THE TAXATION OF ILLEGAL RECEIPTS: A PYRAMID OF PROBLEMS!

A discussion on ITC 1789 (Income Tax Court – Natal)

1 Introduction

The question whether or not income which is received by a taxpayer in the course of carrying on illegal activities should be regarded as being received by or accrued to such taxpayer for purposes of assessing such person's gross income has been an object of debate, both in South Africa and abroad. A recent case on this topic, *ITC 1789* (67 SATC 205), which will be discussed hereunder, once again highlighted the uncertain treatment of illegal income for purposes of income tax. The case concerned the inclusion of proceeds from a pyramid scheme, deposits as well as commissions, as gross income in the hands of the scheme perpetrators. Although this discussion will focus on the said case, the history of cases that have dealt with the concept of "beneficial receipt" will be set out to provide a clear understanding of how the law has been applied and will set the background for determining whether or not the case under discussion has been correctly decided.

It will be shown that the root of the problem, in the cases that dealt with illegal receipts, is the inconsistent application of various approaches to the meaning of "beneficial receipt". The courts have followed an objective approach in some cases, and a subjective approach in others. This discussion will show that, by consistently applying the subjective approach of paying regard to the intention of the taxpayer for purposes of "beneficial receipt", the current confusion can be rectified.

It should be noted that, although the treatment of illegal income involves both the inclusion of illegal income as part of gross income as well as the deductibility of expenses incurred in the carrying on of illegal activities, the case under discussion only dealt with the issue of the inclusion of illegal income. This discussion will be limited to the first issue and will not deal with the deductibility of expenses incurred as part of illegal operations.

2 The facts and arguments

The case involved an unlawful pyramid scheme in which the taxpayer, acting through various entities, solicited millions of rand from various investors through agents. The investors were promised enormous returns on their money. Although some of the investors received the returns (described as

"dividends"), others opted to reinvest the "dividends" into the scheme. An investor was also entitled to claim a refund of his or her capital. The deposits were utilised to fund the dividends, repay any capital and to cover the agent's commission calculated at 1% per month on the amount deposited through an agent. It led to a position where Peter was robbed to pay Paul. The estimated amount deposited into the scheme was R175-million rand. The collapse of the scheme in March 2002 was inevitable. A further consequence of the scheme was the subsequent liquidation of all the involved entities.

The South African Revenue Service (SARS) included the amounts received by the taxpayer from the various investors in its gross income for the tax years 2000, 2001 and 2002. The amounts included all the deposits and payments made to the taxpayer by the investors, not only the so-called commissions. The taxpayer, represented by the joint liquidators of the joint entities, appealed against the inclusion of such amounts.

The principal issue before the court was whether the amounts paid by the investors could be said to have been "received" by the taxpayer as "gross income" within the ambit of the definition in the Income Tax Act 58 of 1962 (hereinafter "the Act"). Interestingly, the only legal issue addressed was whether the amounts constituted receipts for purposes of the Act. The issue whether such receipts, or at least a part thereof, may have constituted receipts of a capital nature, which are specifically excluded in terms of the definition, was not addressed. This aspect will be touched on hereunder.

It was common cause that the scheme was an illegal pyramid scheme and a contravention of the regulations issued in terms of the Consumer Affairs (Unfair Business Practices) Act 71 of 1988. As a consequence of the liquidation of the entities, the transactions concluded between the taxpayer and the investors were in any event declared illegal and *ab initio* null and void by Hartzenberg J in an order dated 28 February 2003.

The taxpayer contended that, because the agreements concluded with the investors were unlawful contracts and void *ab initio*, the *condictio ob iniustam causam* was applicable and the money was therefore refundable and in fact not received for the benefit of the taxpayer. The taxpayer relied on a remark of Schreiner JA in the case of *Commissioner of Inland Revenue v Genn & Co (Pty) Ltd* (1955 3 SA 293 (AD)) namely:

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

It is assumed that the taxpayer relied on the above judgment in the sense that, although the loan agreements entered into by the taxpayer were unlawful and void *ab initio*, including any contractual obligations to repay, the

taxpayer's obligation to repay flowed from the principles of the abovementioned *condictio*.

The Commissioner's counter-argument was that the repayment of the amounts depended on the application of the *par delictum* rule, which application or relaxation was conditional upon the discretion of the court, as well as the fact that the payments were not subject to immediate refund. The effect of the application of the *par delictum* rule is to leave the defendant in possession of the performance in a case where either the reclaiming party or both parties acted *in delicto*.

3 The reasoning of the court

In the first instance Levinsohn JA briefly dealt with the arguments of both parties relating to the *condictio* and *par delictum* rules. Regrettably the effect of the application of such rules to the concept of a receipt, especially in the sense that it influences the conditionality thereof, was not analysed in detail. It was merely concluded that the taxpayer did not discharge the onus of proving that the investment scheme was not in *pari delicto*, the effect of which was that the taxpayer's argument based on the application of the *condictio* was not taken any further. It is uncertain what difference a finding on the facts would have made to the application of the law (see Van der Merwe, Van Huyssteen, Reinecke and Lubbe *Contract: General Principles* 2ed (2003) 187-193 for a discussion on the said principles of the *condictio*).

The *Genn* case (*supra*) is subsequently discussed in great detail. Although the taxpayer relied on this case for authority that borrowed money can never be regarded as gross income of the borrower, because of the underlying obligation to repay the money, the lengthy analysis of such a case is, with respect, superfluous.

The *Genn* case (*supra*) dealt with the question whether or nor expenditure incurred (in the form of commissions) in the raising of loans to finance the purchasing of trading stock could be regarded as expenditure in the production of income and not of a capital nature in terms of the provisions of the general deduction formula contained in section 11(a) of the Act. The question was whether such expenditure was prohibited in terms of section 12(f) and (g) being expenditure in respect of amounts received or accrued which are not included in the term "income" and expenses which are not laid out or expended for the purposes of trade respectively. The argument was that, because loans are not included in "income", the commissions were not expended in respect of "income" and thus prohibited in terms of section 12. The court held, however, that the commissions on the loans were not expended in respect of the loans, but rather in respect of the purchasing of the trading stock. The case did not deal with the inclusion of an amount as gross income, nor did it deal with any illegal transaction. The remark that borrowed money does not form part of the borrower's gross income is merely *obiter dicta.*

Levinsohn JA nevertheless found it necessary to elaborate on the essential ratio of the *Genn* case. He *inter alia* commented that, according to the finding of the court in that case:

> "[I]t was incorrect to say that because borrowed money is exempted from forming part of gross income because of its capital nature, expenditure in connection with loans were not "received" either within the meaning of the definition of gross income or s 12(f)."

With respect, expenditure in connection with loans (interest incurred), can never be said to have been "received" within the meaning of gross income. The question is whether it qualifies as an allowable deduction in terms of section 11(a) and whether or not it is a prohibited as such under the provision of section 12(f).

The above quotation also points to an important question, namely: is borrowed money excluded from the borrower's gross income because of its capital nature, or because it does not constitute an amount received in terms of the Act? Although the judge commented that it is excluded because of its capital nature (see the quotation above), he also commented (with reference to the *Genn* case*)* that:

> "[T]hese borrowings could not be regarded as being received as part of the taxpayer's gross income notwithstanding the wide definition of this concept."

The judge pointed out that the relevance of the *Genn* case to the present facts, as submitted by counsel for the taxpayer, is that, because of the underlying illegality in the present case, there was no receipt within the definition of gross income and the money was repayable at the very moment it was received, just as the borrowed money in the *Genn* case was not regarded as income, due to the fact that the borrower had fallen under an obligation to repay at the same moment that he was given possession of the money.

The *Genn* case dealt with a situation where money was borrowed under a valid loan agreement. Should the borrowed money be regarded as a receipt for purposes of the definition of gross income, but be excluded because of its capital nature, then it is submitted that the underlying (contractual) obligation to repay does not affect the concept of receipt and the relevance of the *Genn* case would fall away for purposes of the present case. This aspect was not investigated and will be discussed hereunder.

The judge then continued to assess the meaning of "receive" in the definition of gross income with reference to case law, in that it means a receipt by a taxpayer "on his own behalf and for his own benefit" (*Geldenhuys v Commisioner for Inland Revenue* 1947 3 SA 256; *CIR v Ochberg* 1931 AD 215; and *SIR v Smant* 1973 1 SA 754 AD).

He stated that it is necessary to pay regard to the essential nature of a receipt before a determination can be made as to whether or not it should be regarded as gross income. A benefit or potential benefit, as he put it, should point clearly in that direction. He also suggested that the intention of the taxpayer, being the recipient, may be relevant to the determination. It is

stated that the taxpayer's intention was fraudulent and designed to profit from ill-gotten gains. It was held that, because of the fact that the taxpayer intended to benefit and did benefit from the money received, it would be wrong to conclude that the amounts were not received for purposes of gross income merely because of the unlawfulness and availability of the *condictio*.

The judge then referred to *ITC 1545* (1992 54 SATC 464) as authority for the view that illegality itself does not preclude an amount from being included as gross income, as set forth by Scott J in the said case (474):

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

Reference is also made to cases supporting the general contention that illegal business ventures and agreements are not robbed from all legal result just because they may be regarded as void *inter partes* (*Commissioner for Inland Revenue v Insolvent Estate Botha; Van der Westhuizen v Engelbrecht and Spouse; Engelbrecht v Engelbrecht* 1942 OPD 191; and *Delagoa Bay Cigarette Co Ltd* 1918 TPD 391).

The judge then concluded that the amounts received by the taxpayer should be regarded as receipts within the definition of gross income, notwithstanding the illegal nature of the transactions and the consequences that flow therefrom *inter partes*. It was not necessary to deal with the aspect of conditionality and the application of the *condictio* and *par delictum* rules. The taxpayer's appeal was accordingly dismissed.

4 Is the judgment in line with the law?

4 1 Received for own benefit

It is trite law 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 his own benefit" (see *Geldenhuys v Commissioner of Inland Revenue supra*; *CIR v Genn (Pty) supra*, and *Commissioner of Inland Revenue v Smant supra*).

The important issue is the meaning of "own benefit" or "beneficial receipt". These concepts have been examined by various authorities and will be discussed below. A distinction will be made between cases that dealt with legal receipts and cases that dealt with receipts derived from illegal operations. It is interesting to note that the courts have applied various approaches. In some cases, especially the cases that dealt with legal receipts, the courts followed an objective approach. The taxpayer's entitlement to the proceeds was the deciding factor. In other instances the courts have favoured a subjective approach by paying regard to the intention of the taxpayer.

4 1 1 Legal receipts

In the *Geldenhuys* case (*supra*) 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. It was held that the usufructuary, being the taxpayer, was not entitled to the amount received on the realisation of the assets subject to the usufruct. It remained the property of the remainder-man. In deciding this, the court paid due regard to the underlying common law obligationary and property rights of the usufructuary. (Court's approach: entitlement.)

In *Brookes Lemos Ltd v Commissioner for Inland Revenue* (1947 2 SA 976 (A)) and *Greases (SA) Ltd v Commissioner for Inland Revenue* (1951 3 SA 518 (A)) the two taxpayers, both in the wholesale trade, required a customer to pay a deposit on a container, to be refunded when the empty container was returned. The courts have in both cases 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.
(Court's approach: entitlement.)

In the *Genn* case (*supra*), which case was heavily relied on by counsel for the taxpayer in the case under discussion, the court remarked that borrowed money cannot be regarded as a receipt in the hands of the borrower for purposes of gross income, due to the fact that the borrower falls under an *obligation* to repay at the same moment that he is given possession of the money.
(Court's approach: entitlement.)

In *Commissioner for Inland Revenue v Witwatersrands Association of Racing Clubs* (1960 3 SA 291 (A)) an association held a horse-racing event in aid of charity. Although the proceeds were duly paid to the charity organisations, 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, use or enjoyment" (293). The court was referred to United States case law (*Brown v Heivering* 294 US 193, quoted with approval in *Robertson Ltd v MNR* 2 DTC 655). 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 money was thus indeed beneficially received by the taxpayer.
(Court's approach: entitlement.)

In *Secretary for Inland Revenue v Smant* (1973 1 SA 754 (AD)) 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.
(Court's approach: entitlement.)

Money received by an agent on behalf of a principal, or for that matter, any person merely receiving money en route to the ultimate beneficiary, should not be regarded as having been received for purposes of the definition of gross income. In the case of *Cape Consumers (Pty) Ltd* (1999 4 SA 1213 (C)) the court found that amounts transferred by the taxpayer, a buy-aid organisation, on behalf of its customers, the buyers, to a buyers' reserve fund, were held for the benefit of the buyers. The taxpayer was *obliged* to credit the income to the buyers' reserve fund. For this reason, the taxpayer did not have a legal entitlement to such income, which was "necessary for such amounts to have been received by or to have accrued to the taxpayer" (see Williams "Two Recent Cases Reconsider the Concept of 'Beneficial' Receipt or Accrual for Income Tax Purposes" 2000 *SALJ* 40 for a discussion of this case).
(Court's approach: entitlement.)

4 1 2 Illegal receipts

In the earliest case in this regard, the 1918 case of *CIR v Delagoa Bay Cigarette Co* (1918 TPD 391, 31 SATC 47), it was stated that it is immaterial for income tax purposes whether or not the business carried on by the taxpayer is in fact illegal or legal (394).

In an interesting Zimbabwean case (*COT v G* 1981 4 SA 167 (ZA)), it was held that stolen money did not constitute gross income in the hands of the thief, because of the fact that the money never became the property of the thief, despite his own intentions. The court stated that the intention of the thief (recipient) is not conclusive. It is also important to pay regard to the intention of the person who passed the money on to him (see Williams *Income Tax in South Africa: Cases and Materials* 2ed (2005) 86 for criticism on this case).
(Court's approach: mutual intention.)

In *ITC 1545* (*supra*) the taxpayer earned illegal profits in various ways. With regard to the profits derived by the taxpayer from the purchase and sale of stolen diamonds, it was common cause that the taxpayer was aware that the diamonds he purchased and sold at a profit were stolen and that his conduct amounted to theft. It was also common cause that the proceeds of the sales amounted to a "receipt or accrual" as required by the Act. The court distinguished the facts from the *COT v G* case (*supra*) in that it was not merely a "taking" by a thief. The court then had to consider whether the liability of the taxpayer to return the diamonds or their value to the owner thereof constituted deductible expenditure in terms of section 11(a). This aspect is not relevant for purposes of this discussion.

The taxpayer was also involved in a scheme where he, through his company, sold milk cultures to members of public ("the growers"). They used

"activators" to grow a "milk culture" which they then dried ("the crop") and were entitled to sell back to the company. The taxpayer, in his personal capacity, participated in the scheme as a grower. The profits so derived by him were taxed by the Receiver of Revenue. Counsel for the taxpayer argued that the scheme was a lottery in terms of section 2(1) of the Gambling Act and that the transactions were therefore void *ab initio*. It was submitted that the taxpayer was not entitled to the amounts in question.

The court stated that it was unnecessary to decide whether or not the scheme constituted an illegal lottery. It was emphasised that an amount will be included as gross income if it is "received by or accrued to" the taxpayer. The use of the word "or" is indicative of the implication that there may be a receipt without an accrual. The proceeds of the void sales could clearly not have been regarded as having been "accrued" to the growers, due to the fact that they were not entitled to the payment. The court then accepted that the meaning of "received" implies a receipt by the taxpayer for his own benefit, although it could never have been intended to include an amount received on behalf of someone else. It was stated that an amount received by a taxpayer for his own benefit in pursuance of a void transaction, should constitute an amount "received" within the ordinary literal meaning of that word. The court then held that the taxpayer's earnings were therefore included in his gross income.
(Court's approach: unilateral intention.)

In *ITC 1624* (59 SATC 373) the taxpayer, a customs clearing and forwarding agent, fraudulently overcharged customers. The court, after having quoted at length from the *COT v G* case, but without dealing with the issue of mutual intention, held that the taxpayer did "receive" the money for purposes of gross income, because he intended to receive it as part of his business receipts, which thus formed part of his business income. The unilateral intention of the recipient seemed to have been sufficient. This judgment has been questioned by many writers, especially in light of the fact that the judge did not deal with the issue of mutual intention, let alone investigate the possible effect of an underlying obligation to repay on the meaning of "receive for own benefit" (See Warneke "Fraudulent Transactions, Are the Receipts Taxable?" 2003 Tax Planning 26; and Stein "Tax on the Fruits of Fraud, A Tale of Two Cases" 1998 Tax Planning 114).
(Court's approach: unilateral intention.)

In the case under discussion the court suggested that "in some cases the intention of the recipient may be relevant to the determination" (15). Although the court was hesitant to state that intention was the conclusive factor, the *ratio* for the decision was clearly based on the intention of the taxpayer. The judge concluded as follows:

> "Her intention was fraudulent and designed to profit from ill-gotten gains … Clearly she intended to benefit and by all accounts, did benefit from the money received in the sense that commissions were appropriated therefrom."
> (Court's approach: unilateral intention.)

Although the courts clearly favoured an intention-based approach in most of the illegal income cases, two very recent decisions on illegal income focused on the taxpayer's entitlement to the income.

In *ITC 1792* (67 SATC 236) a stockbroker (the taxpayer), who acted for "M," became involved in a syndicate with dealers or portfolio managers employed by "M" with the object of manipulating certain share transactions. Generally the syndicate knew beforehand which shares "M" had intended to purchase and the syndicate, with this knowledge, bought the shares in the name of another entity, for which an account in the taxpayer's stockbroking firm had been opened, "warehoused" the shares and resold them to "M" at a profit. The taxpayer was convicted of fraud and was sentenced to imprisonment, but had made full restitution of the illegal profits to "M" together with interest.

The court distinguished the facts of this case from the *COT v G's* case (*supra*) as there was no unilateral taking. The court then referred with approval to the cases of *Geldenhuys*, *Genn*, *Cape Consumers* and *Smant* (*supra*), which followed the entitlement approach as discussed above, and the court consequently disregarded the taxpayer's intention to benefit from the ill-gotten gains. It was concluded that the taxpayer had not "received" the profits on his own behalf and for his own benefit, because the profits did not "belong" to him.
(Court's approach: entitlement.)

In *ITC 1810* (68 SATC 189) the taxpayer invested money in a pyramid scheme. The scheme collapsed and the taxpayer submitted a claim for interest against the insolvent estate. SARS included certain amounts received by the taxpayer from the scheme operators as well as the interest claimed in the taxpayer's income tax assessments. As any interest paid by the scheme operators would have qualified as dispositions without value and were voidable in terms of insolvency legislation, the court concluded that the taxpayer never had an unconditional right to claim interest from the scheme operators. The court stated:

> "However, the court could not come to a conclusion that it could ever have been the intention of the legislature to have a person taxed on income that he never got or, if he obtained it, would lose it in terms of other legislation. Accordingly, the interest claimed by the taxpayer from the insolvent estate of "A" [the scheme operators] had not accrued to him as required by s 5(1) of the Income Tax Act."
> (Court's approach: entitlement.)

4 1 3 Why different approaches?

In the cases that dealt with legal receipts, the courts clearly followed an objective approach. The concept of "beneficial receipt" was linked to the underlying legal entitlement to the amount received. An obligation to repay or redeliver was indicative of the fact that the amount was not received by the recipient for purposes of gross income.

According to the objective approach, any underlying obligation to repay or redeliver, either based on a contractual or delictual obligation (such as unjust

enrichment), or for that matter any other action in terms of statutory or common law (such as the *condictio* referred to above), should indicate that the amount is not received for purposes of gross income.

In the cases that dealt with the receipt of illegal income, the courts have been inconsistent in their approaches. The objective approach of entitlement as well as the subjective approach of intention have both been applied.

In *COT v G* (*supra*) the court found that a unilateral intention to receive was inadequate. It was concluded that the person passing the money should also have intended that the recipient should personally benefit from the receipt. It has been submitted that this decision misconceived the underlying issue and that the question should rather be whether stolen property possesses the quality of "income" in the thief's hands (Williams 86). In my view, it can be argued that, although the court pondered upon the intentions of the parties, the objective approach of entitlement was actually applied. The court stated that a person who borrows a lawnmower from his neighbour receives it from him in the broadest sense of the term, but would clearly not receive it within the meaning of the word in the definition of gross income, and that the same applies in regard to a person who obtains from another a sum of money as a loan. The court referred to the *Geldenhuys* case (*supra*) and then concluded that the intention of the taker cannot of itself result in him receiving the thing in his own *right.* It is submitted that the court's conclusion was actually based on the fact that the thief did not have a "right" to the stolen property and that this reasoning was effectively the application of the objective approach, as was indeed followed in the *Geldenhuys* case.

In the South African cases *ITC 1545* and *ITC 1624* (*supra*) the courts followed a wider approach by paying regard to the intention of the recipient only. In these cases the true intention-and-purpose approach was followed. This approach has been criticised in that the dual intention approach of *COT v G* was not applied (Warneke 2003 Tax Planning 26; and Stein 1998 Tax Planning 114). As explained above, it is submitted that the objective approach of entitlement was in fact followed in *COT v G* and that the courts therefore certainly did not follow this approach in *ITC 1545* and *ITC 1624.*

In the case under discussion, counsel for the taxpayer in fact attempted to convince the court to follow the objective approach by relying on the taxpayer's obligation to repay in applying the principles of the *condictio* and *par delictum* rules. As explained above, the court found it unnecessary to consider these issues due to the fact that the court followed, it is submitted, the subjective approach of intention.

In the cases of *ITC 1792* and *ITC 1810* (*supra*) the courts did not follow the intention-based approach and returned to the application of the objective approach.

If the objective approach, as followed in respect of the legal income cases, were to be applied in respect of all the illegal income cases, it would have been difficult to find that the taxpayers "received" the amounts for their own benefit, due to the underlying illegality. In most cases illegal contracts

are void *ab initio*. If an illegal agreement is invalid, in that it creates no obligations, it follows that performance rendered in terms of the agreement may be reclaimed. Should the concept of "receive for own benefit" indicate legal entitlement, it may be argued that the effect would be to favour dishonest businesses over honest ones!

What is the correct approach and why did the courts follow different approaches, especially in light of the fact that there is absolutely no legislative basis for treating illegal receipts differently?

It is submitted that the view of the court in *ITC 1545*, that there should be a clear and meaningful difference between the concepts of "receive" and "accrual", might be of great importance in solving the puzzle. The use of the word "or" in "received by or accrued to" is indicative of the implication that there may be a receipt without an accrual. The fruits of a void transaction could clearly not have been regarded as having been "accrued" to the recipient, due to the fact that such a person would not be entitled to the amount. It is trite law that the meaning of accrual relates to the taxpayer's entitlement to such an amount (*cf Commissioner of Inland Revenue v People's Stores* 52 SATC 9). Strictly speaking, if the meaning of "receive for own benefit" should also imply entitlement, the concept would seem superfluous. It is submitted that the wider and more subjective approach of attaching importance to the intention of the taxpayer, is a laudable.

Should this subjective approach have been followed in the cases that dealt with legal receipts, it would not have influenced the outcome of the judgments *de facto*. Although the intention of the taxpayer might have influenced a finding of whether or not an amount constituted a receipt as contemplated by the Act, the objective concept of entitlement would have covered the amount as being an "accrual" for purposes of gross income. It is for instance arguable that the amount received by the taxpayer in the *Witwatersrands Association of Racing Clubs*-case (*supra*) did not in fact constitute a "beneficial receipt" due to the fact that the taxpayer's intention was not to benefit from the receipt, but to pay the money over to a charity organisation. The amount would, however, have been included as an accrual due to the taxpayer's legal entitlement to the money.

It is submitted that the courts have confused the concepts of "accrual" and "beneficial receipt".

It is suggested that the meaning of "received by" should be restricted to an amount received by a taxpayer "for his own benefit" by taking into account his own intentions. In this regard, the further question whether or not illegality is of any relevance, must be answered in the negative. It is submitted that the concept of receipt should not entail any investigation into the taxpayer's entitlement to the amount.

It is further suggested that the meaning of "accrued to" should deal with the concept of entitlement. This is indeed the current approach. Illegality might influence entitlement. In this regard, the *condictio* and *par delictum* principles might be important to consider in cases dealing with illegal income. Due to the fact that the taxpayer involved in illegal operations

normally intends to benefit from the receipts (as in *ITC 1545* and *ITC 1624* (*supra*)), the concept of entitlement would be of academic interest only, as the amount would have already been included as a beneficial receipt.

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

A complication in this approach arises in the case where the taxpayer refunds the illegal income. This aspect, it is submitted, was in all probability, the reason for the courts in some instances concluding that the illegal income did not qualify as gross income (See *COT v G, ITC 1792, ITC 1810 supra*). The question is rather whether or not the repayment can qualify as an allowable deduction in terms of section 11(a) of the Act. Although this question can be debated at length, the legislature has recently introduced section 23(o) into the Act, which prohibits the deduction of any expenditure incurred 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, or which constitutes a fine or penalty imposed as a result of any unlawful activity carried out in South Africa or in any other country if that activity would have been unlawful had it been carried out in South Africa.

In my view, the correct application of the current law with regard to illegal income is as follows: in all cases where the taxpayer is not entitled to the income (no accrual) but does intend to benefit therefrom, the proceeds will be “received” by the taxpayer for purposes of gross income. Any repayment will be denied as an allowable deduction in terms of section 23(o).

It should be borne in mind that the definition of gross income does not only entail the concept of accrual or receipt. The taxpayer should engage in trade. The definition also excludes accruals and receipts of a capital nature. The income must be obtained in the course of an operation of business in carrying out a scheme of profit making, because receipts and accruals are revenue if they are not fortuitous but designedly sought for and worked for (see Meyerowitz *Meyerowitz on Income Tax* (2005-2006) par 8.22) It is submitted that, where a taxpayer systematically engages in an illegal activity such as a pyramid scheme, and the elements of a business such as organisation, repetition, regularity and view to a profit are present, then the proceeds from that activity will be proceeds of an income nature according to ordinary concepts. This aspect was highlighted in a recent Australian case, *Federal Commisioner of Taxation v La Rosa* (2003 FCAFC 125). It is surely possible that a court may find that a single isolated event, such as housebreaking or theft, is a receipt of a capital nature (see Monteiro

"*Pecunia non Olet*: Taking Illegal Proceeds" July 2005 5(6) *Without Prejudice* 40-41).

Returning to the case under discussion, it is submitted that, although the reasoning of the court may be criticised at some points, the commissions appropriated by the taxpayer were correctly included in the taxpayer's gross income as income beneficially received by the taxpayer, notwithstanding any illegality. This is, however, not the end of the problem. The court included the total amount received by the taxpayer in its gross income, not only the amount the taxpayer intended to benefit from, namely the commissions. The court included the deposits as well. Was this approach correct?

4 2 Amount included: total amount or only commissions?

The money that the taxpayer solicited from the investors was used to fund the "dividends" and returns that were promised, refund an investor's capital where this was required and to pay any agents' commission. The scheme was operated as a micro-lending business.

It is trite law that money borrowed by a person, in terms of a valid loan agreement, does not form part of the borrower's gross income (See *Genn*-case, *supra*). Only the income earned by the borrower in respect of such borrowed money, such as interest accrued, will be taxed as gross income in such person's hands. In *CIR v Felix Schuh SA Pty Ltd* (1994 2 SA 801 (A), Corbett CJ said the following (812D):

> "The loan and the obligation to repay by themselves have no fiscal consequences whatsoever. They do not figure in either the computation of the respondent's receipts and accruals or in the determination of its deductable expenditure and losses for the tax year in question. The loan itself is what has been termed 'a neutral factor'."

In the case under discussion, the court included the total receipts of the taxpayer as gross income, not only the commissions appropriated therefrom. This aspect was not even highlighted by the counsel for the taxpayer, probably due to the fact that their argument was based on the underlying obligation to repay the total amount, including the commissions appropriated therefrom.

A closer look at the nature of a money-lending transaction highlights an interesting point of interest, namely: is borrowed money excluded from the borrower's gross income because of its capital nature, or because it does not constitute an amount "received" in terms of the Act?

4 2 1 Deposits: Were they "received"?

In the so-called deposit cases (*Pyott Ltd v CIR* 1945 AD 128, 13 SATC 121, *Brookes-Lemos Ltd v CIR* (*supra*) and *Greases SA Ltd v CIR* (*supra*)) it was held that, for a deposit to be excluded from a taxpayer's gross income, it must have been received and held "in trust" in the legal sense of the word.

In *ITC 1346* (44 SATC 31) the decisions in the appellate division cases of *Brookes-Lemos* (*supra*) and *Greases* (*supra*) were followed. It was held that the fact that, in terms of a contract, the taxpayer may have to repay any amount later does not have the effect of excluding these amounts from gross income for the year in which the taxpayer received same.

In the *Pyott* case (*supra*) it was stated that the liability to refund a portion of the purchase price of an article sold, which liability is dependant upon whether a part of the article sold is returned to the seller, is clearly distinguishable from the obligation falling upon a borrower, at the same moment that he is given possession, to repay the loan advanced to him.

In a money-lending transaction the question arises whether the loan (or deposit) is indeed "received" by the borrower or not. It is submitted, as explained above, that entitlement is only relevant with regard to the concept of "accrual." For purposes of "beneficial receipt" the question is whether or not the borrower intends to receive the amount of the loan for his or her own benefit. The question may even be complicated by the fact that the borrower will become the legal owner of the money through *commixtio* and consumption. The lender will not be able to institute the *rei vindicatio*, but will have a personal right for payment of the money advanced to the borrower (see Thomas and Boraine "Ownership of Money and the *Actio Pauliana"* 1994 57 THRHR 679).

Interestingly, in the case of a legal money-lending transaction, it seems that the loan itself will not be regarded as being received for purposes of gross income of the borrower, although the borrower will consume the money advanced to him for his own purposes, only with an obligation to repay the amount so borrowed in a manner as agreed upon with the lender.

It is submitted that, for both legal and illegal money-lending operations, the capital amount of the loan (deposit) does not accrue to the borrower due to the fact that the borrower is not entitled to the money. It is arguable that the deposit should not be construed as being "received" by the taxpayer. In the case of a legal money-lending transaction for instance where a person deposits money into a banking account, it is submitted that the bank, being the borrower, does not receive the money for its own benefit. Although the money is utilised by the bank in other transactions, the deposits are usually well secured, guaranteed and kept in trust. Banks have strict accounting measures. In the case of a pyramid scheme, it is submitted that the taxpayer intends to benefit from the deposits. The deposits are not kept in trust, but appropriated by the taxpayer for its own benefit. There is authority for the proposition that the unilateral act of appropriation of a deposit would result in such an amount forming part of the recipient's gross income. This contention finds support in the so-called unclaimed deposit cases, in terms of which the transfer of an unclaimed deposit in the accounting records of a taxpayer equated to the transfer of control and resulted in the inclusion of that amount in the taxpayer's gross income (see *ITC* 1634, 60 SATC 235; *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 4 SA 39 A).

4 2 2 Deposits: Capital of nature?

The underlying reason for the exclusion of a loan itself from the gross income of the borrower might be that the loan is regarded as capital in nature. This appears from various instances of case law.

In the *Genn*-case the judge commented:

> "[B]orrowed money is exempted from forming part of gross income because of its capital nature …"

The judge, on the other hand, also remarked that, because of the underlying obligation of the borrower to repay the money:

> "[T]hese borrowings could not be regarded as being received as part of the taxpayer's gross income notwithstanding the wide definition of this concept."

Should a loan in the hands of the borrower rather be regarded as capital productively employed? Some cases surely indicate that borrowed money is of a capital nature. In *Allied Building Society* (1963 AD) the court stated that the money borrowed by the taxpayer constituted its "floating capital". In the well-known case of *Commissioner of Inland Revenue v Standard Bank of South Africa Limited* (1085 4 SA 485 (A)) the court commented that deposit-raising is the raising of capital by the borrower (see also *Atlantic Refining Company of Africa Pty Ltd v Commissioner of Inland Revenue* 1957 2 SA 330 (A) 335E-F). It was stated in *Ticktin Timbers CC v Commissioner of Inland Revenue* (1999 11 JTLR 295 (SCA)) that "loan capital is the life blood of many businesses". In *CIR v General Motors SA Pty Ltd* (1982 1 SA 196 (T)) it was stated that borrowed moneys are colourless for income tax purposes. The amount paid to the borrower is, for the borrower, neither capital nor revenue (201).

It has been submitted that the mere reference to "capital" or "loan capital" is an accounting term. In my view, the deposits received in a pyramid money-lending scheme should be classified as "beneficial receipts" and should not be disregarded as receipts of a capital nature.

It is arguable that both the deposits as well as the commissions should indeed have been classified as revenue receipts in the hands of the taxpayer in the case under discussion. The deposits were unilaterally appropriated by the taxpayer for its own benefit. Although the reasoning of the court, as discussed above is, it is submitted, open to criticism, the finding of the court on the facts was correct.

5 Conclusion

It is submitted that the courts have confused the concepts of "accrual" (entitlement, objective approach) and "beneficial receipt" (intention, subjective approach), especially in cases that dealt with the inclusion of illegal income in the taxpayer's gross income. This inconsistency is probably

related to a problem with the formation of a policy basis for the taxation of illegal income.

There has been extensive debate in many countries as to whether or not illegal income should be subject to taxation. However, the overwhelming weight of the authorities, both in South Africa and abroad, is that illegal income should be subject to tax notwithstanding the fact that it is tainted with illegality (*eg* Australia: *FCOT v La Rosa* 2003 FCAFC 125, *MacFarlane v FCT* 1986 13 FCR 356; United Kingdom: *Partridge v Mallandaine* 1986 2 TC 179; *Southern v AB* 1993 1 KB 713; *Minister of Finance v Smith* 1927 AC 193; United States: *James v United States* 1963 366 US 213; *CIR v Tellier* 1966 383 US 687; and Canada: *Erdelyi v R* 2003 WL 5729).

The United States follows an "economic benefits approach," which asks the question whether the taxpayer "has such control over ill-gotten gains that, as a practical matter, he derives readily realizable economic value from it" (see *James v United States supra* 219). In the United Kingdom illegal proceeds will be taxed as long as they arise or accrue from a trade, whether legal or illegal. The general policy seems to have moved away from the idea that the state, by taxing illegal proceeds, condones the activity from which these proceeds spring, to the idea that the state should not allow the wrongdoer to benefit from advantages which are denied to the honest businessman (see Monteiro July 2005 5(6) *Without Prejudice* 40-41).

In the South African context, it is submitted that there cannot be any doubt that the illegality of receipts cannot negate its taxability. This policy approach seems to be fair. It is submitted that by applying the intention-based subjective approach to the concept of "beneficial receipt," the current definition of gross income will suffice in taxing income derived from illegal activities. The objective test of entitlement should be restricted to the concept of "accrual." The question whether or not the legislature was fair in denying such a taxpayer the deduction of any refund or repayment, is a separate issue and will not be addressed in this discussion. Although illegal activities should not receive any absurd advantages (such as non-taxation), tax is after all not levied as a punitive measure (or so they say!).

The case under discussion once again highlighted this fascinating subject and the various inconsistent approaches in a South African context. The recent decisions of *ITC 1792* and *ITC 1810,* in which the objective approach was regrettably followed, proved that the taxation of illegal receipts is currently a court mess of legal uncertainty. Hopefully the Supreme Court of Appeal will soon have a chance to clear the mud.

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