

**A COMPARATIVE STUDY AND ANALYSIS OF THE  
TAXABILITY OF ILLEGAL INCOME IN SOUTH AFRICA  
AND UNITED STATES OF AMERICA**

**BY**

**OLUBUNMI MORENIKE OGUNSANWO**

**(25460171)**

**Submitted in partial fulfilment of the requirement  
for the degree of  
Master's in Tax Law**

**at the**

**University of Pretoria**

**Supervisor: Advocate Louw**

**October 2013**

## DECLARATION

---

I, OlubunmiMorenike Ogunsanwo, declare that the work presented in this study is original. It has never been presented by me to any other University or Institution for a degree. Where other people's works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the degree in LLM in Tax Law.

Signed.....

Date.....

Supervisor: Advocate Louw

Signature.....

Date.....

## DEDICATION

---

I dedicate this work to God Almighty for giving me the grace and strength to complete this programme.

It is also dedicated to my humble husband, Dr Olaoluwa Onabanjo Ogunsanwo for your love, support and encouragement, and to my two beautiful princesses, Temmy and Tommy. I love you all.

I also dedicate this work to Pastor & Mrs Femi Ali, for their continuous moral & spiritual support and encouragement, May God bless you.

Although the journey has been a long and stressful one, it was one that was worth taking.

## ACKNOWLEDGMENTS

---

First and foremost I would like to thank my Creator, the Almighty God, for giving me the strength to undertake this project. Without His blessings, this work would never have seen the light of day.

Secondly, among countless people who contributed in various ways to the existence of this work, the following deserve special mention:

- I owe a special gratitude to my supervisor for his patience in guiding me and providing me with constructive ideas.
- To my husband Ola, for encouraging me to study law as well as for believing in me.
- To my mom for everything that she has done for me and my siblings - may you enjoy the fruits of your labour and may all your hard work never be in vain.
- To Wunmi, Toyin, Folake and others (too many to mention), thanks and God bless you.

I also thank the library staff at the University of Pretoria (Hatfield Campus), especially Ms Liana Viljoen, for her effortless assistance in assisting me in conducting my research. May God bless you all.

# TABLE OF CONTENTS

---

<b>DECLARATION .....</b>	<b>ii</b>
<b>DEDICATION.....</b>	<b>iii</b>
<b>ACKNOWLEDGMENTS .....</b>	<b>iv</b>
<b>ABBREVIATIONS .....</b>	<b>vii</b>
<b>CHAPTER 1. THE JUSTIFICATION AND RATIONALE BEHIND THE TAXATION OF ILLEGAL INCOME.....</b>	<b>1</b>
1.1. Introduction and background to the study.....	1
1.2. Purpose of the research .....	3
1.3. Problem statement.....	4
1.4. Research methodology.....	4
1.5. Ethis.....	4
1.6. Significance of the research.....	5
1.7. Limitations.....	5
<b>CHAPTER 2. SA TREATMENT OF ILLEGAL TRANSACTION.....</b>	<b>6</b>
2.1. Introduction .....	6
2.2. Requirement for tax liabilities in South Africa.....	8
2.3. Is the state entitled to tax proceeds of illegal activities? .....	9
2.4. “Accrued to” or “received by” .....	10
2.5. Case law principle: “Accrued to” or “received by”.....	102
2.6. SA illegal Income tax cases and their applicable principles.....	15
<b>CHAPTER 3. USA TREATMENT OF ILLEGAL INCOME TRANSACTION.....</b>	<b>255</b>
3.1. Introduction.....	255
3.2. USA case laws and the view of the court.....	28
<b>CHAPTER 4. CONSEQUENCES OF TAX EVASION AND ILLEGAL INCOME TAXATION.....</b>	<b>33</b>
4.1. Introduction.....	33

4.2.	SA tax evasion under SA law.....	37
4.3.	Tax evasion under USA law.....	37
4.4.	Deduction of illegal income expenditure under SA law.....	46
4.5.	Deduction of fine, penalties and corrupt activities.....	49
4.6.	Deduction of illegal income expenditure under USA law.....	51
4.7.	Expenses not deductible in USA.....	52
4.8.	Medical Marijuana: Treatment of deduction for expenses legalised under State law.....	53
4.9.	the moral implication of allowing such deduction.....	54
4.10.	the principle of tax neutrality.....	56
<b>CHAPTER 5. A COMPARATIVE ANALYSIS BETWEEN SA AND USA TAX LAW..</b>		<b>59</b>
5.1.	Introduction.....	59
5.2.	Can taxation be used as an additional tool to curtail criminal activities and organised crime?.....	59
5.3.	SA Bill of Rights and taxation of illegal income.....	60
5.4.	Arrested, detained and accused person: the right to remain silent under RSA Constitution.....	61
5.5.	USA Constitution and taxation of illegal incomeError! Bookmark not defined.5	
5.6.	Similarities and differences between SA and USA treatment of illegal income taxation.....	66
5.7.	Are some illegal activities more criminal than the others?.....	71
<b>CHAPTER 6. Findings, Recommendations and Conclusion.....</b>		<b>Error! Bookmark not defined.5</b>
6.1.	Summary of findings.....	75
6.2.	Recommendations.....	79
6.2.	Conclusion.....	82
<b>REFERENCES.....</b>		<b>85</b>

## ABBREVIATIONS

---

Income Tax Act 58 of 1962(The Act)

South African Revenue Service (SARS)

Internal Revenue Service(IRS)

The Internal Revenue Code (IRC)

South Africa(SA)

Republic of South Africa (RSA)

Section (Sec)

United States of America(America)(USA)

# CHAPTER 1. THE JUSTIFICATION AND RATIONALE BEHIND THE TAXATION OF ILLEGAL INCOME

## 1.1. Introduction and background to the study

Prostitution, money making schemes, drug dealings and pyramid schemes, as well as money laundering, are a few examples of illegal activities that have been around for ages. Whether the crime is once-off or is executed with precise planning, the outcome involved affects not only innocent victims but the country as a whole. South African Revenue Service (SARS), as well as its foreign counterparts, are always in a predicament with regards to the consequences of income derived from illegal activities.

Any system of taxation is likely to experience some forms of evasion given the financial and other incentives of non-compliance. The definition of gross income in Section 1 of the Income Tax Act 58 of 1962 (The Act) provides that South African (SA) residents are liable for tax on their worldwide incomes, while non-residents are liable for tax on income generated from South African sources or deemed sources other than receipts or accruals of a capital nature. A person is expected to include all receipts or accruals of income in his tax assessment in order to calculate his tax liabilities.

The question as to whether or not the income received by a taxpayer in the course of carrying on illegal activities should be regarded as being received by, or accrued to, such taxpayer for the purposes of assessing such person's gross income has been the subject of debate in both SA courts and foreign jurisprudence for ages. The meaning of 'received by', or 'accrued to,' as contained in Sec 1 of the Income Tax Act has also seen its own share of debate.

Many a time, SA courts were called upon to decide on cases where SARS has insisted on taxing incomes received from illegal activities. Schreiner JA, as far back as 1955 in the famous case of *Commissioner of Inland revenue v Genn& Co (Pty) Ltd* remarked that,

*'... it certainly is not every obtainance of physical control over money or money's worth that constitutes a receipt for the purposes of the tax provisions. That 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'.*

A borrower who is given possession of something is under an obligation to repay or return the things borrowed. A borrower does not obtain ownership of the things borrowed, except in the case of consumables where in law a change of ownership in the actual things borrowed is possible. The Supreme Court of Appeal in its ruling in the MP Finance MP Finance Group CC (In Liquidation) v CSARS 69 SATC 141<sup>1</sup>(MP Finance case) ruled that illegal gains will be taxed in the hands of the taxpayer who had received the income for his own benefit. The court makes use of the intention test to determine whether income should be taxed in the hands of the taxpayer who received the illegal income. This test, as applied in the MP Finance case,<sup>2</sup> entails that illegal income will be taxable in the hands of a taxpayer who has the intention of keeping the illegal income for his own use.

The non-taxability of illegal income has far reaching consequences than one can imagine. The state revenue is affected in that it can be seen as a tool for tax evasion where such monies are not declared as income, thereby reducing a taxpayer's liabilities

---

<sup>1</sup> *MP Finance Group CC (In Liquidation) v CSARS 69 SATC 141.*

<sup>2</sup> *Supra.*

and thus the community is also affected. Those people who pay their taxes accordingly have the monster of 'unfair discrimination' to deal with when they compare themselves with those who feel that illegal income should not attract any tax liability.

In the United States of America (USA), the Internal Revenue Service (IRS) has been successful in bringing famous criminals to book on tax evasion charges where such criminals had previously proved elusive to criminal charges due to a lack of evidence against them. The Internal Revenue Code of 1986 (IRC Code) was enacted by the USA Congress in part for the purpose of taxing net income. The Code is not a mechanism for enforcing other codes of law, for example, criminal law. A person's taxable income will generally be subjected to the same Federal income tax rules, regardless of whether the income is obtained legally or illegally.

The USA Treasury Department first instituted a case of tax fraud against Al Capone in 1931 and was successful in sentencing him to 11 years imprisonment.<sup>3</sup> The USA Supreme Court also applied the code in *James v United States of America* where the court held that an embezzler was required to include his ill-gotten gains in his 'gross income' for Federal income tax purposes.<sup>4</sup>

## 1.2. Purpose of the research

Firstly, this study will try to show whether or not the Government is justified in taxing illegal income by analysing various sources of literature, as well as analysing principles that were applied by both South African (SA) and USA courts of law. Secondly, it will compare and differentiate between SA and USA tax law application. Thirdly, it will show

---

<sup>3</sup> As cited in the Article: Tax War. (n.d.). *Al Capone's Income Tax Evasion and The Taxation of illegal Income*. Available online at <http://taxwar.net/capone-illegal-income-tax.html>.

<sup>4</sup> *supra*

the impact of taxing/not taxing illegal income. Fourthly, the impact of the constitution on such taxation will be examined.

In addition, it will confirm whether or not SA laws can be 'borrowed' from the USA application of tax law. Lastly, this study will make recommendations that can be utilised in the further development of our tax law.

### **1.3. Problem statement**

Thus the problem statement is as follows:

Is Government justified in taxing illegal income by saddling criminals with tax liabilities?

### **1.4. Research methodology**

The approach of this study will be analytical and comparative in nature. I shall critically employ the analytical approach to evaluate both the SA and USA views on taxing illegal income, and evaluate both countries' similarities and differences with regards to their respective courts' approach in the taxing of such income. I will highlight the South African Bill of Rights, as well as examine the rationale behind taxing such income.

A comparative approach will be employed by researching both USA tax law and SA tax law. The view of the populace in both countries will also be compared by examining some of the defences put forward by legal practitioners on behalf of various tax offenders.

### **1.5. Ethics**

There are no ethical issue associated with the conducting of this research.

## **1.6. Significance of the research**

This research is important for the further development of tax law in SA. Tax law is ever-evolving and one needs to stay ahead by looking at other jurisdictions and note developments that can add value to the existing position. The taxation of illegal income in the USA has been prevalent longer than in SA, and this research will investigate if SA can 'borrow' from some of the developments and court principles applied in the USA to add benefit and reduce SA's problem of illegal income taxation.

## **1.7. Limitations**

This topic is extensive but will be limited to a comparative study between SA and the USA. The results of my findings may not be a generalisation of the global truth; for example, the taxation of illegal income does not play any role in Western African jurisprudence as illegal activities only attract criminal sanctions and asset forfeiture, not tax liabilities. However, this research can form the basis of a further research study.

## **CHAPTER 2. SA TREATMENT OF ILLEGAL TRANSACTION**

### **2.1. Introduction**

The SA Government is not lagging behind in putting in place the required necessary tax tools in combating organised crime within its borders, just like its foreign counterparts. Tax law are constantly updated either by new enacted or amendment to further tighten loopholes as criminals get wiser and wiser by the day. The failure to tax illegal income can have far reaching implications for any country in that those involved in criminal business activities will gain a competitive edge over those engaged in lawful business practices. The unlawful businesses will produce products at a reduced cost, and then sell them at a lower rate than those businesses that pay their taxes. Criminals generate better gains and expect such gains not be subject to tax on the grounds that they originate from illegal activities.

In some countries residence is made the test of liability for taxation. What this means is that a resident, for the privilege and protection of residence, can be justly called upon to contribute towards the cost of good order and Government of the country that shelters him or her. In others such as SA, the applicable principle is both residence and source. In the USA, all persons, even if not resident, may be subjected to tax on their worldwide income, while in SA, only residents are subject to taxation on their worldwide income while non-residents are subject to taxation on source of income or deemed source. The argument behind the residence principle is that resident taxpayers must be subjected to the same tax system since they live in the same country (tax neutrality).

Under a pure source or deemed source system, income is taxed in the country where that income originated, regardless of the physical or legal residence of the recipient of

the income. A taxpayer who is resident in another country but carries on business in South Africa will be liable for tax on income that his or her businesses generates in SA. Likewise, a SA resident who has paid taxes on income generated abroad will be entitled to deduct any amount paid as tax on foreign income if SA has a double taxation agreement with the source country. The primary right of the 'source' country to tax 'active' business income is widely recognised internationally and soundly enshrined in the principles underlying double taxation agreements. This is the case even where the taxing country has a residence system. In terms of double tax treaties, countries are generally required to exempt income generated in the other contracting state or to provide a credit for the tax imposed in the source state.<sup>5</sup>

Accordingly, all residence based systems still tax non-residents on income sourced within their jurisdictions. Countries with a source system have gradually extended the scope of their taxes by statutorily deeming certain types of income, especially of a passive nature, to be sourced within their jurisdictions, and therefore subject to tax there. They then, too, grant relief to their taxpayers for taxes suffered in the source jurisdiction.

The South African Income Tax Act 58 of 1962<sup>6</sup>(The Act) provides that SA residents are liable for taxes on their worldwide income, while non-SA residents are only liable for taxes on income generated within SA or deemed income. The definition of gross income contains the central concept of the entire Act. In terms of Section 5, income tax is levied on taxable income. This simply means that exempt income and allowable deductions will be deducted from total gross income in order to arrive at the taxable income.

---

<sup>5</sup> South African Government Treasury.(n.d.).*5th Report - Basing the South African income tax system on the source or residence principle - options and recommendations*. Available at <http://www.treasury.gov.za/publications/other/katz/5.pdf>.

<sup>6</sup>South African Income Tax Act 58 of 1962

The Act provides further that taxes must be levied on income received by a taxpayer, irrespective of whether or not the income is legal. The source of a taxpayer's income sometimes constitutes a problem, especially where such income is derived from illegal activities.<sup>7</sup> The law is easily applicable where the income concerned is received or derived from a legal source.

## 2.2. Requirement for tax liability in SA

The starting point in determining a person's tax liability can be found in the levying section of the Act being section (sec) 1 of the Income tax Act 58 of 1962<sup>8</sup>. The said section provides that taxes will be collected on income generated by a taxpayer after the deduction of allowable deductions. Taxpayers do generate income from various sources, legal or illegal. But it has been stated by our court<sup>9</sup> that not all money received by a taxpayer is meant for him. The activity through which income is sometimes derived is not always legally acceptable within our community. Nonetheless, such receipts must still be subjected to taxation in order to comply with the principle of tax neutrality. Tax will be payable on an income for as long as such income was received by the taxpayer. The Receiver of Revenue therefore has the duty to ensure that taxes are payable after the deduction of certain allowable expenses on all income received by a taxpayer, as provided for in the Act.

The Act<sup>10</sup> contains certain provisions which will trigger the tax liability of a taxpayer to be liable for tax payment. Sec 1 of the Income Tax Act<sup>11</sup> defines 'gross income' in relation to

---

<sup>7</sup> Lusty, D. (2003). Taxing the Untouchables Who Profit from Organized Crime. *Journal of Financial Crime*, 10 (3).

<sup>8</sup> Income tax Act 58 of 1962

<sup>9</sup> *CIR V Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>10</sup> Ibid at 7

any year of assessment to mean in the case of a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident during a tax year; and in the case of a non-resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, excluding the receipts or accruals of capital nature. It therefore means that both residents and non-residents (natural and juristic persons) with the exclusion of certain persons (such as NGOs) who generate income through trading, whether legal or illegal, will be liable for tax within the Republic.

The starting point for tax liability is to determine a taxpayer's gross income. The definition of gross income is of the utmost importance in calculating a taxpayer's tax liability. Taxable Income has been defined to mean the amount remaining of the gross income of any person for any year or period of assessment after the deduction therefrom of any amounts exempted from normal tax together with allowable deductions.

### **2.3. Is the state entitled to tax proceeds of illegal activities?**

It does not seem likely that Parliament will intentionally allow an individual to setup his own illegal businesses in order to avoid taxation so as to increase the tax burden of other persons who are lawfully engaging in business. There is no specific provision in the South African Income Tax Act of 1962 dealing with the taxation of illegal proceeds. The general gross income definition, in Sec 1 of the Act, provides that gross income (in relation to a resident) means the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during a year or period of assessment, which is not of a capital nature.

---

<sup>11</sup> Act 58 of 1962; Meyerowitz, D. (Ed.) (2007-2008). *Meyerowitz on Income Tax*. Cape Town: Taxpayer Publishing, para 6.1.

The definition does not specify that the total amount in issue must have been derived in the course of a legal pursuit, and it has been left to the courts to decide whether or not to include illegal proceeds in gross income. It has been argued that to tax illegal activities means to legitimise such activities.<sup>12</sup>

*‘There is also a further argument that tax law should not play a role in the matter of criminal activities, that Government should not obtain revenue from ill-gotten gain which has negative impact on the society. It was further argued that illegal activities should rather attract criminal sanction and should only be dealt with in terms of the criminal law Act.*

*Indeed, to refrain from taxing ill-gotten gains or turning a blind eye to taxing such income and proceed by the relevant authorities would amount to exempting such persons from one law simply because they had committed another.’<sup>13</sup>*

Such an approach, if adopted by our law, would certainly shake the confidence of law-abiding citizens in the equity of tax laws and the integrity of officials who have a duty to enforce those laws without fear or favour.

## **2.4. “Accrued to’ or ‘Received by”**

It is trite law in SA that the meaning of ‘receive’ for purposes of the definition of gross income means that the taxpayer should receive the amount ‘on his own behalf and for

---

<sup>12</sup> Monteiro, C. & Bonthuys, E. (2007). *Sex for sale: the prostitute as businesswoman*. Available: <http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>.

<sup>13</sup> PricewaterhouseCoopers. (2007). The taxability of illegal pyramid schemes. *Synopsis* (Volume) 2-3.

his own benefit.<sup>14</sup>It is therefore important to note from the beginning that one cannot discuss the liability for income tax whether in relations to legal or illegally obtained income without first discussing the meaning of received as being applied by our court in time past. 'Received by', 'accrued to' or 'in favour of' a taxpayer are terms that have seen their days in court.<sup>15</sup> SA courts have been called upon many times to determine whether or not a tax payer received an amount for his own benefit or for that of another.

Received by, or for the benefit of, a taxpayer is a very important requirement that gives rise to tax liability. For an amount to attract tax, it must have been received as an income or for the benefit of the taxpayer. The reason why this is very important is because not all money received is regarded as an income for the purposes of tax.<sup>16</sup> The court held that an amount is considered to be received by a person only in cases where it is received for that specific taxpayer's personal benefit.<sup>17</sup> An amount could be received for the benefit of another for which amount a taxpayer cannot be expected to pay taxes. Where the amount received is not received for the taxpayer's benefit, the taxpayer in such cases always puts forward the argument that the amount in question has not been received by him; either as a result of the amount been stolen, refundable as a loan,<sup>18</sup> or is involved in an illegal scheme.<sup>19</sup>

---

<sup>14</sup> See *Geldenhuis v Commissioner of Inland Revenue* (where it was decided that the expression 'received' means that money must be received by the taxpayer in such circumstances that he becomes entitled to it); *CIR v Genn (Pty); Commissioner of Inland Revenue v Smant* (1973 1 SA 754 (AD)).

<sup>15</sup> *Supra*.

<sup>16</sup> *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>17</sup> *Geldenhuis v Commissioner of Inland Revenue* 1947 (3) SA 256 (C) at 266.

<sup>18</sup> *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>19</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

## 2.5. Case law principles: ‘accrued to’ or ‘received by’

The meaning of the phrase ‘received by’, ‘accrued to’ or ‘in favour of a person’ is not explained in the SA Income Tax Act. The courts therefore usually interpret the terms based on the circumstances of each case and the available facts before them.<sup>20</sup> The court applies numerous principles to determine whether or not an amount has been received by the taxpayer.<sup>21</sup> The courts sometimes adopt the subjective approach by looking at the taxpayer’s intention or the intention of the owner where the amount was stolen, as enunciated in the famous Genn case.<sup>22</sup> The keeping of an amount in trust, by a taxpayer, is one situation in which the amount is said not to have been received by the taxpayer for his own benefit and is, therefore, not included in his gross income.<sup>23</sup> This is also true where the taxpayer has to repay an amount equivalent to the one which was given to him, such as in a loan scenario,<sup>24</sup> and where the taxpayer receives an amount in his capacity as an agent and is obliged to pay the amount to his principle.<sup>25</sup> The court has also found that the phrase ‘accrued to or in favour of’ to mean ‘entitled to’.<sup>26</sup> It was concluded in *CIR v Peoples Stores* that an amount will accrue to a taxpayer when he or she has an unconditional right to the funds.

---

<sup>20</sup> Huxham, K. & Haupt, P. *Notes on South African Income Tax*. 26<sup>th</sup> ed., at page 10.

<sup>21</sup> Entitlement Principle, Intention Principle (Subjective & Objective) etc.

<sup>22</sup> *CIR V Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>23</sup> See *Geldenhuis v CIR* 1947 (3) SA 256 (C); *Hiddingh v CIR* 1941 AD 111; *Lambson v CIR* 1946 CPD 69; *Holley v CIR* 1947 (3) SA 119 (A); *KBI v Van Blommenstein* 1999 (2) SA 367 (SCA); *ITC 939 24 SATC* 377; *ITC 1369 45 SATC* 49.

<sup>24</sup> *CIR v Genn and Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>25</sup> *SIR v Smant* 1973 (1) SA 754 (A).

<sup>26</sup> See *Lategan v Commissioner for Inland Revenue* 1926 CPD 203 at 209; *CIR v Peoples Stores (Walvis Bay) Pty Ltd* 1990 (2) SA 353 (A) at 298E; Meyerowitz, D. (2006-2007). *Meyerowitz on Income Tax*, at para. 6.17.

In the *Geldenhuyse* case,<sup>27</sup> the court held that the usufructuary, being the taxpayer, was not entitled to the amount received on the sales of the assets which was subject to the usufruct and that such asset remained the property of the end owner and that the usufructuary is only entitled to the fruits of the asset. In deciding this, the court paid due regard to the underlying common law obligation and the property rights of the usufructuary.

In *Brookes Lemos Ltd v Commissioner for Inland Revenue*,<sup>28</sup> the two taxpayers were both in the wholesale trade business. They required customers to pay a deposit on a container and such deposit would be refunded when the empty containers were 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 court applied the entitlement approach to reach its decision.

In *Commissioner for Inland Revenue v Witwatersrand Association of Racing Clubs*,<sup>29</sup> the Association held a horse-racing event in aid of charity. Although the proceeds were duly paid to the charity organisation, the money so raised was taxed in the hands of the Association, being income beneficially received by the association. 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 or use or enjoyment.<sup>30</sup> The court referred to United States case law. The court, however, held that 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

---

<sup>27</sup> *Geldenhuyse v CIR* 1947 (3) SA 256 (C).

<sup>28</sup> 1947 2 SA 976 (A); *Greases (SA) Ltd v Commissioner for Inland Revenue* (1951 3 SA 518 (A).

<sup>29</sup> 1960 3 SA 291 (A).

<sup>30</sup> *Ibid*, at page 293.

money was thus indeed beneficially received by the taxpayer. The court also applied the entitlement approach in this case.

In *Secretary for Inland Revenue v Smant*,<sup>31</sup> 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 purposes of gross income. The majority of the judges held that the cession divested the taxpayer of his right to receive future payments before they accrued. Due to the fact that the taxpayer was *obliged* to transmit the payments, he did not *receive* them for his own benefit. (Entitlement approach was applied).

As can be seen from the above cases, the most important issue before the courts was the meaning of 'for own benefit' or 'beneficial receipt'. The courts, in examining the meaning of the above phrases, did not distinguish between amounts that dealt with legal receipts by legal businesses and amounts that dealt with receipts derived from illegal operations. It is interesting to note that our courts have applied various approaches to the different cases analysed. The problem is that our courts have not adopted one single test, and this in turn creates uniformity in the decisions reached. In some cases, especially the cases which dealt with legal receipts, the courts have followed an objective approach, while the taxpayer's entitlement to the proceeds was the deciding factor in illegal receipts.

---

<sup>31</sup> *SIR v Smant* 1973 (1) SA 754 (A).

## 2.6. SA Illegal income tax cases and their applicable principles

In SA, many illegal income tax cases come before the courts on a regular basis where income received from an illegal source has been taxed. It is admitted in most of those cases that the legality or illegality of the business from which the income is derived does not affect the taxability of such an income.<sup>32</sup>

As far back as 1918, in the case of *CIR v Delagoa Bay Cigarette Co Ltd*,<sup>33</sup> the court through Bristowe J, who delivered the majority judgment,<sup>34</sup> referred to the English case of *Partridge v Mallandaine*<sup>35</sup> as the authority for the idea that 'the taxability of a receipt is not affected by the legality or illegality of the business through which it was derived'. He held further that the transaction between the taxpayer and the purchasers of cigarettes was essentially a sale and that when the company distributed prizes, these were not in the nature of rebates of purchase money, because some purchasers received no prizes, while those who did received more than they had paid for the cigarettes. The majority, therefore, rejected the notion (which was accepted by the minority) that there was no receipt because the money had been kept by the company in trust for the purchasers. The facts of the case were briefly as follows: the company advertised packets of cigarettes worth six pence for sale at ten shillings. There was a number coupon enclosed in each packet. The company advertised that they will set aside two-thirds from its revenue from sale towards a fund from which prizes will be awarded to the holders of winning numbers on a monthly basis. Two distributions were made and then legal actions were instituted against Delagoa Bay Cigarette Co for running an illegal lottery. In addition, the receiver of revenue claimed that the distribution of prizes was a scheme aimed at disposing of the company's profits after they had been earned and was

---

<sup>32</sup> MP Finance Group CC.

<sup>33</sup> *CIR v Delagoa Bay Cigarette Co Ltd* 1918 TPD 391394.

<sup>34</sup> *Commissioner of Inland Revenue v Delagoa Bay Cigarette Co Ltd* 1918 TPD 391.

<sup>35</sup> (1886) 18 QBD 276.

not a deductible expenditure. Moreover, the receiver of revenue applied for a court order to prevent the payment of prizes in the future on the basis that this will keep the company from paying the tax due. Nevertheless, the court held that the payment of prizes in accordance with legal terms under which the cigarettes were sold was an outgoing incurred in earning the company's income and was in no way a distribution of the company's profit after it had been earned.

It has been argued further that by taxing the proceeds of illegal transactions; SARS is not necessarily condoning those activities.<sup>36</sup> The argument put forward is that SARS is not involved in the commissioning of the illegal act or the conclusion of the illegal contracts as may be applicable, and that SARS is simply carrying out its function as a tax collection agency as provided for in the Income Tax Act. The reason for this rationale is that it would be unfair for SARS to allow illegal traders to enjoy better benefits than those who are involved in legal trade. Tax neutrality plays an important role in any tax regime and can therefore not be overlooked on the basis of illegality of certain transaction.

The case of *Commissioner of Taxes v G* is a famous case that our court makes references to when it comes to the determination of whether or not did a person acquired ownership in respect of things that are stolen or illegally acquired. Even though the case is a Zimbabwean case, our courts sometimes do adopt the same principles as laid down therein where the facts before them are similar. The Zimbabwean Appellate Division adopted a different approach in *Commissioner of Taxes v G*<sup>37</sup>. The court therein has to decide whether the taxpayer, who was employed by the Government and who had stolen certain funds, should be found to have 'received' those funds for the purposes of income tax. It was admitted further that a thief does not receive what was stolen if there was no mutual intention to give and to take, then there is no receipt.

---

<sup>36</sup> *Mann v Nash (HM Inspector of Taxes)* 1932 (1) KB 752.

<sup>37</sup> 1981 (4) SA 167 (ZA).

Therefore, there is no inclusion in gross income. Moreover, the money received by the respondent was not intended for his own benefit despite his intention to treat it as his own. It was received in order to discharge some government's responsibilities. Even though some of the receipts were embezzled, those receipts were given for a specific assignment. Consequently, the income received by the taxpayer was not in his favour or for his own benefit. It does not subsequently form part of his gross income as there was no receipt within the meaning the meaning used in the definition of gross income.

In its judgment, the court seemed to assume that it is possible to tax illegal proceeds, but held (at 169-70) that the word 'received' should be given its ordinary meaning and that no logical reading would take it to mean a 'unilateral taking such as theft' and therefore that money stolen could not be taxable.

It was clear that 'received by' must mean 'received by the taxpayer on his own behalf and for his own benefit', as stated by Steyn J in *Geldenhuis v Commissioner for Inland Revenue*.<sup>38</sup> In deciding whether the taxpayer has received an amount on his own behalf and for his own benefit, it was not only his (the taxpayer's) intention which was important, but also the intention of the giver. It was clear that the Government never intended the thief to keep the funds and do with it what he liked, and therefore the thief could not be said to have received the funds for his own benefit. The court at 171A-D, stated that,

*'Perhaps a better way of reaching the same conclusion might have been to suggest that the facts before the court were analogous to the situation where the taxpayer is given an amount, but has an unconditional obligation to repay it and, therefore, is not considered to have received anything.'*

---

<sup>38</sup> 1947 (3) SA 256 (C) at 260.

In *ITC 1624*,<sup>39</sup> the taxpayer rendered services to a customer, which included the payment to Portnet of wharfage fees, to be recovered from the customer. In a particular year of assessment, the taxpayer fraudulently rendered accounts in respect of wharfage fees to the customer and in this way received amounts which it was not legally entitled to. Counsel for the taxpayer raised a familiar argument (at 377): the taxpayer had not received anything for the purposes of gross income since the amounts had not been received by it 'on its own behalf or for its own benefit'.

In support of this submission, counsel relied *inter alia upon Commissioner of Taxes v G*. The court held (at 378) that,

*'None of these cases is authority for the proposition that where a trader receives payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent, misrepresentation to a customer, it does not receive that money or that it has not intended to receive it as part of its business income and in the course of its business'.*

The taxpayer's argument seems to have been based on the idea that, where an agent receives an amount on behalf of his principal, he cannot be said to have received that amount 'on his own behalf and for his own benefit'. The court put forward (at 380) the following analogy in finding that the taxpayer was not in the position of an agent, with regard to the fraudulent claims:

*'If a dishonest attorney recovered from his or her client a sum for a witness's fee and corruptly negotiated with the witness to accept a lesser sum than he or she had charged, so that he or she could retain the balance, it can surely not be said that the attorney had not received the overcharged amount in the tax sense'.*

---

<sup>39</sup> (1997) 59 SATC 373.

Thus, the court held that the disputed amount had to be included in the taxpayer's gross income.

Finally, the Supreme Court of Appeal in the matter of *MP Finance Group CC (in liquidation) v Commissioner for the South African Revenue Service*<sup>40</sup> has put the question of whether or not to tax illegal income to rest by answering the question in the affirmative. The court held that income illegally received by entities which are conducting an illegal pyramid scheme constitutes income 'received' within the meaning of 'gross income' as defined in the Income Tax Act of 1962.<sup>41</sup> The facts applicable to this case are as follows:

In 1998 MarietjiePrinsloo operated an illegal investment enterprise, commonly called a pyramid scheme (hereinafter referred to as 'the scheme'). The scheme was conducted by way of incorporated and unincorporated entities which were all eventually insolvent. By order of court on 4 February 2003, the Pretoria High Court, for ease of administration and legal practicality, consolidated these entities into a single entity, namely MP Finance Group CC (in liquidation) (hereinafter referred to as 'the Close Corporation');

SARS regarded the Close Corporation as the taxpayer liable for the taxes due by the original entities that conducted the scheme and assessed the Close Corporation for tax in respect of the tax years 2001 to 2002.

The liquidators of the Close Corporation objected to the assessments on the basis that the amounts received by the Close Corporation were not 'received' within the meaning of 'gross income' as defined in the Income Tax Act and were therefore not subjected to tax. Counsel for the Close Corporation further argued that the scheme was liable in law

---

<sup>40</sup> (2007) SCA 71 (RSA).

<sup>41</sup> Fluxmans Attorneys.(2007).Taxation of Illegal Income.*Point of Law*, issue 6 September.

immediately to refund the deposits and that there was no basis on which it could be said that the deposits were 'received' within the meaning of the Income Tax Act. They were, it was argued, consequently not subject to tax.

The Commissioner for SARS disallowed the objection and held that the amounts received by the Close Corporation were taxable. The liquidators appealed to the Durban Tax Court on behalf of the Close Corporation but the appeal was dismissed by the Tax Court. The court held that notwithstanding the fact that the scheme was illegal, the deposits received by the scheme were 'receipts' within the meaning of the Income Tax Act and therefore were automatically subjected to taxation.

The liquidators of the Close Corporation appealed to the Supreme Court of Appeal. Counsel for the Close Corporation argued, *inter alia*, that the deposits received by the Close Corporation were not taxable because they were not amounts that were 'received' as contemplated by the Income Tax Act. Counsel went further in support of its argument and relied on a passage of a judgment in the matter of *Fourie NO v Edeling NO*<sup>42</sup> that all loans made to the scheme were in the light of the provisions of Section 1 of the Banks Act 94 of 1990 and fall under a prohibition under the Consumer Affairs (Unfair Business Practices) Act 71 of 1988 and which is illegal and therefore void.

This proposition of law is uncontested. The scheme never had the least entitlement to retain investors' money until the date which had supposedly been agreed upon as the due date for repayment of the loan amount deposited to it. The court held that Section 1 of the Income Tax Act defines 'gross income' to mean the total amount 'received by or accrued to or in favour' of a taxpayer during a tax year. The court went further in analysing the facts and found that it was of essential importance that through the tax years in question, i.e. 1 March 1999 to 28 February 2002, the perpetrators of the

---

<sup>42</sup> (2006) 4 All SA 393 (SCA).

scheme knew that what they were doing was illegal in that the scheme was insolvent, it was fraudulent, and that it would be impossible to pay all investors what they had been promised.

There is no evidence that any of the investors knew their investments to be tainted and also nothing from which to infer that any of them acted *in any contributory negligent way*. That being so, no question arises of relaxing the *inpan delicto potioresconditio defendantis* rule<sup>43</sup>. Upon receipt of a payment the scheme was liable promptly to repay it to the investor who had a claim for it under the unjustified enrichment action. Instead the scheme used the money to pay the claims of other investors who had invested earlier, while keeping up the face that all was well in order to lure more investors into depositing their hard earned money into their business knowing full well that what they were doing was illegal. The whole idea of the scheme was to defraud the investors of their money.

The court further held and stated that the only inference one can make from the facts and circumstances of the case is that whatever intention there was on the part of the investors to enter into a contractual relationship with the entities concerned, and whatever corresponding intention to contract there might possibly have been on the relevant entities' part prior to 1 March 1999, there could no longer have been any such corresponding intention after that date. The court held that from that date onwards (i.e. subsequent to 1 March 1999) the entities run by Prinsloo made their money by swindling the public, and that the income earned by the scheme were 'received' within the meaning of the Act. It was for the Close Corporation to prove the contrary and that such onus had not been discharged.

---

<sup>43</sup> a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing.

The court referred to the matter of *Commissioner for Inland Revenue v Insolvent Estate Botha*<sup>44</sup> which held that an illegal contract is not without all legal consequences and can have fiscal consequences'. The previous position of illegal pyramid schemes has always been uncertain and the courts did not always want to apportion tax liability to investors in such scheme.<sup>45</sup> The court previously applied the *ex-turpicausa* rule. According to this rule an illegal contract cannot be enforced<sup>46</sup> but that rule has now been changed to mean that certain illegal transactions will attract sanctions, especially where not to sanction such a perpetrator would amount to great injustice.

The courts in the above cases appear to accept that illegal proceeds should be treated no differently than legal ones, and that such income should be included in the taxpayer's gross income for the purposes of determining his or her tax liability. However, in *Commissioner of Taxes v G* and *ITC 1624*, the court operated from a very different angle. The court was intent upon keeping its revenue eye closed and its eye of justice open in both cases. The court focused firmly on the intention of the victim of theft and not on the intention of the taker in reaching the conclusion that there was no receipt. Even the alternative put forward by the counsel that the taxpayer had an unconditional obligation to repay the amount which he stole did not negate the crucial question of the thief's intention in appropriating the funds for himself. Surely what should be decisive in cases of this nature is whether the taxpayer had a *bona fide* intention to return the funds or not and the answer would, most probably be negative.<sup>47</sup>

---

<sup>44</sup> 1990(2) SA 548 (A).

<sup>45</sup> *Fourie NO v Edeling NO & Others* (2005) 4 SA 393 (SCA) at 410A.

<sup>46</sup> *Income Tax Case 1810* (2006) 68 SATC 189.

<sup>47</sup> Olivier, L. (2008). *Taxability of illegal income*. Available at [www.moneywebtax.co.za/moneywebta/view/moneywebtax/en/pa](http://www.moneywebtax.co.za/moneywebta/view/moneywebtax/en/pa).

In conclusion, I make reference to the Canadian case of *No 275 v Minister of National Revenue*,<sup>48</sup> although this case is neither a SA nor USA case, but it's worth mentioning herein as the principle adopted in the MP Finance case supra confirms that SA treatment of illegal income transaction is in line with other foreign jurisdiction. The illegal income that came before the court was that of prostitution. The question was whether earnings from an illicit business are taxable or not. The facts of the case were briefly as follows: A prostitute was assessed for income tax on her earnings, the fruits of prostitution. She appealed, contending that her income was not derived from a business and that alternatively, if it was derived from a business, it was a business which was an evil in itself and not merely an evil by law, and that the state should not share in the profits of such a business by taxing the profits. The appeal was dismissed. The court held that the appellant's earnings were derived from a business, within the meaning given to this word in the Act, and thus were taxable.

The question in issue was whether the proceeds from an illicit business are taxable or not. Once it has been established that an income is taxable because it results from a business, it is not necessary for the taxing power to enquire further into the character of that business or into the means by which the particular income from that business has been earned. The court went further and stated that such a person is estopped from pleading his or her own wrongful act with a view of benefiting thereby.

In taxing the proceeds of an illicit business the state is merely looking at an accomplished fact, which necessitates the taxing of the individual concerned with reference to the facts and circumstances of the case. The court held further that the state did not take part in the illegal act, nor is it condoning the illicit act, and can therefore not be said to be sanctioning the illegal act committed by such persons.

---

<sup>48</sup> 55 DTC 439, Tax Appeal Board, July 29, 1955. Available at <http://www.taxwiki.ca/No.+275+v+Minister+of+National+Revenue+%28TAB%2C+1955%29>.

In conclusion, the MP finance case did answer the question as to whether the proceeds of illegally earned income should be subjected to the same tax treatment as those incomes that are legally earned in the affirmative.

## CHAPTER 3. USA TREATMENT OF ILLEGAL INCOME TAXATION

### 3.1. Introduction

In America, the USA Supreme Court two centuries ago observed that the power to tax involves the power to destroy any organisation that is involved in criminal activities. This was implemented a century later when the IRS dismantled a number of America's most feared organised crime syndicates through the dual enforcement of criminal and civil sanctions for tax evasion.<sup>49</sup> Persons such as Al 'Scarface' Capone, Ralph 'Bottles' and Jake 'Greasy Thumb' Guzik were among those who were arrested, charged and imprisoned for tax evasion based on their criminal activities.<sup>50</sup> Taxation is now recognised in America as one of the most powerful and versatile weapons against organised crime.

The Internal Revenue Code (IRC) was enacted by the USA Congress in part for the purpose of taxing net income in 1926.<sup>51</sup> The IRC is not a mechanism for enforcing other codes of law, such as criminal law. The violations of the United States' tax code are prosecuted under an array of criminal tax statutes,<sup>52</sup> and which statutes will now be examined.

---

<sup>49</sup> Lusty, D. (2003). Taxing the untouchables who profit from organized crime. *Journal of Financial Crime*, 10(3), page 209-228.

<sup>50</sup> Supra. The case is as read from the article.

<sup>51</sup> *Commissioner v Tellier*, 383 U.S. 687, 691, 86 S. Ct. 1118, 66-1 U.S. Tax Case. (CCH) paragraph 9319 (1966).

<sup>52</sup> Cohen, L.M., Dahm, S.G., Gulluni, M., Shah, M.M. & Wynkoop, T. (1993). Eighth Survey of White Collar Crime Substantive Crimes. *American Criminal Law Review*, Spring issue.

The IRC was re-codified in 1939 by an Act of Congress on February 10, 1939 and the new Code was later known as Internal Revenue Code of 1939. The IRC of 1954 later amended and replace the IRC of 1939 as the old code was greatly re-organised. The Tax reform Act of 1986 changed the name of the IRC 1954 to IRC of 1986.

This Act is separately published as Title 26 of the United States Code. References to the IRC before 1954 generally mean Title 26 of the Code as amended. The IRC is now generally refers to as US Code Title 26.

Under Sec 720 of USC Title 26,<sup>53</sup> a violation of the statute is punishable by a maximum fine of \$100,000 (\$500,000 in the case of a corporation), or imprisonment of not more than five years, or both, together with the costs of prosecution. However, the criminal fine provisions under 18 USC Sec 3571 increases the maximum permissible fines for a violation of 26 USC Sec 7201 to not more than \$250,000 for individuals and \$500,000 for corporations. Alternatively, if any person derives pecuniary gain from the offence, or if the offence results in pecuniary loss to a person other than the defendant, the defendant may be fined not more than the greater of twice the gross gain or twice the gross loss that the person may have gain or loss.<sup>54</sup>

The system of income taxation is based on the self-assessment method, which means that tax liability is not calculated by the tax authority but by the taxpayer himself. The payment of tax must be preceded first by the filing of a return declaring the actual amount of tax that is due to the Government. The amount declared in the return will then be checked by the tax authority. This means that the authority assesses the correctness of the calculated amount of income declared by the taxpayer. The taxpayer is obliged to

---

<sup>53</sup> USC Title 26, (Internal Revenue Code of 1986) Section 720. Available at [http://www.irs.gov/irm/part9/irm\\_09-001-003.html](http://www.irs.gov/irm/part9/irm_09-001-003.html).

<sup>54</sup> *Supra*.

possess and keep all records and documents that prove the amount declared, as well as the type of income declared.

In the absence of a legal type of income, however, the tax authority may report the suspicion of crime to criminal authorities. Furthermore, in the case of a prosecution, the declared income without a legal source can be used as evidence against the defendant in a court of law. For instance, in the case of *Garner v United States*,<sup>55</sup> the income tax returns in which Garner revealed himself to be a gambler were later introduced in court as evidence against him and this served as proof of the Federal gambling conspiracy offence with which he was charged. In consequence, the obligation to declare illegally earned income can be seen as indirect self-incrimination and therefore contrary to the Fifth Amendment law.<sup>56</sup> The United States Supreme Court has ruled that requiring a person to declare income on a Federal income tax return does not violate an individual's right to remain silent',<sup>57</sup> although if the privilege applies, 'it allows the person to refrain from revealing the source of the income'.<sup>58</sup> If there is no obligation to declare an income, then the crime of tax evasion cannot be said to have been committed.

Formerly in USA, the court's approach was that of 'claim of right of doctrine', which held that illegal proceeds could not constitute income because the taxpayer has no claim of right to the income and is under an obligation to return the proceeds. This doctrine was rejected by the United States Supreme Court in *James v United States*<sup>59</sup> in favour of an

---

<sup>55</sup> *Garner v United States*, 424 U.S. 648 1976.

<sup>56</sup> The Fifth Amendment (Amendment V) to the United States Constitution is part of the Bill of Rights and protects against abuse of Government authority.

<sup>57</sup> 274 U.S. 259 (1927).

<sup>58</sup> *Garner v United States*, 424 U.S. 648 (1976).

<sup>59</sup> 366 US 213 (1961).

'economic benefits approach', which asks the question whether the taxpayer has control over the ill-gotten gains and whether he had derived economic value from it.<sup>60</sup>

The court in this case held that embezzled money is taxable income of the embezzler in the year of the embezzlement under Section 22(a) of the Internal Revenue Code of 1939. The said section defines 'gross income' as including 'gains or profits and income derived from any source whatever. Section 22(a) upon amendment was replaced by 61(a) of IRC of 1954. The new section being Section 61(a) defines 'gross income' as 'all income from whatever source. The rejection of the 'claim of right doctrine' was based on a clearly delineated policy decision by the Supreme Court (at 221) where the court stated that we should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.<sup>61</sup> In addition, the court went further and stated that the purpose of Congress was to use the full measure of its taxation power to derive revenue for the state. It therefore reflects that the policy underlying the decision was one which is directly opposed to the notion that the taxation of illegal proceeds implies that the state condones criminal activities.

### **3.2. USA case law and the views of the court**

'The income tax law is a lot of bunk. The Government can't collect legal taxes from illegal money.'<sup>62</sup> Historically, the USA uses criminal prosecution for tax evasion to prosecute criminals who could not be prosecuted otherwise. For example, Al Capone was

---

<sup>60</sup> *Ibid*, at 219.

<sup>61</sup> *Ibid* at 28.

<sup>62</sup> Al Capone Statement during his tax evasion trial. See *ibid* at 64.

successfully prosecuted for tax evasion.<sup>63</sup> Additionally, Soviet spy Aldrich Ames, who had earned more than \$2 million cash for his espionage, was also charged with tax evasion as none of the Soviet money was reported on his tax returns.<sup>64</sup> Ames attempted to have the tax evasion charge dismissed on the grounds that his espionage profits were illegal, but the charges stood.

*'It does not make sense for one to tax persons who are involved in legitimate enterprises, and allow those who thrive by violation of the law to escape taxation.'*<sup>65</sup>

Thieves are required to report their stolen money as income when they file for taxes but they usually do not do so because doing so would serve as a confession of theft. For this reason, suspected thieves are sometimes charged with tax evasion when there is insufficient evidence to try them for theft.

In *James v United States*,<sup>66</sup> the Supreme Court held that an embezzler was required to include his ill-gotten gains in his 'gross income' for Federal income tax purposes. In reaching this decision, the court looked to the seminal case setting forth the tax code's definition of gross income,<sup>67</sup> *Commissioner of Internal Revenue v Glen*, in which the Supreme Court held that a taxpayer has gross income when he has 'an accession to

---

<sup>63</sup> Tax War: Al Capone's income Tax Evasion Case and The Taxation of illegal income (available online at <http://taxwar.net/capone-illegal-income-tax.html>) (accessed 10<sup>th</sup> July 2013).

<sup>64</sup> As read from the article: *Taxation of illegal income in the United States*. Available at [http://en.wikipedia.org/wiki/Taxation\\_of\\_illegal\\_income\\_in\\_the\\_United\\_States#Deductible\\_expenses\\_in\\_illegal\\_activity\\_.E2.80.93\\_the\\_general\\_rule](http://en.wikipedia.org/wiki/Taxation_of_illegal_income_in_the_United_States#Deductible_expenses_in_illegal_activity_.E2.80.93_the_general_rule).

<sup>65</sup> *Sullivan v US* 15 F.2d 809, 811 (1926).

<sup>66</sup> *James v United States*, 366 U.S. 213 (1961), overruling *Commissioner v Wilcox*, 327 U.S. 404 (1946).

<sup>67</sup> *Commissioner of Internal Revenue v Glenshaw Glass Co.*, 348 U.S. 426 (1955).

wealth, clearly realised, and over which the taxpayers have complete dominion'.<sup>68</sup> The court further stated that at the time the embezzler acquired the funds, he did not have a consensual obligation to repay them, or any restriction as to his disposition of the funds. If he had acquired the funds under the same circumstances legally, there would have been no question as to whether it should be included in his gross income. Therefore, the embezzler's illegal income must be included in his gross income under the tax code, even though the application of another body of law might later force him to return the money.

Al Capone, the world's best known gangster and public enemy number one at the time, was allegedly head of a crime organisation that netted huge profits from the illegal liquor trade during the Prohibition era.<sup>69</sup> In 1931 Capone was found guilty of tax evasion and was sentenced to jail.<sup>70</sup> The conviction of Capone was based on the 1927 USA Supreme Court ruling in the *United States v Sullivan* case.<sup>71</sup> In this particular case, the defendant did not pay income tax on his gains from illicit traffic in liquor. The defence was based on the fact that according to the Fifth Amendment to the Constitution of the United States of America, no person shall be compelled in any criminal case to be a witness against himself. The U.S. Supreme Court decided the following:<sup>72</sup>

- Gains from illicit traffic in liquor are subject to the income tax.

---

<sup>68</sup> *James v United States*, 366 U.S. at 219 (quoting *Commissioner v Glenshaw Glass*, 348 U.S. 426, 431).

<sup>69</sup> The case is as read from the article: Tax War. (n.d.). *Al Capone's income Tax Evasion Case and The Taxation of illegal income*. Available online at <http://taxwar.net/capone-illegal-income-tax.html>.

<sup>70</sup> *Supra*.

<sup>71</sup> 274 U.S. 259 (1927).

<sup>72</sup> Tax War. (n.d.). *Al Capone's income Tax Evasion Case and The Taxation of illegal income*. Available online at <http://taxwar.net/capone-illegal-income-tax.html>.

- The Fifth Amendment does not protect the recipient of such income from prosecution for wilful refusal to make any return under the income tax law.
- If disclosures called for by the return are privileged by the Amendment, the privilege should be claimed in the return.<sup>73</sup>

Tax neutrality is crucial and must not be overlooked when dealing with matters of illegality. A person must be liable for tax once it has been established that he or she has earned and received income from activities. The source of that income should not be used as a defence to get away from the fulfilment of one's obligation to the economy and society as a whole.

As can be seen from the case of Al Capone, organised crime boss; Heidi Fleiss; the 'Hollywood Madam'; and William Aramony, former president of the United Way of America, the courts convicted all three of them of tax crimes.<sup>74</sup> Their convictions demonstrate that tax offences are among the most versatile weapons in the Government's hand for fighting crime. Tax offences can be used to prosecute variety of tax cheats who fail to report all or some of their ill-earned income, or they may be used to prosecute individuals, like Capone, Fleiss, and Aramony, who earned income illegally through organised crime such as prostitution, fraud or embezzlement and failed to report their ill-gotten gains.

Many criminals may be able to distance themselves from their illegal business activities, especially if they occupy top positions in the criminal organisation where they are not directly linked to the crime, but this applies to the few who are willing to distance themselves from the financial fruits of their illegal activities. It is very easy for the

---

<sup>73</sup> *Supra*fn 37.

<sup>74</sup> Tax War. (n.d.). *Al Capone's income Tax Evasion Case and The Taxation of illegal income*. Available online at <http://taxwar.net/capone-illegal-income-tax.html>.

Commissioner to prove tax evasion once he or she can establish that an individual lives beyond his or her means, especially where such persons cannot explain where the additional income comes from.

## CHAPTER 4. CONSEQUENCES OF TAX EVASION AND ILLEGAL INCOME TAXATION

### 4.1. Introduction

It is trite law that there is a relationship that exists between illegal taxation and tax evasion. The failure to declared one's income will usually amount to tax evasion in terms of which a person deliberately conceal certain aspect of his income with the purpose of escaping his or her tax liabilities.

'Tax evasion refers to illegal activities deliberately undertaken by a taxpayer with the aim of freeing his or her self from his or her tax burden'.<sup>75</sup>

*'It has also been defined as efforts by individuals, corporations, trusts, and other entities to evade taxes by illegal means and it usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities in order to reduce their tax liability. This includes, in particular, dishonest tax reporting such as declaring less income, profits or gains than actually earned; or overstating deductions.'*<sup>76</sup>

In contrast, tax avoidance is the legal use of tax laws to reduce one's tax burden in a perfectly legal manner with the result that that one has reduced one's income, or with the result that no tax is payable on income generated.<sup>77</sup> Both tax evasion and avoidance can be viewed as some form of tax noncompliance as they encompass a range of

---

<sup>75</sup> Stiglingh, M. *et al.* (2012). *Silke on South African Income Tax*. Durban: LexisNexis, page 773.

<sup>76</sup> As read from the Article Tax Evasion: Available at [http://en.wikipedia.org/wiki/Tax\\_evasio](http://en.wikipedia.org/wiki/Tax_evasio).

<sup>77</sup> Stiglingh, M. *et al.* (2012). *Silke on South African Income Tax*. Durban: LexisNexis, at page 773.

activities that are unfavourable to a state's tax system.<sup>78</sup> Avoidance of taxes or non-payment of taxes is not a criminal offence in itself. Any attempt to reduce, avoid, minimise, or alleviate taxes by legitimate means is acceptable in our law. An example of such a structuring will be where a taxpayer donates R100, 000 to his child in a particular year. This amount will not attract donation tax. There is no obligation on a taxpayer to pay more tax than is legally due under the tax Act.<sup>79</sup>

A taxpayer cannot be stopped from concluding a *bona fide* transaction which will have the effect of reducing its tax liability. This principle was confirmed by the judgment of Lord Tomlin in *Duke of Westminster v IRC*<sup>80</sup> where the judge stated that,

*'Everyone is allowed to if he can order his affairs so that the tax payable under the appropriate Act is less than it would otherwise have been and if he succeeded in ordering them so as to secure this result, then he cannot be compelled to pay an increase tax even if the Commissioner or his fellow taxpayer are unappreciative of his ingenuity'.*

The distinction between tax avoidance and tax evasion is a fine one, yet definite. One who avoids tax by legal means does not intend to conceal or misrepresent his or her affairs, but shapes events to reduce or eliminate his or her tax liability and upon the request, makes a complete disclosure. 'Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to colour or obscure events or to make things seem other than they are'.<sup>81</sup> For example, the creation of a *bona fide* partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. Upon further investigation, the facts may show that the alleged partnership was never established and that one or more of the alleged

---

<sup>78</sup> *Ibid.*

<sup>79</sup> *Suprafn* 73.

<sup>80</sup> (1953) at 520.

<sup>81</sup> *Suprafn* 76.

partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would amount to an instance of attempted evasion.

## 4.2. Tax evasion under SA Law

Tax evasion is an offence and is subject to penalties in terms of Section 234 and 235 of the SA Tax Administration Act. Tax avoidance is seen as either the dodging of one's duties to society or as part of a strategy of not supporting a particular Government activities, or just the right of every citizen to find all the legal ways to avoid paying too much tax in terms of legally acceptable means. Tax evasion, on the other hand, is a crime in almost all countries and may subject the guilty party to fines or imprisonment under certain circumstances.<sup>82</sup>

Laws known as General Anti-Avoidance Rules (GAAR) are statutes which prohibit 'tax aggressive' avoidance and which law have been passed in several developed countries<sup>83</sup>. The reasons for passing such laws is that aggressive tax avoidance can leads to tax evasion as the line between both is a thin one.

In SA, the general anti-avoidance rule for a number of years was contained in sec 103 (1) of the Tax Act. However, SARS was of the opinion that certain weaknesses were found in the said section with the result that new provisions (Sec 80A-80L) on impermissible tax avoidance arrangements were incorporated into the Act.<sup>84</sup> The new

---

<sup>82</sup> Albinet.(n.d.).*Differences between Tax Avoidance and Tax Evasion*. Available at <http://albinet.com/articles/offshore-company/taxes>.

<sup>83</sup>including the United States (since 2010),<sup>83</sup> Canada, Australia, New Zealand, South Africa, Norway and Hong Kong. In addition, judicial doctrines have accomplished similar purposes

<sup>84</sup> Part IIA, SS 80A to 80L of the Tax Act.

sec is applicable to transactions or arrangements entered into on or after 2<sup>nd</sup> of November 2006. The important part of the legislation is termed the impermissible tax avoidance arrangement. This implies that tax avoidance itself is not impermissible but only certain types of arrangement are impermissible.<sup>85</sup> SARS Practice Note 20 deals with Section 103(1), (2) and (5). Although Sec 103 (1) had been deleted, the Practice Note of SARS remains relevant as far as Sec 103(2) (uses of assessed losses) and Sec 103(5) (cession of assessed losses) are concerned.

In the SA tax evasion case of *Commissioner of Inland Revenue v Delagoa Bay Cigarette Co*,<sup>86</sup> the taxpayer was a company which sold cigarettes. In each packet, a numbered coupon could be found, which put the buyer in line to win a prize, distributed monthly. The question was whether two-thirds of the purchase price, allocated by the taxpayer for the distribution of prizes, should be included in its gross income since the amount had been received in contravention of an Act regulating lotteries. The court held that the said amount must be included in the taxpayer's gross income and must therefore be taxed. The Court held that the failure to include the amount received by the company amounts to tax evasion as the amount was received by the said company in line with the principle of received for once own benefit. The Commissioner was of the opinion that the reason for the whole structure was for the company to avoid paying its tax and that such tax avoidance amounts to tax evasion and should therefore not be allow by the court.

---

<sup>85</sup> Huxham, K. &Haupt, P: (2012). *Notes on South African Income Tax*.30<sup>th</sup> edition. Cape Town: H & H Publications.

<sup>86</sup> *Ltd 1918 TPD 391*.

In SA, there have been no important cases dealing with the application of Section 80A-80L.<sup>87</sup> However, there were several cases that dealt with the earlier version of the anti-avoidance rule.<sup>88</sup>

### 4.3. Tax evasion under USA Law

It has been said that tax cheats hurt society in five ways:<sup>89</sup> firstly, they do not contribute to the resources that support a society's infrastructure. Secondly, they corrupt the economic marketplace because they gain a competitive edge over individuals and businesses who are shouldering their full tax burden. Thirdly, the success of tax cheats in avoiding their responsibility, and the detection and consequences of their cheating, encourages others to follow suit. Fourthly, tax cheats easily become apathetic citizens since they are not contributing to society's coffers, they have less reason to be concerned how those coffers are spent. Lastly, because only a small fraction of tax cheats are actually prosecuted within the large population of defendants, it often conveys a sense of arbitrariness.

In the USA, the IRS is the Federal Governmental agency responsible for enforcing the USA tax code under Title 26 of the United States Code. The IRS consists of two enforcement divisions; namely the Examination Division which considers civil tax cases issues, while the other division is the Criminal Investigation Division which examines potential criminal violations of the tax law. According to the Internal Revenue Manual,

---

<sup>87</sup> Stiglingh, M. *et al.* (2012). *Silke on South African Income Tax*. Durban: LexisNexis, at page 779.

<sup>88</sup> *Meyerowitz v CIR* (1963) A; *CIR v Kings* (1947) A; *SIR V Geustyn, Forsyth & Joubert* (1971) A; *Hicklin v SIR* (1980) A; *CIR v Louw* (1983) A; *ITC* 1636 (1998) 60; *SATC* 267.

<sup>89</sup> Bucy, P.H. (1997). *Criminal Tax Fraud: The Downfall of Murderers and Thieves*. *Arizona State Law Journal*, 639.

criminal tax investigations serve two objectives; the first objective is to enforce the tax laws and the second objective is to encourage voluntary compliance.<sup>90</sup>

Felony Tax Evasion is outlined under the USA Internal Revenue Code Sec 7201. This is the general statute under which the IRS usually brings criminal tax charges against taxpayers who trespasses tax law legislation. This code is the most commonly used criminal Sec because its broad applicability covers a wide range of tax evasion offences. Title 26 USC, sec 7201 provides that,

*'Any person who wilfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution'.*

The code placed an important emphasis on the term 'attempt in any manner'.<sup>91</sup> The statute does not define 'attempt', nor does it limit or define the means or methods by which the attempt to evade or defeat any tax may be violated. The courts have held, however, that the term 'attempt' implies some affirmative act or the commission of some omission. This affirmative act need not be the filing of a false or fraudulent return, although most cases in this area do involve the filing of such a return. Courts have also held that a false statement made to Treasury agents for the purpose of concealing unreported income is an attempt to evade or defeat a tax.<sup>92</sup> The wilful omission of a duty

---

<sup>90</sup> Internal Revenue Manual, Practitioner's Edition Four Volume Set P4-84) as cited by Vishal Amin Felony Tax Evasion under I.R.C. Sec 7201, Georgia State University College of Law. Available at [http://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1000&context=col\\_lib\\_student](http://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1000&context=col_lib_student).

<sup>91</sup> 26 USC § 7201 - Attempt to evade or defeat tax: Legal information Institute: available at <http://www.law.cornell.edu/uscode/text/26/7201>.

<sup>92</sup> Ibid at 91.

or the wilful failure to perform a duty imposed by statute does not *per se* constitute an attempt to evade or defeat a tax. However, a wilful omission or failure (such as a wilful failure to make and file a return) when coupled with affirmative acts or conduct from which an attempt may be inferred would constitute an attempt.

The Supreme Court in *Spies v United States*<sup>93</sup> provided examples of conduct that may imply 'the attempt to evade or defeat any tax', which include but are not limited to the following:

- Keeping a double set of books
- Making false entries, alterations, invoices, or documents
- Destroying books or records
- Concealing assets or covering up sources of income
- Handling one's affairs to avoid making records usual in transactions of the kind
- Any conduct, the likely effect of which would be to mislead or to conceal

The term 'attempt' does not mean that one whose efforts are unsuccessful cannot be convicted under Sec 26 USC S7201. The crime is complete when the attempt is made and nothing is needed or added to its criminality by omission or commission. This means that an attempted crime is committed whether the taxpayer succeeds or not in carrying out his or her intention. As the courts have stated, the real character of the offence lies not in the failure to file a return or in the filing of a false return, but rather in the attempt to evade any tax. It is well settled that a separate offence may be committed with respect to each year. Therefore, an attempt for one year is a separate offence from an attempt for a different year. There may also be more than one violation in one year resulting from the same acts, such as the wilful attempt to evade the payment of tax and

---

<sup>93</sup> *Spies v United States*, 317 U.S. 492 (1943).

the wilful attempt to evade tax. Likewise, there may be a wilful attempt to evade tax and a wilful failure to file a return for the same year.

*'Tax evasion, being the process whereby a person, through commission of Fraud, unlawfully pays less tax than the law mandates is a criminal offence under federal and state statutes. A person who is convicted may be subjected to a prison sentence, a fine, or both. The failure to file a federal tax return is a misdemeanor, but a consistent pattern of failure to file for several years will constitute evidence that these failures were part of a scheme to avoid the payment of taxes. If this pattern is established, the violator may be charged with a felony under section 7201 of the Internal Revenue Code'<sup>94</sup>.*

The U.S. Supreme Court, in *Spies v. United States*<sup>95</sup>, ruled that an Overt Act is necessary to give rise to the crime of Income Tax evasion. Therefore, the government must show that the taxpayer attempted to evade the tax rather than passively neglected to file a return, which could be prosecuted under section 7203 as a misdemeanor. A person who has evaded taxes over the course of several years may be charged with multiple counts for each year that taxes were allegedly evaded.

According to the Supreme Court in *Sansone v. United States*<sup>96</sup>, a conviction under section 7201 requires proof beyond a reasonable doubt as to each of three elements: the existence of a tax deficiency, wilfulness in an attempted evasion of tax, and an affirmative act constituting an evasion or attempted evasion of the tax.

---

<sup>94</sup> As read from the article: Tax Evasion. Available at <http://legal-dictionary.thefreedictionary.com/Tax+Evasion>

<sup>95</sup> 317 U.S. 492, 63 S. Ct. 364, 87 L. Ed. 418 (1943)

<sup>96</sup>, 380 U.S. 343, 85 S. Ct. 1004, 13 L. Ed. 2d 882 (1965),

An affirmative act is anything done to mislead the government or conceal funds to avoid payment of an admitted and accurate deficiency. Affirmative behaviour can take two forms: the evasion of assessment and the evasion of payment. Affirmative acts of evasion include evading taxes by placing assets in another's name, dealing in cash, and having receipts or debts paid through and in the name of another person. Merely failing to pay assessed tax, without more, does not constitute tax evasion<sup>97</sup>.

*'In the 1970s and 80s, The IRS undertook the Taxpayer Compliance Measurement Program (TCMP) in an attempt to measure unreported income and the tax gap. The tax gap is the difference between the amount of tax legally owed and the amount actually collected by the Government. The TCMP program was believed to produce the most reliable information about noncompliance, but these 'audits from hell' were deemed to be overly intrusive and were discontinued in 1988. The National Research Program was undertaken in the 1990's as a less intrusive means of measuring noncompliance and was described as the most careful and comprehensive estimates of the extent and nature of tax noncompliance anywhere in the world. However, critics point out numerous problems with the tax gap measure'.<sup>98</sup>*

The court, through the 'business purpose' and 'economic substance' doctrines established in *Gregory v Helvering*,<sup>99</sup> the court has established its stand that aggressive tax avoidance will not be acceptable as it amounts to tax evasion. The facts of the case are as follows:

---

<sup>97</sup>Ibid at 96

<sup>98</sup> Supra.

<sup>99</sup> 293 U.S. 465 (1935) was a landmark decision by the United States Supreme Court concerned with U.S. income tax law. The case is cited as part of the basis for two legal doctrines: the business purpose doctrine and the doctrine of substance over form. The doctrine of substance over form is essentially that, for Federal tax purposes, a taxpayer is bound by the economic substance of a transaction where the economic substance varies from its legal form.

Mrs Evelyn Gregory was the owner of all the shares of a company called United Mortgage Company ('United'). United Mortgage in turn owned 1,000 shares of stock of a company called Monitor Securities Corporation ('Monitor'). 'On September 18, 1928, she created a new company called Averill Corporation ('Averill'). Three days after she created Averill, she had United transfer its Monitor stock to Averill and she had Averill issue all Averill shares to herself (not to United). She now owned 100% of United, which no longer owned Monitor shares, and 100% of Averill, which only owned 1,000 shares of Monitor.

On September 24, she dissolved Averill and had all its assets — the 1,000 Monitor shares — distributed to herself. On the same day, she sold the Monitor shares to a third party for \$133,333.33, but claiming costs of \$57,325.45, she claimed that she should be taxed on a capital net gain on \$76,007.88. On her 1928 Federal income tax return, she treated the transaction as a tax-free corporate reorganisation under Section 112 of the Revenue Act of 1928, the tax statute applicable at that time. Indeed, the legal form of this set of transactions arguably appeared to qualify under the literal language of the statute. However, the Commissioner of Internal Revenue (Mr Guy Helvering) argued that in terms of economic substance form, there was really no 'business reorganisation' and that Mrs Gregory, who controlled all three corporations, was simply following a legal form to make it appear to be a reorganisation so that she could dispose of the Monitor shares without having to pay substantial income tax on the gain that otherwise would have been deemed to have been realised. The Commissioner determined that she had understated her 1928 income tax by over \$10,000.

In the ensuing litigation, the Board of Tax Appeals (a predecessor to today's United States Tax Court) ruled in favour of the taxpayer.<sup>100</sup> However, on appeal, the United States Court of Appeals for the Second Circuit reversed the Board of Tax Appeals, ruling

---

<sup>100</sup> See *Gregory v Commissioner*, 27 B.T.A. 223 (1932).

in favour of the Commissioner.<sup>101</sup> Finally, the Supreme Court of the United States also ruled in favour of the Commissioner. The court stated,

*'It is earnestly contended on behalf of the taxpayer that since every element required by the statute is to be found in what she has done, a statutory reorganization was effected. That the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make it unlawful what the statute allows. It is quite true that if reorganization in reality was effected within the meaning of the statute, the ulterior purpose mentioned will be disregarded'.*

The legal right of a taxpayer to decrease the amount of what otherwise would be his or her taxes, or altogether avoid them, by means which the law permits, cannot be doubted but the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below (the reasoning of the Court of Appeals) in justification of a negative answer leaves little to be said.<sup>102</sup>

The court reasons as follow:

*'When the statute speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as can be seen in this case. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose but a mere device which put on the form of a corporate*

---

<sup>101</sup> See *Helveringv Gregory*, 69 F.2d 809 (2d Cir. 1934).

<sup>102</sup> *ibid* fn 87.

*reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death'.<sup>103</sup>*

The court went further and stated that,

*'In these circumstances, the facts speak for themselves and are susceptible to one interpretation. The whole undertaking, though conducted according to the terms of the statute, was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The transaction upon its face lies outside the plain intent of the statute and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose'.*

The court then ruled that the transaction amounted to tax evasion and that the whole profit made must be subjected to taxation as the purpose of the whole transaction was not to restructure the organisation but to avoid payment of tax.<sup>104</sup>

In conclusion, the aim of discussing tax evasion in relation to taxation of illegal income is to show that a relationship indeed existed between them. Tax avoidance is generally the legal exploitation of the tax regime to one's own advantage in order to reduce the amount of tax that is payable by means that are within the law whilst making a full

---

<sup>103</sup> *Gregory v Commissioner*, 27 B.T.A. 223 (1932).

<sup>104</sup> *Supra*.

disclosure of the material information to the tax authorities. Examples of tax avoidance involve using tax deductions, changing one's business structure through incorporation, or establishing an offshore company in a tax haven<sup>105</sup> and this is said to be legal. By contrast, tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade the payment of taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as under declaring income, profits or gains; or overstating deductions).<sup>106</sup>

The mere failure or wilful failure to pay tax does not constitute an attempt to evade or defeat the payment of that tax. The courts have held that the disbursement of available funds to creditors other than the Government, or to corporate stockholders, is not in itself an attempt to evade or defeat the payment of taxes and that something more with intention to defraud is required.

A person who is involved in the act of criminal activities in most cases will not disclose such activities as can be seen in most of the case laws discussed throughout this write up. Such a person will therefore be involved in what is known as tax evasion. As defined above, the failure to disclose one's income may amount to one form of tax evasion or the other.

Once the tax evasion act comes before the Commissioner, he will then institute criminal proceedings against such person with the aim of claiming the outstanding tax. The commissioner's aim is not to prosecute such persons for the criminal act of tax evasion.

---

<sup>105</sup> Albinet.(n.d.).*Differences between Tax Avoidance and Tax Evasion*. Available at <http://albinet.com/articles/offshore-company/taxes>.

<sup>106</sup> *Ibid.*

It is further obvious from many of the caselaw examined above both under SA and USA law that the basis upon which the commission is proceeding against such person is because they have committed the crime of tax evasion by failing to disclose the income derived from their illegal activities. A person who simply committed a criminal act which is not related to tax evasion will usually not be prosecuted by the Commissioner but will rather be prosecuted under the criminal act law is relevant to the criminal act committed and which and not necessarily under the tax act.

The commissioner in some case will usually proceed against persons who are involved in criminal activities where it is obvious that such person will likely escape prosecution under the normal criminal law Act. The fact that the commissioner usually proceed against such person who amongst other are involved in criminal activities did confirms that there exist a relationship between tax evasion and taxation of illegal income.

#### **4.4. Deduction of illegal income expenditure in SA**

The Income Tax Act allows the deduction of business expenses from income in order to arrive at the taxpayer's taxable income. Business expenses will mean expenditure incurred in the production of income. Section 11(a) of the Income Tax Act reads:

*'For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such a person so derived expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature'<sup>107</sup>.*

---

<sup>107</sup> Sec 11 (a) of the Income Tax Act 58 of 1962.

However, Sec 11(a) should be read together with Sec 23(g), which prohibits the deduction of 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. Also, Sec 23(f) prohibits the deduction of any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in Sec 1.

The taxability of illegal receipts therefore poses a problem when it relates to the deduction of expenditure incurred in the production of illegal income. It is provided in the Income Tax Act 58 of 1962 that expenditure incurred in the production of income should be allowed as a deduction in the calculation of taxable income. But it is noted that expenditure incurred in relation to corruption, corrupt activities, bribes or fines are not allowed to be deducted from the income of the taxpayer.<sup>108</sup> Does this imply that if the expenditure incurred is not in relation to corruption, corrupt activities, bribes or fines, will such expenditure be allowed as a deduction from income?

In *Griffiths v J P Harrison (Watford) Ltd*,<sup>109</sup> Lord Denning asked if a gang of burglars was involved in trade or an adventure in the nature of trade. He further examined the following characteristics; for example, in relation to a gang of burglars in the said case in order to ascertain whether or not they are engaged in trade or an adventure in the nature of trade. They have an organisation, they spend money on equipment, they acquire goods by their efforts, and they sell the goods and make profits. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not a requirement for trade, but still it is not a trade. The court said such an activity is simply a burglary and that is all there is to it. If one then considers such an activity as a trade, will their business expenses such as the cost of dynamite to blow open safes or the cost of petrol used by their getaway cars be allowed to be deducted from their

---

<sup>108</sup> SARS Interpretation Note No. 54.

<sup>109</sup> *J P Harrison (Watford) Ltd v Griffiths*[1962] 40 TC 281, at page 299

income?<sup>110</sup>It is implicit in Lord Denning's view that the consequences of crime should be dealt with in terms of criminal law (which may, *inter alia*, decree that the proceeds of crime are to be forfeited to the state) and that the fiscus should not allow itself to be tainted by taxing the proceeds of crime.

SARS taxes money derived from crime and presumably other unlawful trade.<sup>111</sup> Based on that, one can reasonably argue that expenses such as bribes, fines and penalties actually incurred in the course of carrying on an illegal trade should be deductible for income tax purposes if such expenses are incurred in the generation of the income, but this is not as easy as said. In the Genn case,<sup>112</sup> it was admitted that when assessing the deductibility of expenses, the closeness of the relationship between the expenditure and the income earning operations should be looked at, having regard to the purpose of the expenditure and what it really affects. Therefore, the prohibition of a deduction under S 23(o) does not arise if the expenditure does not pass the test under S 11(a).

*Port Elizabeth Electric Tramway Co Limited*<sup>113</sup> was the case of a tramway driver who claimed compensation for injury sustained while on duty. The taxpayer claimed the deduction of the compensation paid to the driver. As the compensation was so closely linked to the employment as to be regarded as part of the cost of performing it, the cost incurred was deductible. Should the act or omission that led to the compensation be deemed unlawful or negligent the expenditure would not necessarily be deductible.

---

<sup>110</sup> Van Zyl, S.P. (2011). The Value Added Tax Implications of Illegal Transactions. *Potchefstroom Electronic Law Journal (PELJ)*, vol. 14, issue 4.

<sup>111</sup> MP Finance Case.

<sup>112</sup> *CIR V Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>113</sup> *Port Elizabeth Electric Tramway Co v CIR* 1936 CPD 241.

In *ITC 1490*<sup>114</sup>, the taxpayer claimed the deduction of traffic fines under Sec 11(a). Sec 11(a) allows the deduction of expenditure incurred in the production of income. The court disallowed the deduction claiming that it is contrary to public policy. Should such a fine be allowed as a deduction, it will frustrate the intention of the legislator to punish the taxpayer for his actions and eventually lighten the punishment imposed.

#### **4.5. Deduction of fines, penalties and corrupt activities**

On 26 February 2010 SARS issued Interpretation Note No.54 regarding the prohibition, in terms of section 23(o) of the Income Tax Act No. 58 of 1962 (the Act), of the deductibility of expenditure in respect of corrupt activities, fines and penalties.

Section 23(o) reads as follows:

*'No deductions shall in any case be made in respect of any expenditure incurred*

*i where the payment of that expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 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 in any other country if that activity would be unlawful had it been carried out in the Republic.'*

---

<sup>114</sup> *ITC 1490* [(1990) 53 SATC 108 (T

The Interpretation Note further stated that corruption hampers democratic processes, good governance, sustainable development and fair business practices, and that many countries, including South Africa, prohibit the tax-deductibility of bribes. It further states that section 23(o) was enacted in 2005 and took effect from 1 January 2006, and that before the enactment of this sub-section; the Act did not specifically address the non-deductibility of expenses incurred in respect of illegal activities.

It provides further that some commentators argued that bribes, fines and penalties were deductible if they satisfied the criteria for deductibility laid down in the general deduction formula (that is to say, Section 11(a) read with Section 23(o) of the Act, in other words, if the expenditure was incurred for the purpose of producing income). Thus, for example, prior to the enactment of Section 23(o), it was arguable that a taxpayer who carried on a road haulage business ought to be able to deduct fines paid for overloading his trucks, on the grounds that his purpose in overloading them was to earn income. Section 23(o) now rules out any deduction being granted for expenditure falling within its scope.

The Interpretation Note observes that the common law crime of bribery committed by state officials was abolished by the enactment of the Corruption Act of 1992 which created a new offence called 'corruption' which subsumed both the common law crime and the offences created by previous legislation. This situation is now covered by the Prevention and Combating of Corrupt Activities Act, 12 of 2004.

Corruption is defined in the Prevention and Combating of Corrupt Activities Act, 12 of 2004 as an agreement to give, or an offer to give or the giving of a benefit that is not due to a person vested with a duty by virtue of his or her office, employment or status intending to influence the receiver or offeree to do something or to refrain from doing something at variance with his or her duty, or intending to reward the offeree or recipient for having done it or for having refrained from doing it.

The deduction of fines and penalties is prohibited to justify good governance and instigate an anti-corruption drive, as mentioned in the SARS's Interpretation Note 54.

Even though the deduction of expenditure related to illegal activities does not have any justification from a policy point of view; allowing such fines to be deducted from income would be contrary to the foundation of the law that imposed them.

The Interpretation Note 54 fails to acknowledge whether illegal income is, or should be, subject to income tax. It would be double standards for a tax system to deny a tax-deduction for a corrupt payment, yet take a slice of that payment by taxing the recipient. Yet, it would seem that this may indeed be the way our law stands at present, and if the law had to change, the legislature will have to amend the Act as it stands.<sup>115</sup>

#### **4.6. Deductibility of illegal income expenditure in USA**

In the United States, the internal Revenue Code (IRC) was enacted by the USA Congress in part for the purpose of taxing net income.<sup>116</sup>The Code is not a mechanism for enforcing other codes of law, for example, criminal law. A person's taxable income will generally be subject to the same Federal income tax rules, regardless of whether the income was obtained legally or illegally. While embezzlers, thieves, and the like are forced to report their ill-gotten gains as income for tax purposes, they may also take deductions for costs relating to criminal activity.

For example, in *Commissioner vTellier*,<sup>117</sup> a taxpayer was found guilty of engaging in business activities that violated the Securities Act of 1933.<sup>118</sup>The taxpayer subsequently tried to deduct from his gross income the legal fees he spent while defending himself.

---

<sup>115</sup> Van Zyl, S.P. (2011). The Value Added Tax Implications of Illegal Transactions. *Potchefstroom Electronic Law Journal (PELJ)*, vol. 14, issue 4.

<sup>116</sup> *Commissioner vTellier*, 383 U.S. 687, 691, 86 S. Ct. 1118, 66-1 U.S. Tax Cas. (CCH) paragr.9319 (1966).

<sup>117</sup> *Ibid.*

<sup>118</sup> 383 U.S. at 688.

The Supreme Court held that the taxpayer was allowed to deduct the legal fees from his gross income because they meet the requirements of S162(a) which allows the taxpayer to deduct all the 'ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business'. The court reasoned that it was ordinary and necessary for a person engaged in a business to expect to have legal fees associated with that business, even though such things may only happen once in a lifetime. Therefore, the taxpayer in the *Tellier* case<sup>119</sup> was allowed to deduct his legal fees from his gross income, even though he incurred the fees because of his crime.

The court in the *Tellier* case<sup>120</sup> reiterated that the purpose of the tax law was to tax net income, not punish unlawful behaviour. The court suggested further that if this was not the case, Congress must change the tax code to include special tax rules for illegal conduct.<sup>121</sup>

#### 4.7. Expenses not deductible in the America

Deductions relating to unlawful conduct may be disallowed when to allow them would sharply frustrate national or state policy prohibiting such conduct.<sup>122</sup> Congress may impose specific provisions that prohibit deductions in connection with illegal activity or other violations of law. No deduction is allowed for fines or similar penalties paid to a Government for the violation of any law.<sup>123</sup> Internal Revenue Code section 280E

---

<sup>119</sup> Commissioner v *Tellier*, 383 U.S. 687, 691, 86 S. Ct. 1118, 66-1 U.S. Tax Cas. (CCH) paragr.9319 (1966).

<sup>120</sup> *Commissioner v Tellier*, 383 U.S. 687, 691, 86 S. Ct. 1118, 66-1 U.S. Tax Cas. (CCH) paragr.9319 (1966).

<sup>121</sup> Wikipedia.(n.d.). *Taxation of illegal income in the United States*. Available at [http://en.wikipedia.org/wiki/Taxation\\_of\\_illegal\\_income\\_in\\_the\\_United\\_States#Deductible\\_expenses\\_in\\_illegal\\_activity\\_.E2.80.93\\_the\\_general\\_rule](http://en.wikipedia.org/wiki/Taxation_of_illegal_income_in_the_United_States#Deductible_expenses_in_illegal_activity_.E2.80.93_the_general_rule).

<sup>122</sup> *Tellier*, 383 U.S. at 694.

<sup>123</sup> See 26 U.S.C. & 162(f).

specifically denies a deduction or credit for any expense in a business consisting of trafficking in illegal drugs ‘prohibited by Federal law or the law of any State in which such trade or business is conducted’.<sup>124</sup>

Similarly, no business deduction is allowed for any payment made, directly or indirectly, to an official or employee of any Government. If the payment constitutes an illegal bribe or kickback or, if the payment is made to an official or employee of a foreign Government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977.<sup>125</sup> Similarly, tax deductions and credits are denied where for illegal bribes, illegal kickbacks, or other illegal payments under any Federal law or under a state if such state law is generally enforced, if the law ‘subjects the payer to a criminal penalty or the loss of license or privilege to engage in a trade or business’.<sup>126</sup> No deduction is allowed for kickbacks, rebates, or bribes made by those who furnish items or services for which payment may be made under the Social Security Act.<sup>127</sup>

#### **4.8. Medical marijuana: Treatment of deductions for expenses in business legalised under state law**

In USA, the provisions of Internal Revenue Code section 280E are recently being applied by the Internal Revenue Service (IRS) to businesses operating in the medical marijuana industry. Even though 18 states have medical marijuana laws, the IRS is applying section 280E to deny otherwise valid business deductions. Businesses operating legally under state law argue that section 280E should not be applied because Congress did not intend the law to apply to businesses that are legal under state law.

---

<sup>124</sup> See 26 U.S.C. & 280E.

<sup>125</sup> See 26 U.S.C. § 162(c)(2).

<sup>126</sup> See 26 U.S.C. § 162(c)(2).

<sup>127</sup> Wikipedia.(n.d.). *Taxation of illegal income in the United States*. Available at [http://en.wikipedia.org/wiki/Taxation\\_of\\_illegal\\_income\\_in\\_the\\_United\\_States](http://en.wikipedia.org/wiki/Taxation_of_illegal_income_in_the_United_States).

The IRS asserts that it was the intent of Congress to apply the provision to anyone ‘trafficking’ in a controlled substance, as defined under Federal law. Thus, section 280E is at the centre of the conflict between Federal and state laws with respect to medical marijuana<sup>128</sup> and therefore the deductions of expenses related to such transactions are not allowed.

#### **4.9. The moral implication of allowing such deductions**

The Income Tax Act of 1962 clearly prohibits the deduction of expenditure related to illegal activities. Such prohibitions are supported by the Prevention and Combating of Corrupt Activities Act of 2004<sup>129</sup>, which makes provision regarding corrupt activities relating to specific matters (witnesses or evidential material in certain proceedings, contracts, the procuring and withdrawal of tenders, corrupt activities related to auctions, sporting events, gambling games and games of chance) and to specific persons (public officers, foreign public officials, judicial officers, members of the legislative authority and members of the prosecuting authority).

The Prevention and Combating of Corrupt Activities Act of 2004 also addresses corruption and corrupt activities with regard to parties to an employment relationship. It provides for the receiving and an offering of an unauthorised gratification and inducing another person to commit an offence. Gratification includes gifts, contracts of employment or services, and the avoidance of punishment or loss.

---

<sup>128</sup> Ingold, J. (2011). IRS opens audit of Denver medical-marijuana dispensary., *Denver Post*, April 26 issue. Also see Ingold, J. (2011). IRS opens audit of Denver medical-marijuana dispensary. Available at [http://www.denverpost.com/news/marijuana/ci\\_17927752](http://www.denverpost.com/news/marijuana/ci_17927752).

<sup>129</sup>The Prevention and Combating of Corrupt Activities Act of 2004

The Act<sup>130</sup> acknowledges that corruption and corrupt activities are obstacles to democratic processes, good governance, sustainable development and fair business practices. They are an infringement to ethical considerations and represent a threat to morality. The deduction of expenditure incurred in relation to illegal activities, as well as fines and penalties, is prohibited by law. Section 23(o) of the Income Tax Act of 1962 specifically prohibits the deduction of expenditure related to corrupt activities, fines and penalties.

There is no evidence in the South African judicial system of cases where expenditure related to corrupt activities, fines or penalties have been allowed as deductions from income. It is therefore clear that receipts or accruals from corruption and corrupt activities are included in gross income, while expenditure related to such receipts or accruals are prohibited from being deducted from the income when calculating taxable income.

In terms of section 23(o) of the Income Tax Act of 1962, a taxpayer will not be allowed a deduction where the expenditure incurred contemplates an activity in terms of Chapter 2 of the Prevention and Combating of Corrupt Activities Act of 2004<sup>131</sup> or if it constitutes a fine or penalty for unlawful activities.

Bristow J, in the *Delagoa* case<sup>132</sup> expressed the opinion that it is common sense that if an amount, which was received illegally or by illegal means, is taxable, that amount should be subject to the same allowable deductions as if the amount had been acquired legally.

---

<sup>130</sup> Supra

<sup>131</sup> Prevention and Combating of Corrupt Activities Act 12 of 2004.

<sup>132</sup> *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391394.

In the USA case of *Commissioner of Internal Revenue v Doyle*,<sup>133</sup> the court held that it's aversion to the illegality of the transaction should not hinder the court's neutral application of the law. Conversely, if the expense complies with the requirements of the general deduction formula or the deduction requirements for that specific type of deduction that is sought, it should be deductible. It is therefore trite law that any deduction in relation to an expenses will only be allow if it complies with the requirement of the specific section in terms of which the said deduction is sought.

#### 4.10. The principles of tax neutrality

In applying the principles of tax neutrality to determine the taxability of illegal transactions, a moral dilemma is created where the layman could construe the taxation of illegal contracts as Government's approval of illegal transactions. Olivier<sup>134</sup> quite rightly opines that Government benefits from crime if amounts illegally received are taxed, and that this is a matter that calls for social outcry. She states further that it not right or just to condemn an agreement that is morally wrong or illegal for purposes of the law of obligations but at the same time tax the agreement or the proceeds resulting from the agreement as if the agreement was legally and morally sound.<sup>135</sup>

This creates a moral dilemma where, on the one hand illegal and immoral agreements are punished by law, and on the other hand it is 'acknowledged and enforced' by law to benefit Government coffers. It can furthermore not be argued that the taxation of illegal transactions should be seen in a punitive light as the taxation of illegal transactions is not a sanction for illegal activities. The Commissioner may, in addition to the outstanding tax,

---

<sup>133</sup> *Commissioner of Internal Revenue v Doyle* 231 F2d 635 (11 April 1956).

<sup>134</sup> As cited by Van Zyl, S.P. (2011). The Value Added Tax Implications of Illegal Transactions. *Potchefstroom Electronic Law Journal (PELJ)*, vol. 14, issue 4.

<sup>135</sup> *Ibid.*

claim interest and penalties, and in some cases of evasion, claim double the amount of tax as a penalty.

It is clear from the judgments on the income taxability of illegal proceeds that the courts, in applying the principles of tax neutrality, are not concerned with the moral desirability thereof. It been argued above that taxation of illegal transactions does not put the Government in a partnership with the taxpayer in any way whatsoever. Furthermore, by not charging tax on illegal transactions, the non-tax paying business owner is put at an unfair economic advantage to the tax paying business owner. The legitimate businessman cost of producing goods is higher and the goods are effectively sold at higher price than the illegitimate goods. This creates an untenable situation where the seller of legitimate goods needs to compete with the seller of illegitimate goods.

The misconception that taxing illegal transactions attaches a quasi validity to the transaction and that the Government ultimately approves of such activities might stem from the administration of punitive measures in the prosecution of gangsters in the United States of America, such as the likes of Al Capone.<sup>136</sup> This is, strictly speaking, an abuse of the punitive measures built into tax legislation and should not be taken as the norm but should rather be seen as the prosecutor's last resort to jail such persons.

Another problem might arise when the illegal vendor is allowed to claim tax. Keesling<sup>137</sup> opines that the notion that the allowance of a deduction of illegal items frustrates public policy fails to distinguish between interfering, assisting and remaining neutral. The core of the principle of tax neutrality is not to assist taxpayers (i.e. illegal activities) nor to interfere in business or the prosecution of criminals, but to remain neutral in applying tax laws. Taxing an illegal transaction in the same way as a legal transaction (and thus allowing the same deductions) reflects an attitude of neutrality which neither hinders nor

---

<sup>136</sup> Keesling, F.M. (1958). *Illegal Transactions and the Income Tax*. *UCLA Law Review*, 31.

<sup>137</sup> *Supra*.

encourages the transaction that is concerned.<sup>138</sup> The disallowance of a deduction of expenses on illegal transactions will most certainly discourage these transactions. It should, however, be noted that the primary purpose of tax legislation is to tax the taxpayer. Tax legislation should not therefore be interpreted as such to serve as a penalty for punishing persons who are involved in illegal transactions, either as an additional penalty, or a form of punishment where common law or legislation fails to penalise it adequately.

---

<sup>138</sup> Supra.

# CHAPTER 5. A COMPARATIVE ANALYSIS BETWEEN SA AND USA ILLEGAL INCOME TAX LAW APPLICATION

## 5.1. Introduction

A person's taxable income will generally be subject to the same Federal income tax rules, regardless of whether the income was obtained legally or illegally.<sup>139</sup> All persons are required to be treated equally with regards to their tax calculation and liability. As a general rule, countries have a long standing difficulty in collecting their own fair share of illegal income proceeds. Instead of proving the crime and confiscating the proceeds, the state in many cases attempts to tax the earnings. This is because proving the existence of income or wealth is often much easier than proving the commissioning of the crime. In addition, taxation can be used to imprison people who commit a crime that is difficult to prove.

## 5.2. Can taxation be used as an additional tool to curtail criminal activities and organised crime?

Both the SA and USA treatment of illegal taxation can be deduced from many of the cases that come before the courts. The proceeds of an illegal transaction will usually not be declared in a taxpayers return as this will amount to self-incrimination. The matter usually comes before the court after it has been established that the taxpayer is involved in illegal or criminal activities. The implication of this is that in some cases, criminal

---

<sup>139</sup> Wikipedia. (n.d.) *Taxation of illegal income in the United States*. Available at [http://en.wikipedia.org/wiki/Taxation\\_of\\_illegal\\_income\\_in\\_the\\_United\\_States](http://en.wikipedia.org/wiki/Taxation_of_illegal_income_in_the_United_States).

procedure has already been instituted against the perpetrator before the tax authority becomes aware of the proceeds in question.

### **5.3. SA Bill of Rights and taxation of illegal income activities**

One cannot conclude a study of this nature without taking into account the constitutional aspect of taxing illegal income and the Bill of Rights, especially the right regarding self-incrimination. The laws governing taxation cannot be looked at in isolation but must be seen within the body of other legal principles, including but not limited to the Constitution, which is the supreme law of the land, as well as other bodies of law within and outside of South Africa jurisprudence.

South Africa is a constitutional democratic country and all laws are subject to the Constitution. What this means is that the Constitution is the supreme law of the land and any law that is inconsistent with it must or will be declared invalid. Chapter 2 of the Constitution contains the Bill of Rights and these rights are the cornerstone upon which the country's democracy is built. These rights apply to all laws and bind all branches of the Government, including the national executive, parliament, the judiciary, provincial Governments and municipal councils as well as natural and juristic persons.<sup>140</sup>

### **5.4. Arrested, detained and accused persons: The right to remain silent under RSA Constitution**

Section 35 of the Constitution of the Republic of South Africa<sup>141</sup>

---

<sup>140</sup> Sec 8 of the Constitution of RSA.

<sup>141</sup>Section 35 of the Constitution of the Republic of South Africa 1996

- a. Everyone who is arrested for allegedly committing an offence has the right to remain silent;
- b. to be informed promptly
  - i. of the right to remain silent; and
  - ii. of the consequences of not remaining silent;
- c. not to be compelled to make any confession or admission that could be used in evidence against that person;

The right to remain silent is a legal right that is recognised by many countries. This right covers a number of issues that revolve around the right of an accused or the defendant to refuse to comment or provide an answer when questioned, either prior to or during legal proceedings in a court of law.

This right protects one against self-incrimination and entails the right to remain silent when questioned or giving information in a written format. The right usually encompasses that an accused who does not want to incriminate his or herself has the right to remain silent and the judges or jury may not make any negative inferences simply because the accused decided to exercise his or her right to remain silent during or before proceedings where instituted against him in any court of law. This right is an

important part of our criminal justice system and is guided by our Constitution in order to protect an accused person.<sup>142</sup>

On the one hand, the Bill of Rights as provided for in the Constitution guarantees the right of an accused who is arrested for allegedly committing an offence not to be compelled to make any confession or admission that could be used as evidence against him or her in any subsequent court of law.<sup>143</sup> The same Constitution further guarantees the right of every accused person not to give self-incriminating evidence.<sup>144</sup> On the other hand, SARS, being the revenue collector, is mandated by statute to collect taxes on behalf of the Government. The Commissioner through the Act has been given wide powers to determine the tax base, to verify information provided by taxpayers or third parties, and to collect taxes which are due.<sup>145</sup> There may be a conflict between the use of these powers to minimise tax evasion in order to ensure that all taxpayers are fairly treated and the need to respect the right of an individual taxpayers. The right to privacy,

---

<sup>142</sup> Section 35: the rights of arrested, detained and accused people, including the right to silence, protection against self-incrimination, the right to counsel and legal aid, the right to a fair trial, the presumption of innocence and the prohibition of double jeopardy and *ex post facto* crimes (Double jeopardy is a procedural defence that forbids a defendant from being tried again on the same (or similar) charges following a legitimate acquittal or conviction. In common law countries, a defendant may enter a peremptory plea of *autrefois acquit* or *autrefois convict* (*autrefois* means 'in the past' in French), meaning the defendant has been acquitted or convicted of the same offence. If this issue is raised, evidence will be placed before the court, which will normally rule as a preliminary matter whether the plea is substantiated; if it is, the projected trial will be prevented from proceeding. In some countries, including Canada, Mexico, and the United States, the guarantee against being 'twice put in jeopardy' is a constitutional right. In other countries, the protection is afforded by statute law.

<sup>143</sup> Section 35(1) (c) of the Constitution. Sinjela, M. (1997). *The Process of Democratization in South Africa and the Protection of Human Rights under the New South African Constitution. African Yearbook of International Law*, 175 at 187.

<sup>144</sup> Sec 35(2) (j) of the Constitution.

<sup>145</sup> Croom, B. (Taxpayers' Rights in South Africa 1<sup>st</sup> Edition (2010 Juta)

confidentiality, access to information, and to appeal against decisions of the administration are for example, fundamental rights in many democratic societies.<sup>146</sup>

It is therefore important to consider whether the powers granted to the Commissioner in the various fiscal statutes conform to the requirements set out in the Constitution. Taxpayers are in an unequal relationship with SARS in that it compels them, by statute, to contribute to the state's purse.

A person is expected to disclose all information relating to his or her trading activities in his or her income tax assessment form. But in terms of Section 35 of the Bill of Rights, an accused person has a right to remain silent, especially where disclosure of certain information might be used against him as evidence in a criminal court of law. It is very important to note from the onset that none of the rights entrenched in the Bill of Rights as contained in the Constitution are absolute.<sup>147</sup> Tax legislation requires taxpayers to make full disclosure of their income in order to determine their taxable income. A taxpayer who fails to make full disclosure might be found guilty of the crime of tax evasion. All the rights in the Bill of Rights are subject to the limitation clause.<sup>148</sup> Any limitation of constitutional rights must be reasonable and justifiable in an open and democratic society, based on human dignity, equality and freedom.<sup>149</sup>

To limit any right in the Bill of Rights, one must take into account the following:

- The nature of the right,

---

<sup>146</sup> *Ibidfn* 142.

<sup>147</sup> Sec 36 of the South African Constitution

<sup>148</sup> Croom, B. (2010). *Taxpayers' Rights in South Africa*. 1st Edition. Cape Town: Juta.

<sup>149</sup> Sec 39 of SA Constitution.

- The importance and purpose of the limitation,
- The nature and extent of the limitation,
- The relation between the limitation and its purpose,
- Whether or not there are less restrictive means that one can adopt in achieving same purpose without infringing or limiting those rights.

SARS, being the South African tax collector, has a mandate to collect taxes and requires all taxpayers to make full disclosures that may in certain circumstances be seen as self-incriminating. Can one then say that the disclosure of such information is justifiable in terms of the limitation clause (Section 36), or can SARS adopt a less restrictive means in achieving the important purpose of collecting tax without asking the taxpayer to provide information that may be seen as self-incriminating? The Constitution provides that no right may be arbitrarily violated without a good cause. Revenue collection is an integral, if not the most important, part of income generation for the Government and as such must be accorded the importance that it deserves.

It must be noted that when a person files his or her tax returns, he or she does not meet the definition or requirement of an accused person, and Section 35 is only applicable to an accused or detained person. It can happen that SARS sometimes does not pick up the fact that a person is involved in criminal activities when such person's tax returns are filed. SARS, as stated above, usually finds out about the illegality of the income once criminal proceedings have already been instituted against such persons and that is when the right to remain silent, as well as the right against self-incrimination, can kick in.

To find a balance between the two rights, one must then weigh both against each other by applying the limitation clause principle as contained in Section 36 of the Constitution in order to find a balance. A blanket rule cannot be adopted as each case will be decided on circumstances applicable to it. From the above argument, one can make inferences that SARS' right to information may prevail over that of the taxpayer. The court in the

MP Finance case<sup>150</sup> did not delve into the constitutionality of SARS' action to compel the taxpayer into making disclosures. The argument before the court in that case was to question whether or not tax is payable on an illegally generated income and the court answered in the affirmative. The importance of the rights of all taxpayers to be treated equally can also not be overemphasised enough. Placing the right of those individuals who are involved in criminal activities over law abiding individuals cannot be justified under the Constitution.

## 5.5. USA Constitution and the taxation of illegal income

It has been argued that the requirement by the IRS that income from illegal activities be disclosed does not violate the Fifth Amendment to the Constitution. A taxpayer may elect to claim the Fifth Amendment privilege to certain specific entries on his tax return if the disclosure could reasonably expose him to the risk of criminal prosecution. The implication of this provision is that a person's right not to criminally expose him or herself is protected by the 5<sup>th</sup> Amendment Privilege in terms of which a person may claim the privilege at the time of completing his or her tax return. This means that the Constitution give room for a person to be truthful while filling his tax return without the fear of been exposed to criminal charges as information contained therein cannot be used against him as evidence in any court of law. It is important to note that failure to claim such privilege at the time of disclosure will have the implication that such information may be introduce as evidence against such person in future prosecution and it is then understood that such person's failure it claim the privilege means that he does not mind if the information is use against him.

In conclusion, the privilege right as contained in the Fifth Amendment to the USA Constitution is not automatic as one must elect at the time of disclosure whether or not

---

<sup>150</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

he or she wishes to claim it. Should one fail or neglect to claim it at the time of disclosure, the information can then be used against such person and a defence that he now wishes to claim it as a right at time when proceedings has been instituted will not stand as can be seen from case law that is related to it thereof<sup>151</sup>.

## 5.6. Similarities and Differences between SA and USA treatment of taxation of illegal income

Having examined both case laws and numerous legislations in relation to this topic, one noted that not much similarities or differences exist between both countries. The few that one noted there therefore discussed herein.

- Firstly, in South Africa, the Supreme Court of Appeal decision's in the *MP Finance Group CC (in liquidation) v SARS*<sup>152</sup> does not articulate the principle that amounts derived from illegal activities have the characteristics of income, but such a finding is obvious from the court's conclusion that the entities in question made their money by swindling the public and that the money generated was their income.

There are two angles to this judgment. The first is the complete silence of the court on the moral and ethical dimension of the case, and the question as to whether SARS (as an organ of state) makes itself a party to fraud by taxing the proceeds of fraudulent activities, and if yes, whether this is consistent with the constitutional values that underpin South Africa's legal order. The answer to this multi-faceted question is far from self-evident, but it is unfortunate that the Supreme Court of Appeal chose to remain silent on an issue of such importance.

---

<sup>151</sup> *United States v Sullivan* 274 U.S. 259 (1927) at 264; *Garner v United States* 424 U.S. 648 (1976) at 666.

<sup>152</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

The second issue of this judgment in MP Finance case<sup>153</sup> was that SARS, by virtue of its statutory preferential status to the residue of the proceeds of the now-insolvent pyramid scheme, had first claim to the depleted proceeds of the scheme. In other words, the payment of income tax to SARS ranks first before any payment can be made from the now depleted meagre funds available for reimbursement to the innocent and cheated investors whose money were the object of the fraud. Given the public outcry and concern about the prevalence of crime and corruption in South Africa, it is unfortunate that the Supreme Court of Appeal confined its decision to the particular facts of the case and did not give the country the benefit of its view on the larger question of the taxability of the proceeds of crime in general. It is believed that SARS' view will be that all proceeds derived from crime, notwithstanding the type of crime committed, will be subject to taxation. There is nothing in the Supreme Court of Appeal's judgment in the MP Finance case<sup>154</sup> to suggest that the court would regard this practice as not sanctioned by the tax laws.

- The position in USA is very clear could be seen from the numerous case laws discussed. The Court therein were quick to point out that a person who is engaged in criminal activities will not be treated differently from persons who are engaged in legitimate trade as failure to levy tax on such proceeds will amount to great injustice as this will further show prospective criminals that they can get away with tax evasion by relying on their own wrong doing as a defence.
- Secondly, it is not clear whether SARS uses taxation as an additional tool to combat criminal activities for the following reasons: it been said above that criminal activities' proceeds will only come before the court for taxation after the perpetrator has been caught. This means that they are already facing criminal charges in court and the court is already concerned with how to impose adequate

---

<sup>153</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

<sup>154</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

criminal sanctions for the crime committed without an additional input from SARS.

- It has further been said that when SARS gets involved and taxes the proceeds of crime, the people who suffer most are usually the innocent victims of the crime. These are the people who were swindled out of their hard earned income (such as in the MP Finance case<sup>155</sup>). These persons are trying to see if they can get something back from the money invested by them. One might say here that criminal law is adequate enough to cover this aspect of law without bringing in tax law which can easily give the impression that SARS now intrudes on criminal law by taking over its duty.
- The USA courts are very clear as could be seen from the numerous case laws discussed above especially as seen from Al Capone case. The Commissioner uses tax law as additional tools in relation to tax evasion to prosecute those who are likely to escape criminal prosecution under the normal criminal act due to the fact that those persons are not directly link to the commissioning of the crime in question. If it is obvious from their assets value that such person earned more than what was disclosed in their tax return filed or they fail to file tax return as mandated by the act, and that they could also not provide legitimate answers to the questions asked by the commissioner with regards to the sources of the income from where such assets were generated, the commissioner will institute criminal proceeding against them for the crime of tax evasion and such persons not only faces monetary sanctions but also faces jail terms if they are found guilty of the crime for which they are been prosecuted for.
- Thirdly, although the Constitution of RSA makes provision against self-incrimination of oneself in terms of which one may remain silent when asked to disclose self-incriminating information or evidence and which information or evidence can later be used against such persons in a criminal court of law.<sup>156</sup> The

---

<sup>155</sup> *Supra.*

<sup>156</sup> Section 35 of SA Constitution.

- said protection is actually not available for use at the time of filling one's tax return and therefore, such information may later be used against such person in a criminal proceeding.
- Unlike the position in South Africa which does not protect the right of the taxpayer at the time of disclosure, in USA, it has been argued that the requirement by the IRS that income from illegal activities be disclosed does not violate the rights as contained in the Fifth Amendment to the Constitution. A taxpayer may elect to claim the Fifth Amendment privilege to certain specific entries on his tax return if the disclosure could reasonably expose him to the risk of criminal prosecution. However, in South Africa, a taxpayer who discloses in his or her tax return that the income originates from illegal sources remains exposed to criminal prosecution, based on information obtained from the documentation filed, which may later be admissible as evidence in a criminal court of law.
  - Fourthly, SARS and the IRS, upon conducting an investigation into the taxpayer's financial affairs, will determine where the bulk of the taxpayer's income comes from. It can happen that the taxpayer is involved in legal activities but declares less income than he or she received. These matters normally attract tax evasion sanctions and this can lead to the imprisonment of the taxpayer or the payment of fine, as may be determined by the court. Tax evasion is not the main objective of this research, although there is a relationship between tax evasion and taxation of illegal income as failure to declare an illegal income will usually amount to tax evasion. SARS taxes illegal income not because persons who involve in criminal activities are usually also involved in tax evasion due to the fact that not all of their income is declared but because it is the right thing to do. Not much will be said about tax evasion at this point, but it will be dealt with later in subsequent chapter below. What this research is concerned with is taxation as a result of being involved in illegal activities.

From the views of both countries' court decisions, one can actually reach the conclusion that South African courts treat illegal income proceeds no differently from its American counterpart. Both countries' courts conclude that persons who earn income by illegal

means are required to report unlawful gains as income when filing their tax returns. Furthermore, the USA court held that such persons are entitled to invoke the Fifth Amendment in their tax return form where full details are required concerning their illegal income activities to protect them against self-incrimination.

In conclusion, having put forward the above argument, Section 39 of RSA Constitution regulates the interpretation of the Bill of Rights. A court must promote the values that underlie an open and democratic society based on human dignity, equality and freedom. It must further consider international law/jurisprudence as well as foreign laws when dealing with matters before it. In our courts, the right of an accused to remain silent supersedes the right of SARS to obtain information. The court in such a matter, after having applied the limitation clause to each right, might further draw on foreign law and other international jurisprudence, such as the law of USA for guidance on how to balance both rights.

South African Court and the USA Courts in all the cases examined, except for *Commissioner of Taxes v G* and *ITC 1624* were of the opinion that all tax payers should be treated equally and that one should not derive benefit from one's own wrongdoing or criminal activities. The USA approach of 'claim of right doctrine' is similar to the approach adopted in the Genn case<sup>157</sup> in that both held that illegal income cannot be taxed in the hand of the recipient.

---

<sup>157</sup> *CIR V Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

## 5.7. Are some illegal activities more criminal than the others?

In this regard, South Africa must contend with the legacy of English jurisprudence which concentrates upon the linking of receipts or accrual to trade. The English courts usually distinguish between activities which are illegal *per se* and therefore not subject to income tax treatment and those which are tainted with illegality and are therefore subject to income tax treatment<sup>158</sup>. The latter category relates to legitimate businesses engaging in some illegitimate practices and it was this type of business that came before the court in *ITC 1624*<sup>159</sup>. The court only looked at the aspect of fraudulently obtained wharfage fees, and it is submitted that because the court only looked at the wharfage fees collected from the customers, the 'taint of illegality' argument led the court to the conclusion that the amount in question must be included in the taxpayer's income and therefore subject to taxation.

It is therefore suggested that the South African courts should move away from making a distinction between activities which are illegal *per se* and those which are merely tainted with illegality, as the English courts have begun to do (my own suggestion). In *Commissioner of Inland Revenue v Aken*,<sup>160</sup> the Commissioner sought to tax the income earned by a woman through prostitution and succeeded in showing that she was engaged in a trade. Prostitution is not an offence in England but it is immoral. It is illegal for the prostitute to engage in many of the activities which a moral business person would, for example, the forming of a company (at 402DE). Despite this, the court surveyed a line of English cases and commented (at 405F-H) as follows:

---

<sup>158</sup>In *Commissioner of Inland Revenue v Aken* 1990 63 TC 395

<sup>159</sup>59 SATC 373

<sup>160</sup> Ibid fn 46

*'... various courts have repeatedly rejected the argument that a trade ceases to be a trade for the purposes of the Taxes Acts because it is illegal. The reason why they have said that profits of burglary are not taxable is not because burglary is illegal but because burglary is not a trade. Therefore, if the activity is a trade, it is irrelevant for taxation purposes that it is illegal. Whether the trade is lawful or not is also irrelevant as it is still a trade.'*

The Court of Appeal did not find it necessary 'to reach any conclusion as to whether profits from an illegal trade are liable to income tax under the present law of England.' (at 413G). Thus, the courts in the United Kingdom have reached a level of clarity in that proceeds will be taxed as long as they arise or accrue from a trade, whether legal or illegal. This standpoint appears to be underscored by a move away from the idea that the state, by taxing illegal proceeds, condones the activity from which these proceeds spring from to the idea that the state should not allow the wrongdoer to benefit from advantages which are denied to an honest taxpayer.

If South Africa does not make a distinction between the taint of illegality and illegality *per se*, all illegally obtained proceeds that meet the requirement of a receipt or accrual will be subjected to the scheme-of-profit-making test as laid down in *Natal Estates v SIR*<sup>161</sup> as well as other tests under the element of the gross income definition but will exclude the receipts and accruals of capital nature.

This will in many cases be a difficult undertaking, especially where the illegal activity possesses many of the characteristics of a legal scheme of profit making; for example, prostitution, hijacking or drug-dealing. It is submitted that the courts will probably find the proceeds to be of a revenue nature rather than capital. The problem, however, lies with illegal activity which consists of a single isolated transaction; for example

---

<sup>161</sup> 1975 (4) SA 177 (A).

housebreaking. This is because the South African Appellate Division, in *CIR v Stott*<sup>162</sup> held as a general rule that one or two isolated transactions cannot be described as the carrying on of a business'. There is no doubt that exceptions do exist. A single undertaking may be of such a nature that it can be correctly described as a business. Thus in *Stephan v Commissioner for Inland Revenue*,<sup>163</sup> the court held that,

*'... the salvaging of a single ship's cargo was considered a business because these salvage operations which were managed by the staff of the appellant's business, and which necessitated so many ordinary business acts such as the engaging of services of men, hiring apparatus, purchasing equipment, the transfer of the cargo to Cape Town and the likes stand on an entirely different footing'*.

The court went further and said before for it be said that an individual is carrying on a business, there must be some proof of continuity. This application of the 'continuity' requirement applies to an individual but not to a company; this principle may be criticised, yet it is a finding of our highest court at that time.

South Africa is on top of its game and is not lagging behind its foreign counterparts when it comes to keeping its revenue eyes open with regards to criminal activities and taxation of illegally derived income. The SA courts, for example as seen from the MP Finance case as well as other cases whose judgments are in line with the MP Finance case are of the opinion that a person who is involved in illegal or criminal activities should not further benefit from his or her own wrong doing as doing so would lead to the greatest injustice to law abiding citizens of the country.

---

<sup>162</sup> 1928 AD 252, held (at 26;2).

<sup>163</sup> *Stephen v Commissioner for Inland Revenue* 1919 WLD 132 SATC 54.

I concludes this chapter by asking the question asked by many scholars; would the SA court have reached the same decision reached in the MP Finance case by taxing the proceeds of the illegal pyramid scheme had the crime been that of car hijacking, robbery or drug trafficking? I am of the view that the court would probably have taken a similar decision but I doubt whether SARS in the first place would have taken such a matter before the court as such action would have attracted a huge public outcry. Although the USA courts tax all illegal activities irrespective of what type of criminal act the proceeds come from, this question remains unanswered by our courts for now. Hopefully, it will come before the courts in the near future and such a decision will generate much debate within our scholar's community.

## CHAPTER 6. FINDINGS, RECOMMENDATION AND CONCLUSION

### 6.1. Summary of findings

Is Government entitled to tax illegal income or justified in taxing illegal proceeds? It is obvious from the above argument that this question cannot be answered in a straight forward way, despite the judgment of the MP Finance case,<sup>164</sup> as courts in SA apply different principles in deciding different cases, based on the facts and circumstances of each case. The MP Finance case<sup>165</sup> sheds some light on this aspect of the law but fails to answer all the required questions pertaining to this issue. The South African courts, as far back as 1918 in the Delagoa Bay case<sup>166</sup> held that taxability of a receipt is not affected by the legality or illegality of the business through which the income was generated. The examination of the phrase 'received by', 'accrued to' or 'in favour of' a person, as enunciated in the above cases, has assisted in answering the question of whether or not is illegal income liable for taxation in the affirmative.

These phrases connote the underlying principle in terms of which one's liability for tax is determined under the relevant applicable law. On the one hand, one can say that the Government is justified in taxing certain businesses that are involved in illegal transactions that are tainted with illegality. The illegality *per se* in such businesses affects

---

<sup>164</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

<sup>165</sup> *Ibid.*

<sup>166</sup> *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391 394.

only the means adopted in conducting such businesses.<sup>167</sup> It has been noted above that South Africa and the USA do not differentiate between illegal transactions that are tainted with illegality and those that are illegal per se, like its English counterpart. It has been further argued that the non-taxability of such businesses will result in them gaining advantages over those who pay their taxes legally.

The courts agreed in some instances that not all physical control over money constitutes a receipt in the legal sense.<sup>168</sup> For example, the principle that a thief can never appropriate the thing stolen as his own even though he or she has the intention of keeping the funds for their own benefit. The court in such a case looks at both the intention of the taker and the owner, and concludes that the owner has no intention of relinquishing ownership of the things stolen by the thief and therefore the thief is under an obligation to return what was stolen.<sup>169</sup>

On the other hand, certain scholars in South Africa argue that illegal transactions that are morally wrong cannot be said to fit into the same tax liability bracket with those stated above. It was argued above that such transactions, for example armed robbery, drug trafficking or human trafficking, are viewed by the public as morally wrong and for Government to derive any form of advantage from them can be seen by the public as approval of the transaction by SARS. One must also not forget that the principle of tax neutrality, the rule of law, and the Constitution play an important role in our society and their importance cannot therefore be emphasised enough. According to these principles, all persons must be treated equally before the law. Other courts in South Africa were of the view that once a fraudster has the intention of keeping the funds for himself and uses them for his own benefit, then he has received the funds for his own benefit as provided

---

<sup>167</sup> An example of such business will be the duplication and selling of fake musical cassettes and DVD, pyramid schemes etc.

<sup>168</sup> CIR V Genn & Co (Pty) Ltd 1955 (3) SA 293 (A).

<sup>169</sup> *Ibid.*

for by the Income Tax Act of 1962 and cannot thereafter argue otherwise. In such cases, the funds will be taxed in the hands of the fraudster.

What one also notices in the literature reviewed is that victims' rights were not considered where pyramid schemes are concerned. Upon liquidation, tax is deducted from the funds available for distribution to the victims, and thus those who were defrauded are left at the mercy of SARS. In such cases, the court is usually concerned about whether or not tax is payable, and not whether the victim gets anything back from the leftovers, however small it may be.<sup>170</sup>

What one notices further is that what is being taxed is the victims' money invested in the scheme and not the income generated by the company as the company was never involved in any trading business activities in terms of which it actually earned income, illegally or otherwise.

There is no specific provision in the South African income tax legislation that provides for the taxation or non-taxation of illegal income. The general income tax provision is applicable to all who meet the requirements for tax liability. The legality or illegality of a business does not affect its taxation, as stated above by our courts. Legality is not a requirement for the levying of a tax burden. One must therefore not be concerned with whether a business is being carried on for the purpose of making legally recognised income. What SARS is rightly concerned about is the fact that an income is being generated and must therefore be taxed, unless it is exempt income as provided for in tax law.

---

<sup>170</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

The court in the *Geldenhuys v CIR*<sup>171</sup> looked at both the intention of the giver and taker and concluded that the giver did not intend the taker to keep the funds for himself and therefore the amount could not be taxed in the taker's hands.

The court further, in *CIR v G* and *ITC 1624*, were of the same opinion as in the Genn case.<sup>172</sup> The courts keep its revenue eyes closed and its justice eyes wide open. The courts focus their attention on the intention of the victim of theft, rather than on the intention of the taker.

The above court cases having been referred to, the MP finance case<sup>173</sup> added clarity on this question by proving that tax should and will be levied on illegally generated income but failed to differentiate whether the same principle would be applicable where the income concerned emanates from criminal activities, such as armed robbery.

As could further be seen from the above argument, USA has been using taxation as a strong tool in sending criminals to jail for tax evasion right from the time of Al Capone. Those who had proven elusive to the justice of criminal law were brought to book by using tax law as a last resort in convicting them.

It was found that taxing illegal income is not illegal. The basic principles or arguments laid down in these cases are that the illegality and unenforceability of the agreement only affects the parties *inter partes*. The Income Tax Act<sup>174</sup> is also not concerned with the lawful or unlawfulness of a transaction. If the proceeds comply with the requirements of an income as laid down in the Act, such income will be taxable.

---

<sup>171</sup> *Ibid.*

<sup>172</sup> *CIR V Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A).

<sup>173</sup> *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

<sup>174</sup> Value Added Tax Act 89 of 1991.

In following the judgment of the European Court of Justice in *Vereniging Happy Family Rustenburgerstraalnspecteur der Omzetbelasting*,<sup>175</sup>the court decided that criminal charges or penalties can be the only result that could flow from an illegal transaction. This is also clear from the *ex turpi* rule that there can be no consequence resulting from an illegal contract but criminal charges if sanctions of some sort are provided. The argument that taxing the illegal transaction would lead to a false sense of validity, that quasi validity indirectly decriminalises the parties' actions and could be construed as Government's approval of illegal activities, were rejected by our courts.

The found that USA uses tax law to fight criminal activities of all nature, while SA has only applied same in certain categories of illegal transactions.<sup>176</sup>

That unlike RSA Constitution, the 5<sup>th</sup> Amendment to the USA Constitution provides taxpayers with protection against self-incrimination and which right one can claim at the time of completing the tax return form. The same cannot be said of the SA Constitution. Although the right of the accused to keep silent and the right against self-incrimination is provided for in the SA Constitution, Section 35's right is only available to three sets of persons; an arrested person, a detained person and an accused person.<sup>177</sup> One can only lay claim to these rights once it is obvious that criminal proceedings are about to be instituted against the taxpayer. It therefore means that the Section 35 rights will not protect the taxpayer at that stage as the information disclosed in the tax return form can still be used as evidence in a court of law against the accused.

---

<sup>175</sup> Case 289/86 ECJ.

<sup>176</sup> Pyramid scheme, theft and prostitution.

<sup>177</sup> Currie, I. & De Waal, J. (2013). *The Bill of Rights Handbook*. 6<sup>th</sup> edition. Cape Town: Juta.

## 6.2. Recommendations

It is recommended that SARS, apart from the collection of outstanding tax, adopt the method used by IRS in the USA in taxing the ill-gotten gains of criminal activities by sending such criminals to jail for tax evasion.

It has been argued by some authors, as shown above, that criminal sanctions can adequately take care of the crime committed by persons who are engaged in criminal activities, but in some cases, you find that sanctions imposed might not be commensurate with the crime committed as our courts will only impose criminal sanctions on crimes that have been proven beyond reasonable doubt. Proving beyond a reasonable doubt might be difficult in some illegal activities cases as evidence is tampered with along the line, but a crime of tax evasion can easily be proven in that the person's assets and liabilities can easily be determined and proved; unlike other evidence which might be hidden before the matter proceeded to court. It is therefore recommended that SARS' powers to prosecute criminal offenders must not be taken away as this will have a negative impact on the Commissioner's ability to collect taxes from persons who are involved in illegal activities.

It is further recommended that provisions be put in tax legislation where deemed necessary to protect taxpayers' rights against self-incrimination as this will put SA tax law in line with its American counterpart by protecting the use of disclosed information from being used as evidence in a court of law by the Commissioner or the Public Prosecuting Authority. This will be in line with the SA constitutional provision against self-incrimination.

It is also recommended that provisions should be put in tax legislations in terms of which a taxpayer may enter into a plea bargaining arrangement with the Commissioner or Public Prosecutor whereby it is can be agreed that any self-incriminating information declared in a taxpayer's return will only attract certain sanctions if all information provided is true and correct. When taxpayers are certain of the sanctions involved, it

might provide some form of incentive to persons who are involved in criminal activities to come forward and disclose their illegal transactions to SARS.

In balancing the rights of the taxpayer as provided for in the Bill of Rights against that of the Commissioner, it can further be provided in tax law that criminal activities will only attract criminal sanctions and that only the Public Prosecutor will have the power to institute criminal charges against the taxpayer. In such cases, the assets of the taxpayer will be forfeited to the state. This will take away the argument that SARS sanctions such illegal activities by profiting from them. The implication of this is that tax law will play no role in illegal transactions.

It is further recommended that the SA courts, when faced with illegal transaction cases, should strive towards applying a common test, irrespective of what type of illegal activities are involved. This will provide clarity on all matters as adopted by USA courts.

It is also recommended that a form of immunity provision be worked into tax law in terms of which a taxpayer who has declared his or her illegally earned income will not be prosecuted under tax law as this may also provide some form of incentive to a taxpayer who is involved in criminal activities to disclose his or her income in his tax return and pay tax on such income. This recommendation stems from the fact that the purpose of any tax law is to collect tax at all levels from all persons who generate income and not be concerned with criminal law.

It is obvious that South African laws keeps up with development just like other foreign counterparts and tax law is one type of legislation that changes on a frequent basis. As criminals get wiser, so also must the law get tighter. Although the RSA Constitution empowers the courts to develop the common law, it is further suggested that SA legislator should not leave the issue to the courts alone for development but must also take all necessary bold steps towards the amending of the Income Tax Act in terms of which taxation of illegally derived income will be treated rather leaving it to the court as it stands presently. I am sure that our legislators will continue to strive towards the

development of new legislation that will cater for the prosecution of those who are involved in criminal activities in order for SARS to achieve tax-neutrality in order to treat all persons equally before the law.

### **6.3. Conclusion**

In closing, Section 9 of the SA Constitution provides that everyone is equal before the law and has the right to equal protection and benefit of the law. If this section is applied to tax law, the implication is that everyone must be treated equally before the law. All taxpayers must therefore be treated equally when determining their taxable income, irrespective of where or how the income is generated (i.e. tax neutrality).

It must be noted that this equality before the law does not include the deduction of illegally expanded expenditures, especially where legislation specifically prohibits the deduction of such expenditure.<sup>178</sup> Both countries' Constitutions are very clear in that criminals cannot be expected to be treated differently simply because they are engaged in illegal activities. Failure to tax illegal income will lead to unfair discrimination between law abiding citizens and criminals. Taxing such proceeds may further serve as a successful tool for combating criminal activities that rises every day within our communities. The non-taxability of illegal income will put an extra tax burden on legal taxpayers and this might cause them to lose faith in the state tax system.

The Constitution introduced Section 35(5), which provides that evidence obtained in a manner that violates any right in the Bill of Rights must be excluded if the admission of such evidence would render the trial unfair or would be detrimental to the administration of justice.

---

<sup>178</sup> The Prevention and Combating of Corrupt Activities Act of 2004.

Even though criminal sanctions might be imposed on criminal activities, any other form of additional sanction will be welcome in order to further discourage persons who have the intention of engaging in criminal activities. Non-taxation of the ill-gotten gains of such persons might further also encourage illegal activities as fewer criminals will be brought to book.

It was submitted by the learned author Olivier<sup>179</sup>, and which submission I agree with,

*'... that it is possible for one to reconcile the decision taken in ITC1624 with that taken in Commissioner of Taxes v Gon the basis that, in the case of stolen money, the thief unilaterally takes the money whereas, in the case of amounts derived from illegal activities, the recipient does not unilaterally take the money, but the customers/clients intend the recipient to receive it. In other words, the thief received the money for his/her own benefit and on his/her own behalf and therefore such receipt should attract tax'.*

Taxation of income was put in place for a reason. It is designed as a tool of making everyone who is engaged in economic activities contribute to one general purse, which fund is then used for the benefit of all. Furthermore, money generated is used to fund state security as well as the provision of social amenities, amongst other things. In South Africa, it is submitted that the phrase 'accrued to or in favour of' a person as it appears in the definition of gross income could be relied upon by SARS to levy tax on illegally produced income. It is also submitted that the taxation of illegally generated income is constitutional as all person must be treated equally before the law.

---

<sup>179</sup> Olivier, L. (2008). *Taxability of illegal income*. Available at [www.moneywebtax.co.za/moneywebta/view/moneywebtax/en/pa](http://www.moneywebtax.co.za/moneywebta/view/moneywebtax/en/pa).

If the proceeds of illegally earned income are not taxed for the purpose of tax neutrality alone, it can be said further that it must be taxed for the following reason further reasons, to deter crime by reducing actual and expected profitability of the said crime in order to deter others who are looking at the possibility of engaging in such activities. To prevent crime by diminishing the capacity of offenders to finance further criminal activity, to redress the unjust enrichment of those who profit at society's expense through their evil deeds, to compensate society for the harm, suffering and human misery caused by crime activities, to reimburse the state for the ever-increasing cost of fighting criminal activities and finally to further restored the public confidence in the administration of justice by demonstrating to the community that crime does not pay and that should one proceeds with such activities, it will be met with severe consequences.

In South Africa, the judgment in the MP Finance case is a very important one as it puts to a rest the debate as to whether illegally earned income is taxable or not in South Africa. The conclusion of the court is that illegally obtained income is a 'receipt' and therefore such income must be subjected to tax liability. The MP Finance case remains the authority for South African law and will remain so until the contrary is proven or when the law is changed through legislation.

With regards to USA, it is clear from this write up that the USA Government uses taxation as an additional tool in fighting organized crimes. The Government further uses it to deter persons who are contemplating in engaging in such criminal activities from doing so as persons who are found guilty of the crime of tax evasion are not only faced with monetary sanctions but are further sent to jail.

**WORD COUNT EXCLUDING TABLE OF CONTENT AND BIBLIOGRAPHY: 22, 898**

## REFERENCES

---

Albinet.(n.d.).*Differences between Tax Avoidance and Tax Evasion*.Available at <http://albinet.com/articles/offshore-company/taxes>.

Bucy, P.H. (1997). Criminal Tax Fraud: The Downfall of Murderers and Thieves. *Arizona State Law Journal*, 639.

Classen, L.G. (2007). Legality and Income Tax: Is SARS 'Entitled to' Levy Income Tax on Illegal Amounts 'Received by' a Taxpayer? *SA Mercantile Law Journal*, Vol.19, issue 4.

Cohen, L.M., Dahm, S.G., Gulluni, M., Shah, M.M. &Wynkoop, T. (1993). Eighth Survey of White Collar Crime Substantive Crimes. *American Criminal Law Review*, Spring.

Croom, B. (2010). *Taxpayers' Rights in South Africa*.1<sup>st</sup>Edition. Cape Town: Juta.

Crump, D. (2009). Criminals Don't Pay: Using Tax Fraud to Prohibit Organized Crime. *Houston Business and Tax Law Journal*, Vol. X9.

Currie, I. & De Waal, J. (2013).*The Bill of Rights Handbook*.6<sup>th</sup>edition. Cape Town: Juta.

De Koker, A.P.& Kruger, D. (2013).*Value-Added Tax in South Africa. Issue 14 – Commentary*. Durban:LexisNexis Butterworths.

Fluxmans Attorneys.(2007). Taxation of Illegal Income.*Point of Law*, issue 6.Available at <http://www.fluxmans.com/news/polPage.asp?id=35&pageid=107>.

Huxham, K.&Haupt, P: (2012).*Notes on South African Income Tax*.30<sup>th</sup> edition.Cape Town:H & H Publications.

Ingold, J.(2011). IRS opens audit of Denver medical-marijuana dispensary.*Denver Post*, April 26 issue. Available at [http://www.denverpost.com/news/marijuana/ci\\_17927752](http://www.denverpost.com/news/marijuana/ci_17927752).

Internal Revenue Manual, Practitioner's Edition Four Volume Set P4-84, as cited by Vishal Amin Felony Tax Evasion under I.R.C. § 7201, Georgia State University College of Law.Available at [http://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1000&context=col\\_lib\\_student](http://scholarworks.gsu.edu/cgi/viewcontent.cgi?article=1000&context=col_lib_student).

Keesling, F.M. (1958).Illegal Transactions and the Income Tax.*UCLA Law Review*, 31.

Lederman, L. (2003). The Interplay Between Norms and Enforcement in Tax Compliance. *Ohio State Law Journal*, no. 1453.

Lusty, D. (2003).Taxing the Untouchables Who Profit from Organized Crime.*Journal of Financial Crime*, vol. 10, issue 3,

Meyerowitz, D. (Ed.) (2007-2008). *Meyerowitz on Income Tax*.Cape Town: Taxpayer Publishing.

Monteiro, C. &Bonthuys, E. 2007.*Sex for sale: the prostitute as businesswoman*. Available: <http://wwwserver.law.wits.ac.za/workskop/workshop03/WWLSBonthuysandMonteiro.doc>

Muller, E.O. (2007). The Taxation of Illegal Receipts: A Pyramid of Problems.*Obiter*, volume.28 (1).

Olivier, L. (2008). *Taxability of illegal income*. Available at [www.moneywebtax.co.za/moneywebta/view/moneywebtax/en/pa](http://www.moneywebtax.co.za/moneywebta/view/moneywebtax/en/pa).

Oxford Dictionary. (n.d.). *Entertainment*. Available at [www.oxforddictionaries.com](http://www.oxforddictionaries.com).

Prebble R. & Prebble J. (2010). Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law? *Saint Louis University Law Journal*.

PricewaterhouseCoopers. (2007). The taxability of illegal pyramid schemes. *Synopsis* volume 2-3.

Sinjela, M. (1997). The Process of Democratization in South Africa and the Protection of Human Rights under the New South African Constitution. *African Yearbook of International Law*.

South African Government Treasury. (n.d.). *5th Report - Basing the South African income tax system on the source or residence principle - options and recommendations*. Available at <http://www.treasury.govza/publications/other/katz/5.pdf>.

Stiglingh, M. *et al.* (2012). *Silke on South African Income Tax*. Durban: LexisNexis.

Tax War. (n.d.). *Al Capone's income Tax Evasion Case and The Taxation of illegal income*. Available online at <http://taxwar.net/capone-illegal-income-tax.html>.

Van Zyl, S.P. (2011). The Value Added Tax Implications of Illegal Transactions. *Potchefstroom Electronic Law Journal (PELJ)*, vol. 14, issue 4.

Webber Wentzel. (2005) *The taxation of illegal proceeds*. Available at <http://www.webberwentzel.com/wwb/content/en/page1874?oid=1929&sn=Detail&pid=1874>.

Wikipedia.(n.d.).Right to silence.Available at [http://en.wikipedia.org/wiki/Right\\_to\\_silence](http://en.wikipedia.org/wiki/Right_to_silence).

Wikipedia.(n.d.).*Tax Evasion and illegal income*. Available at [http://en.wikipedia.org/wiki/Tax\\_evasion#Economics\\_of\\_tax\\_evasion](http://en.wikipedia.org/wiki/Tax_evasion#Economics_of_tax_evasion).

Wikipedia.(n.d.).*Taxation of illegal income in the United States*. Available at [http://en.wikipedia.org/wiki/Taxation\\_of\\_illegal\\_income\\_in\\_the\\_United\\_States#Deductible\\_expenses\\_in\\_illegal\\_activity\\_.E2.80.93\\_the\\_general\\_rule](http://en.wikipedia.org/wiki/Taxation_of_illegal_income_in_the_United_States#Deductible_expenses_in_illegal_activity_.E2.80.93_the_general_rule).

## **ACTS**

Banks Act 94 of 1990

Consumer Affairs (Unfair Business Practices) Act 71 of 1988

Prevention and Combating of Corrupt Activities Act 12 of 2004.

Sexual Offences Act 23 of 1957

Social Security Act.

Tax Administration Act.

The Income Tax Act 58 of 1962

The Constitution of the United State of America.

The Constitution of the Republic of South African 1996.

## **CASE LAW**

Brooks Lemos Ltd v CIR1947 2 SA 976 (A).

Commissioner of Inland Revenue v Aken, 1990 63 TC 395

Commissioner of Inland Revenue v Delagoa Bay Cigarette Co Ltd 1918 TPD 391

Commissioner of Internal Revenue v Doyle 231 F2d 635

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

Commissioner of Inland Revenue v Genn& Co (Pty) Ltd 1955 3 SA (AD).

Commissioner for Inland Revenue v Insolvent Estate Botha1990 (2) SA 548 (A).

Commissioner for Inland Revenue v Namsov Fishing Enterprise (Pty) Ltd2009 (2) SA 567 (NMS).

Commissioner for Inland Revenue v Peoples Stores (Walvis Bay) Pty Ltd 1990 (2) SA 353 (A)

Commissioner for Inland Revenue v Smant 1973 (1) SA 754 (A).

Commissioner for Inland Revenue v Stott 1928 AD 252

Commissioner v Tellier, 383 U.S. 687

Commissioner v Wilcox, 327 U.S. 404 (1946)

Commissioner for Inland Revenue v Witwatersrand Association of Racing Clubs 1960 3 SA 291 (A).

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

Garner v United States, 424 U.S. 648 1976

Geldenhuys v Commissioner for Inland Revenue 1947 3 SA 265 (C).

Gregory v Commissioner for Inland Revenue, 27 B.T.A. 223 (1932).

Gregory v Helvering 293 U.S. 465 (1935)

ITC 1490 [(1990) 53 SATC 108 (T)

ITC 1624 (1997) 59 SATC 373.

ITC 1789 67 SATC 205

James v United States 366 US 213 (1961).

Mann v Nash (HM Inspector of Taxes) 1932 (1) KB 752

Metcash Trading Ltd v Commissioner South African Revenue Services 2001 1 SA 1109 (CC)

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

Natal Estates v SIR 1975 (4) SA 177 (A).

National Educare Forum v CSARS 2002 3 SA 111 (TkHC) 129-130.

Ochberg v Commissioner for Inland Revenue 1933 CPD 263-264

Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue 1936 CPD 241

Price Waterhouse Meyernel v Thoroughbred Breeders' Association of South Africa 2003 3 SA 54 (SCA).

Spies v United States, 317 U.S. 492 (1943).

Stephen v Commissioner for Inland Revenue 1919 WLD 1 32 SATC 54.

Sullivan v US 15 F.2d 809, 811 (1926).

Vereniging Happy Family RustenburgerstraalInspecteur der Omzetbelasting, Case 289/86 ECJ