an employee receives a salary before he earns it he derives no entitlement to the amount because he has not yet performed his obligation.

¹⁶² Lategan v Commissioner for Inland Revenue 1926 CPD 203, at 208-209.

¹⁶¹ Lonhro v Salisbury Municipality 1970 4 SA 1, at 4.

¹⁶³ Cactus Investments v Commissioner for Inland Revenue 1999 (1) SA 315.



The laws of advanced payments hold that where a person holds an amount and there is no existing legal obligation, he has received. Impliedly the Court meant that once an obligation exists that has to be performed by the holder of the amount, he has not yet received at that point until all obligations have been performed that which gives the right to a claim of the amount. A person cannot receive an amount that does not accrue, that is an amount that does not give rise to a right to claim. Unless and until he accrues the amount, that is, when he performs his obligations, then he becomes entitled and has a right to claim an amount.

The courts have ruled that a unilateral taking such as theft confers no right upon the taker. In other words, they said he takes; he does not receive. The Oxford dictionary has added the word 'take' to describe a receipt. If a strict interpretation of the term 'receipt' is to be adopted, 'a taking' would amount to a receipt and a thief would be taxable. However, in view of the fact that the term 'received by' must be read in its context, even if a strict application of the term is applied, there must be a transfer of a right to the taker. If the taker infringes the property right of another, then there is no receipt because no rights have passed to the taker. An amount is a property right and rights cannot be transferred to a thief because it is an infringement of property rights of another.

The common law does provide an instance where a right is passed by a unilateral taking through occupation. Occupation takes place only if the taker takes an unowned thing with the intention of becoming its owner. If a person finds an unowned or unclaimed property interest, then rights are transferable and tax liability arises.

The Zimbabwean case, COT v G, reveals that only a receipt that transfers rights results in tax liability. It is silent on whether a right could be passed on illegal acts such as prostitution, illegal gambling and drug dealing. The Supreme Court in CIR v Delagoa Bay Cigarette ruled that the source of income whether legal or illegal is immaterial. There is a submission that illegal activities that do not traverse the property rights of others, such as illegal gambling, drug dealing and prostitution which are taxable under the Income Tax Act, whilst poaching, theft, fraud and embezzlement do not result in the

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¹⁶⁴ Commissioner of Taxes v G 43 SATC 159, at 162.

¹⁶⁵ www.dictionary.oed.com, accessed 12 July 2007.



transfer a right but are forms of infringements of proprietary interests. The submission is questionable because a criminal derives no legal or moral entitlement to the proceeds of crime. No legal rights can be passed in a drug deal, prostitution or illegal gambling.

The interpretation of the term 'received by' with reference to a subjective intention of taxpayer in the MP Finance group CC case is a clear adoption of the foreign concept; i.e. the doctrine of the claim of right which was formulated in the United States. ¹⁶⁶ The claim of right simply creates liability for a taxpayer who claims a right on a possession of an amount and does not focus on whether there is in fact a right to the amount. The doctrine was established as a result of an amendment that disregarded legality of a receipt by a taxpayer in the United States. This approach was clearly rejected by the New Zealand Appeals Court that ruled that in determining a taxable gain, the application of ordinary concepts of property rights should be considered. If a taxpayer receives with a counter balancing obligation to repay, he should not be taxed on such amounts. In the absence of a specific statutory provision allowing an amendment that fosters a claim of a right to be the determining test for a receipt for tax purposes, legal rights and obligations will not be ignored. ¹⁶⁷

The Supreme Court in the MP Finance case should not have adopted the foreign approach of a subjective test in determining liability. Reference to a subjective intention is not the proper interpretation of the term 'received by' in South Africa because this approach was formulated in the United States of America after legislative reform that shifted from legal rights, and as evidenced by the Appeals Court in New Zealand by the Appeals Court, such an approach is vindictive if applied without legislative reforms that harbour its existence.

The decision in the MP Finance case determined that pyramid schemes are taxpayers under the Income Tax Act; therefore the crucial question is whether pyramid schemes are entitled to a deduction. Regard must be had to the Act in order to determine permissible deductions to the language used in the Act.

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¹⁶⁶ James v US, 366 US 213.

¹⁶⁷ A Taxpayer v CIR (1997) 18 NZTC 13,350.



It is not enough to qualify for a section 11(a) general deduction, but also the section 23(g) trade requirement. The courts have determined that a *bona fide* expense that is a necessary concomitant to the production of income is deductible under section 11(a).¹⁶⁸ A pyramid scheme should only show that the expenses it incurred, no matter how devious they may be, where necessary to the production of their fraudulently earned income.

The courts in South Africa have prohibited certain deductions, such as fines imposed on criminal activities on the grounds of public policy. The Appeals Tribunal in Australia has determined that if a court adopts a strict, literal interpretation in determining a receipt on a taxpayer, then it should adopt the same approach in determining whether an illegal enterprise is entitled to a deduction. Criminality of an enterprise is irrelevant in the determination of a deduction under the Act. There should not be a higher tax burden by refusing a deduction to be imposed on those business activities that are unlawful than that imposed in relation to lawful business activities, and punishment for those who engage in unlawful activities is imposed by criminal law and public policy has no role unless specifically stated. Furthermore, fines and penalties are prohibited by public policy because a person cannot benefit from his punishment by deducting it as an expense. It must be understood that an expense is not a punitive expenditure such as a fine and should not be disallowed by public policy.

Before a section 11(a) deduction can be claimed, an illegal enterprise must satisfy the requirement that it carries on a trade under section 23(g) of the Income Tax Act. A Trade is defined under section 1 of the Act as

'EVERY, profession, trade, business, employment, calling, occupation or routine including the letting of any property and the use of, and the granting of permission to use any Patent as defined in the Patent Act or any design as defined in the Designs Act or any other which is of a similar nature.'

In South Africa, the courts have not yet determined whether an illegal business constitutes a trade.

¹⁶⁸ Port Elizabeth Electric Tramway Co. v CIR 1936 CPD 241, at 246-247.



However, the New Zealand and Australian Courts have held that businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, nor because that business is illegal.¹⁶⁹ Therefore, if this approach is adopted in South Africa, then pyramid scheme will qualify as a trade.

In the United Kingdom, an illegal activity could fall under a trade if there are legal parallels to the illegal activity. By this approach, illegality goes to the root of the transactions that are incapable of being a trade. Trafficking in drugs may in circumstances be illegal but because there is a legal activity in drug sales, trafficking is regarded as a trade. Theft or burglary would never be considered as these ventures have no legal parallels. So if any of these approaches are adopted, pyramid schemes could be described as a trade.

Income of a pyramid scheme is not passive. It derives active income through the active steps of creating convincing documentation and the hiring of individuals that solicit clients. There is degree of continuity¹⁷⁰ until the scheme collapses over a number of years, and therefore these schemes must receive a deduction, regardless of its illegality. The definition of trade uses the word 'EVERY'. This wording is critical as it could mean that anything with the attributes of a trade, business or profession, regardless of illegality, is a trade under the Income Tax Act. Therefore if illegality does not affect an adventure to be regarded as a 'profession, trade, business, employment, occupation or routine' then a pyramid scheme is a trade.

Investors of pyramid schemes are the most affected. In view of the fact that these investors receive fictitious interests that, in most cases, they reinvest, they are deemed to have accrued in the form of interest promised by the Investment scheme. In addition, the investor is affected by the Income Tax payable by the scheme for the amount received from the investors, which reduces any amounts that may be recovered or be refundable by the scheme to the investor. Under section 11(a) of the Income Tax Act, the investor must prove that his expenditure is of revenue, and not a capital nature.

¹⁶⁹ Grieve v CIR 1984 6 NZTC 61, 682, at 61, 691.

¹⁷⁰ ITC 1476 (1989) 52 SATC 141.



In determining whether an amount is floating or fixed capital, capital lent constitutes fixed capital because it is not consumed in the very nature process of income production. Capital lent can be deducted if the investor carries out business as a money lender, banker, or that he was involved in the management and he had no control or say in how their money was utilized in the business. Investors that do not carry on business as bankers or money lenders, especially, natural persons do not qualify for this deduction because they cannot satisfy the requirements.

Furthermore, investors who reinvest purported profits cannot deduct those amounts as bad debts because reinvesting these amounts is tantamount to a receipt due to the act of reinvestment that amounts to a control of the amount even though they are fictitious. Bad debts can only be deducted if income was due but not received, and they have become bad during the year of assessment and a reinvested amount is not due to the investor. There is a need to amend the Income Tax Act to assist innocent investors of fraudulent schemes who are taxed on an accrual of fictitious interests promised by a scheme to qualify for a deduction, as is provided for in Australia¹⁷¹ and the United States of America.¹⁷²

¹⁷¹ Section 24-25 Australian Income Tax Assessment Act (1997).

¹⁷² Section 165(c) 3 of the Internal Revenue Code.



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Word count: 24 160.