



**THE TAXATION OF EMBEZZLED FUNDS – ARE EXPENSES AND LOSSES
INCURRED AS A RESULT OF EMBEZZLEMENT ACTIVITIES TAX-
DEDUCTIBLE?**

by

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DECLARATION

I, **Ngonidzashe Mangoyi**, do hereby declare that this is mini-dissertation is my own original and unaided work, and that it has not been submitted to any other university by me or by anyone else.

Signature:

31 October 2015

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List of definitions

The following definitions are used in this document:

Definition	Description
CSARS	Commissioner of the South African Revenue Service
SCA	Supreme Court of Appeal
Act	Income Tax Act 58 of 1962
SARS	South African Revenue Service
CIR	Commissioner for Inland Revenue
CoT	Commissioner of Taxes
ITC	Income Tax Court
SIR	Secretary for Inland Revenue
FCoT	Australian Federal Commissioner of Taxation
ACIR	American Commissioner for Internal Revenue



ABSTRACT

The study analyses whether taxpayers may deduct for tax purposes losses and expenses which they incur as a result of embezzlement activities. Whilst the SCA finally got the chance and held that income which is illegally obtained by a taxpayer as a result of illegal activities indeed forms part of the taxpayer's gross income, the SCA is still to get the chance to pronounce whether taxpayers should be allowed to deduct expenses and losses which are incurred as a result of embezzlement activities which may be perpetrated by shareholders, partners, senior managers, junior employees and people unrelated to the taxpayers.

The study utilises legislation, cases and commentary from South Africa and other jurisdictions. For a deduction to be allowed for losses and expenditure which are incurred as a result of embezzlement, it must be established that losses and expenditure which the taxpayer incurs as a result of embezzlement are sufficiently close to the taxpayer's production of income as held by the court in *CoT v Rendle*.¹ As required by section 11(a) of the Act, embezzlement losses and expenditure which are incurred in the production of income may be allowed for deduction. For a deduction to be allowed, the risk of incurring the loss or the expenditure must be inherent to the business enterprise of the taxpayer.

The study concludes by proffering recommendations which our courts can consider when they get an opportunity to pronounce on whether losses and expenditure which taxpayers incur as a result of embezzlement activities come before our courts again.

The study recommends that losses and expenditure which are incurred by taxpayers as a result of embezzlement activities by partners and shareholders in a firm should not be allowed for deduction, and that they should rather be treated as drawings by those partners or shareholders.

The study recommends that losses and expenditure which are incurred as a result of embezzlement activities by senior managers in a firm may be allowed if the senior managers did not occupy a position which is akin to that of a shareholder of the company.

¹ 1965 SA 59, 26 SATC 326 at pg. 327 and pg. 333.



The study recommends, in line with the decision in *Rendle*² that losses and expenditure which are incurred as a result of embezzlement activities by people unrelated to the company should be allowed for deduction. The study also recommends that losses and expenses incurred as a result of embezzlement by junior employees should be allowed for deduction.

Finally, the study recommends that as embezzlement activities are secretive and may take long to be detected, the Act must be interpreted flexibly so that taxpayers are not restricted to claiming embezzlement losses and expenditure in the years in which the embezzlement activities occur, as taxpayers may be disadvantaged if they discover embezzlement after some period. Taxpayers should be allowed to claim for tax deductions in the year which they discover the embezzlement losses, even though the losses might have been incurred in prior years. This is the approach which was advanced in the United States cases in *Alison v United States*³ and *United States v Stevenson-Chislett Inc*⁴ and also the approach which is used by the United States Treasury.

² 1965 SA 59, 26 SATC 326 at pg. 327 and pg. 334.

³ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 2. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

⁴ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 2. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).



CHAPTER 1: BACKGROUND TO THE RESEARCH

1.1 Introduction

In the course of their trading activities, taxpayers often incur expenses and losses as a result of embezzlement by employees, directors, suppliers, partners etc. The question whether such expenses and losses which taxpayers may suffer as a result of embezzlement or fraudulent activities and transactions are tax-deductible has always been a vexing question in our income tax law. Whist the question relating to whether income which an embezzler gains as a result of embezzlement should be included in the taxpayer's gross income has also been a vexing question in our income tax law, that question was answered affirmatively by the SCA in 2007 in *MP Finance Group CC v CSARS*.⁵ The SCA held that the income of a taxpayer who was involved in a pyramid scheme indeed formed part of the gross income of that taxpayer.⁶

Sections 11(a) and 23(g) of the Act provide guidelines on when deductions are allowable or disallowable for income tax purposes. In terms of sections 11(a) of the Act, (i) deductions are allowable for losses and expenses, (ii) the losses and expenses must actually be incurred, (iii) in the production of income (iv) the losses and expenses must not be of a capital nature and (v) the losses and expenses must have been incurred during the year of assessment. Section 23(g) contains the trade requirement and disallows a taxpayer from claiming a deduction from income which the taxpayer will have derived from trade if the taxpayer did not incur the losses or expenses for the purposes of trade.

On 5 November 2014, the SARS released Interpretation Note number 80⁷ (hereinafter referred to as Interpretation Note) on how it assesses tax on embezzled funds. It is important to note that interpretation notes are only meant for guidance purposes, are not binding to the SARS, and indeed are not law. It is thus possible for the SARS to argue against the contents of its own interpretation notes it court. The

⁵ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 11.

⁶ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 11.

⁷ SARS *Interpretation Note Number 80: The Income Tax treatment of stolen money* (2014) SARS. <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2014-05%20-%20IN80%20Income%20Tax%20Treatment%20of%20Stolen%20Money.pdf> (Accessed 06 February 2015).



study thus seeks to critically analyse whether deductions should be allowed for expenses and losses incurred as a result of embezzlement activities and also analyse the position with regards to the inclusion of funds derived from illegal activities under a taxpayer's gross income.

1.2 Problem Statement

Whilst sections 11(a) and 23(g) of the Act provide for the tax deductibility of expenses, there have always been disputes with regards to whether the expenses or losses which are incurred as a result of embezzlement are closely related to the production of income so as to be regarded as part of the costs of earning it. In *CoT v Rendle*,⁸ the court allowed for a tax deduction on embezzled funds. In deciding to allow for the deduction, the court held that the expenses were incurred in the business operations of the taxpayer.⁹ The court also held that whether or not a deduction is allowable for fortuitous expenses and losses would depend on whether such losses or fortuitous activities are closely related to the business of the taxpayer.¹⁰

In *Lockie Bros Ltd v CIR*,¹¹ the court disallowed a deduction for a loss which a taxpayer had incurred as a result of the embezzlement of funds by a senior manager. The court held that the embezzlement of funds is something which is not done for the purposes of trade.¹² In *ITC 952*,¹³ a deduction was also disallowed as the court was of the view that the embezzlement of funds by senior managers cannot be said to be something which is incurred in the ordinary course of business. In *ITC 952*,¹⁴ the court reinforced the decision of the court in *Lockie Bros Ltd*¹⁵ and speculated that one of the reasons for the *Lockie Bros Ltd*¹⁶ decision could be that it is not reasonably expected for a senior manager to embezzle a company's funds.¹⁷

⁸ 1965 SA 59, 26 SATC 326 at pg. 327,335 and 336.

⁹ 1965 SA 59, 26 SATC 326 at pg. 327,335 and 336.

¹⁰ 1965 SA 59, 26 SATC 326 at pg. 331.

¹¹ 1922 TPD 42, 32 SATC 150.

¹² 1922 TPD 42, 32 SATC 150 at pg. 150 and 155.

¹³ 1961 24 SATC 547 (F).

¹⁴ *Ibid.*

¹⁵ *Supra.*

¹⁶ *Ibid.*

¹⁷ 1961 24 SATC 547 (F) at pg. 551.



1.3 Research Objectives

The objectives of the study are to analyse how embezzled funds are treated for tax purposes both in the hands of the victim and also in the hands of the embezzler. Specifically, the study will examine whether:

- (i) Losses and expenses which are suffered by a victim of embezzlement should be allowable for deductions;
- (ii) The income which the embezzler gains from the embezzlement should be included under the embezzler's gross income.

1.4 Importance and significance of the study

As the tax-deductibility of embezzled funds remains a subject of conjecture in South Africa, it remains critically important to analyse all the contesting views with regards to whether the losses and expenses which arise as a result of embezzlement should be allowed for deduction. In addition, it is paramount to examine whether the embezzled funds should be treated as part of the gross income in the hands of the embezzler.

It is of extreme importance to study the issues as the position with regards to the tax-deductibility of embezzled funds has not been settled in our law. Even though the SARS released the Interpretation Note, the views of the SARS in interpretation notes are not law, and indeed the position of the SARS in interpretation notes ought to be contested. Furthermore, the courts can arrive at different decisions from the views of the SARS. The study will therefore also focus on other approaches which may be different from the approach of the SARS.

1.5 Research Methodology

The study will make use of desktop research by analysing the legal position on the tax treatment of embezzled funds. Historical documents and the positions of other countries will be carefully analysed so as to determine the legal position in South Africa and make recommendations on how expenses and losses incurred as a result of embezzlement are treated for tax purposes.



1.6 Data Collection

So as to assist with the study, the following information will be collected:

- (i) Legislation (the Act);
- (ii) Legislation (other jurisdictions);
- (iii) Case law (South African);
- (iv) Case law (other jurisdictions);
- (v) The Interpretation Note; and
- (vi) Journal articles.

1.7 Data analysis

The South African legislation, legislation from other jurisdictions, South African case law, case law from other jurisdictions, the Interpretation Note and journal articles will be critically analysed so as to look at the competing approaches with regards to the tax treatment of embezzled funds.

1.8 Structure of the study

Chapter 1 gives a background to the study, identifies the research problem, details the research objectives, importance and benefits of the study, and sets out the research methodology, data collection methods and the approaches to the analyses of the data.

Chapter 2 analyses the approaches which have been used by the courts with regards to the inclusion under a taxpayer's gross income of revenue which a taxpayer may receive as a result of embezzlement activities.

Chapter 3 looks at the general deduction formula and the approaches which the courts have used in the past with regards to the tax-deductibility of embezzlement losses and expenses.

Chapter 4 analyses the necessity of the risk of the taxpayer incurring the embezzlement losses and expenses. Losses and expenses maybe allowed for deduction for tax purposes if the risk of incurring them was a necessary incident to the taxpayer's trade.



Chapter 5 analyses the approaches which have been used by other countries with regards to the tax-deductibility of embezzlement losses and expenses. Approaches in Canada, the United States and Australia are analysed.

Chapter 6 concludes the study and recommends approaches which our courts can take into consideration when and if the issues of tax-deductibility of losses and expenses incurred as a result of embezzlement are the subject of enquiry.

1.9 Conclusion

This introductory chapter identifies the research problem, sets out the research objectives, spells out the importance and the benefits of the study and sets out the structure of the dissertation.



CHAPTER 2: THE TAXABILITY OF ILLEGALLY OBTAINED INCOME

2.1 Background

Once a taxpayer has ascertained the total quantum of his/her expenditure and losses (incurred as a result of both legal and illegal activities), the total figure is used in calculating the taxpayer's taxable income.¹⁸ The taxpayer determines his/her gross income and then subtracts exempt income (to arrive at the taxpayer's income), and further subtracts allowable deductions from the income to arrive at the taxpayer's taxable income.^{19,20} The applicable tax rate will then be used to determine the taxpayer's tax liability.²¹

The definition of gross income is contained in section 1 of the Act as follows: *"the total income in cash or otherwise received by or accrued to or in favour of such person [but] excluding receipts and accruals [which are] of a capital nature."*

2.2 Taxability of receipts from legal activities

South African courts have mainly applied the objective approach with regards to whether receipts derived legally form part of the gross income of a taxpayer or not. For example, in *Brookes Lemos Limited v CIR*,²² the court held that the deposits which a taxpayer had received from its customers had been so received within the meaning of the definition of gross income which is contained in section 1 of the Act. In this case, the taxpayer would require its customers to pay the deposits for containers, and the deposits would be refunded to the customer upon the return of the container by the customer. The court held that the deposits had been received

¹⁸ Croome B (eds) et al. *Tax Law: An Introduction*. (2013) Juta. Johannesburg para 2.4; Haupt P and Huxman K. *Notes on South African Income Tax*. (2013) Roggebaai: H&H para. 1.3.1; Stiglingh, M. et al *SILKE: South African Income Tax 2014*. (2014) 16th ed. LexisNexis. Johannesburg. para 1.2.

¹⁹ Croome B (eds) et al. *Tax Law: An Introduction*. (2013) Juta. Johannesburg para. 2.4; Haupt P and Huxman K. *Notes on South African Income Tax*. (2013) Roggebaai: H&H para. 1.3.1; Stiglingh, M. et al *SILKE: South African Income Tax 2014*. (2014) 16th ed. LexisNexis. Johannesburg. para 1.2

²⁰ Where applicable, taxable capital gains will also factored into account (Haupt P and Huxman K. *Notes on South African Income Tax*. (2013) Roggebaai: H&H para. 1.3.1; Stiglingh, M. et al *SILKE: South African Income Tax 2014*. (2014) 16th ed. LexisNexis. Johannesburg. para 1.2).

²¹ Croome B (eds) et al. *Tax Law: An Introduction*. (2013) Juta. Johannesburg para 2.4; Haupt P and Huxman K. *Notes on South African Income Tax*. (2013) Roggebaai: H&H para. 1.3.1; Stiglingh, M. et al *SILKE: South African Income Tax 2014*. (2014) 16th ed. LexisNexis. Johannesburg. para 1.2

²²1947 2 SA 976, SATC 295 at pg. 299-300.



within the meaning of the definition of gross income as the customers were not in any way obliged to return the cases to the taxpayer.²³

The court also applied the objective approach in the case between the *CIR v Witwatersrand Association of Racing Clubs*.²⁴ In this case the taxpayer was left aggrieved by the decision of the court. The taxpayer organised a horse-racing function whose proceeds would go towards assisting charity institutions. The CIR included the proceeds under the gross income of the taxpayer. The court upheld the CIR's decision as the court held that the taxpayer was not obliged to pay over the proceeds of the horse-racing function to the charities, and thus the taxpayer had received the proceeds of the charity function beneficially within the meaning of the definition of gross income.²⁵

2.3 Taxability of illegally obtained income

In *ITC 1792*²⁶ the issue related to whether secret profits which were received by a taxpayer formed part of his gross income. In this case, the taxpayer was a successful stockbroker and a member of the Johannesburg Stock Exchange. The taxpayer's job would entail getting mandates from clients to purchase shares on behalf of the clients and also to sell the shares on behalf of the clients. Thus the taxpayer's relationship with his clients was one of principal-agency.²⁷

The taxpayer, over the course of two years in the early 1990s, breached the fiduciary duty which he had with regards to the business and interests of one of his principals. The taxpayer entered into clandestine deals with a syndicate of portfolio managers in which, for the benefit of the syndicate and the taxpayer, the syndicate would buy shares through an intermediary vehicle which had been established for the sole and exclusive purpose of fleecing principal.²⁸

The syndicate was in a position in which it could manipulate the transactions and the syndicate had knowledge beforehand of the shares which the principal was

²³ 1947 2 SA 976, SATC 295 at pg. 299-300.

²⁴ 1960 3 SA 291.

²⁵ 1960 3 SA 291 at pg. 398-399.

²⁶ 67 SATC 236.

²⁷ 67 SATC 236 at pg. 237.

²⁸ 67 SATC 236 at pg. 237.



interested in.²⁹ With this knowledge, the syndicate would buy exactly those shares through the intermediary vehicle. After the shares had gone through the books and temporary ownership of the intermediary vehicle, the syndicate would sell them to the principal of the taxpayer at a profit. The taxpayer was convicted for his role in fleecing the principal and sentenced to imprisonment for the indiscretions. He however managed to reimburse the principal for the funds (both principal and interest) which he had fleeced from the client. The dispute which was before the court in this case was whether the secret and fraudulent profits which were earned by the taxpayer could form part of his gross income. The taxpayer had initially included the secret profits which he earned from fleecing the clients under his gross income; but later amended his tax returns and argued that the secret profits should not form part of his gross income as the taxpayer had not received the profits for his own benefit.³⁰

The court held that the secret profits which the taxpayer earned from fleecing the principal could not form part of the taxpayer's gross income.³¹ The court was of the view that the shares which the syndicate acquired never belonged the syndicate, but that they belonged to the principal throughout the entire period regardless of the intentions of the syndicate and/or the taxpayer.³² The court held that even though the intention of the taxpayer was to receive the secret profits for his own benefit, the law then did not make provision for the syndicate and/or the taxpayer to receive the profits for their own benefit.³³ The court was of the view that since the taxpayer worked for and in the best interests of the principal in terms of the mandate which emanated from the principal-agency relationship, any profits which the agent (taxpayer) earned were necessarily earned by and for the benefit of the taxpayer, and could not form part of the taxpayer's gross income.³⁴

In *CoT v G*,³⁵ the question whether embezzled funds formed part of the gross income of a taxpayer came before the Zimbabwean High Court. In this case, the

²⁹ 67 SATC 236 at pg. 237.

³⁰ 67 SATC 236 at pg. 236.

³¹ 67 SATC 236 at pg. 240.

³² 67 SATC 236 at pg. 240.

³³ 67 SATC 236 at pg. 240.

³⁴ 67 SATC 236 at pg. 240.

³⁵ 1981 (4) SA 167.



taxpayer was entrusted by the Zimbabwe government with funds for use in the government's secret operations. The taxpayer abused his position and the Zimbabwe government's trust in him by converting a substantial amount of the government's funds for his own use. The taxpayer deposited part of the funds into his bank account and used the other part of the funds to purchase things which were meant for his own personal use. The taxpayer was subsequently convicted for the embezzlement. The court which convicted the taxpayer suspended his sentence on the condition that the taxpayer reimbursed the Zimbabwe government for the funds which he embezzled from the government.

The issue which was in dispute when the case came before the Zimbabwe High Court was whether the funds which the taxpayer embezzled from the Zimbabwe government could be construed as having been "received" by the taxpayer and form part of the taxpayer's gross income. Then, in Zimbabwe, the provisions of the legislation which defined gross income had the exact wording which is contained in section 1(1) of the Act.

The court held that the act of embezzlement did not satisfy the definition of gross income as contained in the Zimbabwean tax legislation.³⁶ The court held that within the definition or act of a receipt there should be a conscious effort by one party to give or proffer another party something; and that the person to whom something is proffered upon must accept the thing which is proffered upon him. In this context, the court held that the embezzled funds could not fall within the definition of gross income as the taxpayer unilaterally appropriated the funds for own use instead of the funds being offered to him and accepting them.³⁷ The court further held that when the Zimbabwean government handed over the funds to the taxpayer this was done for a precise and explicit purpose and it could not be construed that the taxpayer would thus "receive" the funds for his own benefit, and thus concluded that the embezzled funds could not form part of the taxpayer's gross income.³⁸

³⁶ 1981 (4) SA 167 (ZA), 43 SATC 159 at 162.

³⁷ 1981 (4) SA 167 (ZA), 43 SATC 159 at 163.

³⁸ 1981 (4) SA 167 (ZA), 43 SATC 159 at 163.



In *CIR v Delagoa Bay Cigarette Company Limited*,³⁹ the issue of whether income which was earned by a company in the course or as a result of illegal activities came before the courts. In this case, the taxpayer company ran an illegal lottery in which it sold packets of cigarettes, and each packet of cigarettes contained numbered coupons which would be entered in a raffle. The taxpayer company committed to reserve two thirds of the amount which it would have received from the selling of the numbered coupons towards a prize fund. The taxpayer company furthermore pronounced that it would make monthly distributions at the discretion of the directors of the company to people who would have bought the cigarette packets.⁴⁰

After the taxpayer company had made two distributions, the CIR instituted criminal proceedings against the officials of the taxpayer company, based on the argument that the taxpayer company was operating an illegal lottery. The CIR was also of the view that the distribution of prizes by the taxpayer company to winners of the raffle was in fact a disposal of the profits which the company would have been earned and thus requested the taxpayer company to file interim returns for the income which it had earned from the sale of the cigarettes with the numbered coupons.⁴¹

The major issues which the court was confronted with in this case were whether the money which the taxpayer company earned from the sale of the numbered coupons constituted part of the taxpayer's gross income; and if that was answered in the affirmative whether a claim for deduction for the expenditure which the taxpayer incurred pursuant of earning the income would succeed.

The court held that it is not relevant for tax liability purposes whether the income which is received by the taxpayer has been earned legally or illegally.⁴² The court held that tax liability arises on taxpayers as soon as income has been earned, and that it is not material whether the income has been earned through legitimate means or otherwise.⁴³ The court thus held that *Delagoa Bay Cigarette Company Limited's*⁴⁴ tax liability arose as soon as it started accumulating income from the sale of the

³⁹ 1919 TPD 391,32 SATC 47.

⁴⁰ 1919 TPD 391,32 SATC 47 at pg. 48.

⁴¹ 1919 TPD 391,32 SATC 47 at pg. 48.

⁴² 1919 TPD 391,32 SATC 47 at pg. 48.

⁴³ 1919 TPD 391,32 SATC 47 at pg. 48.

⁴⁴ 1919 TPD 391,32 SATC 47 at pg. 48



numbered coupons. Conversely, the court held that the taxpayer was entitled to claim a deduction on the expenditure which the taxpayer company incurred in the production of the income.⁴⁵ The court held that since the income which the taxpayer company earned in the course of illegal activities was held to constitute part of the taxpayer's gross income, it also followed that the taxpayer would also succeed in claiming for deductions for the expenses incurred.⁴⁶

In *ITC 1545*,⁴⁷ the taxpayer was an established criminal who caved a living from the illegal buying and selling of stolen diamonds and also from the operating of an illegal scheme in which he sold dried "milk cultures." The taxpayer sold his business of buying and selling "milk cultures" to a company which he owned and directed. The main questions which came before the courts pertained to whether the expenditure which he incurred in the buying and selling of stolen diamonds was incurred in the production of income and thus qualify for deduction and also whether the income which the taxpayer earned from the sale of the dried "milk cultures" was "received by" the taxpayer and thus constituted part of the gross income of the taxpayer.

In terms of the business in which the company bought and sold "milk cultures", the taxpayer was the mastermind and promoter of the scheme. In the scheme, the company would sell the milk cultures referred to as "activators" to members of the public who were referred to as "growers" for R30 per unit. The "activators" would in turn be used to grow the "milk cultures" and dry the crop and in terms of the arrangements would sell the milk cultures back to the company for R10. The company would however not use the crop, but in fact it would mill it and resell it back to the public as "activators." The scheme blossomed for a while as more and more "growers" were enlisted by the taxpayer. The scheme however folded when the number of "activators" which were sold by the company to additional "growers" plummeted to the level where the company could not manage to pay "growers" for the "crops" which they would have supplied.

The taxpayer also actively participated in the scheme as a "grower" and from the adventures he earned R1 million. The issue that came before the courts related to

⁴⁵ 1919 TPD 391,32 SATC 47 at pg. 49.

⁴⁶ 1919 TPD 391,32 SATC 47 at pg. 49.

⁴⁷ 1992 54 SATC 464.



whether the income which the taxpayer earned from participating as a “grower” in a company which he owned and controlled constituted part of his gross income. The CIR included the income which the taxpayer received from participating as a grower in the “milk culture” business under the taxpayer’s income. The taxpayer however opposed the taxpayer’s decision on the basis that the “milk culture” business was tantamount to a lottery as defined in terms of section 2(1) of the Gambling Act.⁴⁸ The taxpayer thus contended that the transactions which took place with regards to the “milk culture” business were void. In addition, the taxpayer argued that he did not have a legal right to the income which he received pursuant of the “milk culture” business, and that the income was not “*received by or accrued to or in favour*”⁴⁹ of him within the context of the definition of gross income.

The court, however, disagreed with the arguments which were advanced by the taxpayer.⁵⁰ The court held that as long as income has been received by the taxpayer for his own benefit then it should form part of the gross income of a taxpayer. The court emphasized that the construct of the definition of gross income as contained in section 1 of the Act is meant to cover any income which is received or which accrues to a taxpayer regardless of whether that income is received or accrues to the taxpayer legally or otherwise, as long as that income accrues or is received by the taxpayer “*on his own behalf and for his own benefit*.”⁵¹ The court furthermore held that even if income is received or accrues to a taxpayer courtesy of an illegal contract it is not necessarily correct to assume that that such a contract does not have legal consequences as such a contract can operate “*inter-partes*.”⁵² The court thus concluded that indeed the income which the taxpayer earned courtesy of the participation in the “milk culture” business as a grower fell with the definition of gross income as contained in section 1 of the Act.⁵³

In *ITC 1810*,⁵⁴ the issue which came before the court was whether interest which had accrued to a taxpayer as a result of investments which the taxpayer had made in an

⁴⁸ 1992 54 SATC 464 at pg. 466.

⁴⁹ 1992 54 SATC 464 at pg. 473.

⁵⁰ 1992 54 SATC 464 at pg. 474.

⁵¹ 1992 54 SATC 464 at pg. 474.

⁵² 1992 54 SATC 464 at pg. 474.

⁵³ 1992 54 SATC 464 at pg. 474.

⁵⁴ 2006 68 SATC 189.



illegal pyramid scheme pyramid fell within the definition of gross income as contained section 1 of the Act. In this case, the taxpayer invested sums of money amounting to R865 963 into a pyramid scheme. In terms of the agreement which the taxpayer entered into with the operator of the pyramid scheme, an acknowledgment of debt was entered into in which the operators of the pyramid scheme admitted to the debt which they owed the taxpayer.⁵⁵ Further, in terms of their agreement, any money which would be paid by the pyramid scheme to the taxpayer would go towards the payment of the interest first and subsequently towards the repayment of the principal.⁵⁶

The pyramid scheme was subsequently sequestered. It was put on record that no interest had been paid to the taxpayer at the time of sequestration.⁵⁷ The taxpayer submitted a claim to the value of R1 166 000 to the trustees of the insolvent estate (of the pyramid scheme), of which the taxpayer claimed that R449 036 of that amount represented interest that had accrued to the taxpayer. Based on this representation by the taxpayer, the CSARS then issued revised assessments for the tax on the income which had accrued to the taxpayer in terms of the investments in the pyramid scheme.

The court held that the pyramid scheme, as it envisaged paying one investor from the money which it would have received from another investor, was insolvent *ab initio*, and whatever dispositions it would have made would not have been for value.⁵⁸ As any dispositions made by the pyramid scheme would not have been for value, the taxpayer would have lost whatever interests (even if any interest payments had been made to him) or income it would have received from the pyramid scheme.⁵⁹

Although the court concurred with the commissioner that the Act seeks to assess all income which accrues to taxpayers regardless of whether the income has been received by or has accrued to taxpayers legally or illegally, it however held that it is not within the tenets of income tax fairness for someone to have tax liability on the

⁵⁵ 2006 68 SATC 189 at pg. 189.

⁵⁶ 2006 68 SATC 189 at pg. 189.

⁵⁷ 2006 68 SATC 189 at pg. 189.

⁵⁸ 2006 68 SATC 189 at pg. 192.

⁵⁹ 2006 68 SATC 189 at pg. 192.



basis of income which they never got.⁶⁰ The court furthermore held that the Act should not be interpreted in such a manner that taxpayers incur tax liability on income which they would immediately lose in terms of other legal provisions.⁶¹ The court thus concluded that the income which the taxpayer earned from the investments in the pyramid scheme was not received by the taxpayer as envisaged in the definition contained in section 1 of the Act.⁶²

In *ITC 1624*,⁶³ the main issue which came before the court was whether income which a taxpayer earned as a result of the fraudulent overcharging of its customers would be regarded as having been received by the taxpayer within the context of the definition of gross income contained in section 1 of the Act. In this case, the taxpayer was a close corporation which operated as an agent involved in the business of freight clearing and forwarding.

The taxpayer as an agent would provide services to clients and make payments to the harbour authority (Portnet). The taxpayer would subsequently recover the funds which it would have paid from its principals. In 1991, in the course of its business operations, the taxpayer fraudulently overcharged one principal for wharfage fees to the extent that the principal paid R299 814 more than it was supposed to pay. In its arguments, the taxpayer contended that the income which it received in the year of assessment was so received not on its own behalf but on behalf of its principals, and that such funds were of a capital nature; and that subsequently the taxpayer would need to repay the principals so as to discharge what the taxpayer owed the principals.⁶⁴ The taxpayer further contended that it had not received the funds within the context of the definition which is contained in section 1 of the Act as in any case it neither received the funds so as to benefit from them nor did it have an entitlement to the funds.⁶⁵ The taxpayer further contended that it did not receive the funds within the meaning of the concept of gross income as upon receiving the fraudulently

⁶⁰ 2006 68 SATC 189 at pg. 192.

⁶¹ 2006 68 SATC 189 at pg. 192.

⁶² 2006 68 SATC 189 at pg. 192.

⁶³ 1996 59 SATC 373.

⁶⁴ 1996 59 SATC 373 at pg. 374.

⁶⁵ 1996 59 SATC 373 at pg. 374.



obtained funds a duty instantaneously fell upon the taxpayer to return the funds to the principal.⁶⁶

The court dismissed the taxpayer's arguments and held that since the taxpayer received the funds in the course of its business activities through fraudulently misrepresenting to the principal, such funds necessarily fell under the taxpayer's gross income as the taxpayer indeed intended to benefit from the fraudulently obtained funds.⁶⁷ The court held that the negligent misrepresentation by a taxpayer would also result in the funds falling under the taxpayer's gross income.⁶⁸ In deciding that the fraudulently obtained funds fell under the taxpayer's gross income, the court factored into account the subjective intention of the taxpayer.

2.4 MP Finance Group CC v CSARS⁶⁹

In *MP Finance Group CC v CSARS*,⁷⁰ the issue of whether funds which a taxpayer earned as a result of embezzlement should be treated as having been "received by" the taxpayer and thus included in the taxpayer's gross income was finally settled by the SCA. In this case, a certain Marietjie Prinsloo operated, in cahoots with her associates, operated a pyramid scheme in which they defrauded unsuspecting people whom they enticed to invest in the pyramid scheme in return for substantial but unrealistic returns.

The scheme which Ms Prinsloo and her associates ran conducted its activities through the use of entities which were successively created for the purpose of running the pyramid scheme. Some of the entities were incorporated while some of the entities were unincorporated. Whilst the pyramid scheme paid some investors their returns using the investments which would have been made by other investors, the scheme was insolvent as it could not pay all the investors the returns which the scheme had promised to them.⁷¹ The pyramid scheme eventually collapsed. So as to make the administration of the scheme easier, when the matter came before the

⁶⁶ 1996 59 SATC 373 at pg. 374.

⁶⁷ 1996 59 SATC 373 at pg. 375.

⁶⁸ 1996 59 SATC 373 at pg. 375.

⁶⁹ *Supra*.

⁷⁰ *Ibid*.

⁷¹ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 11.



Gauteng North High Court, the High Court consolidated all the successive entities into the name MP Finance Group CC.⁷²

The CSARS assessed income tax on MP Finance Group CC for the amounts which the successively created entities had received from the investors. The liquidators of MP Finance Group CC disagreed with the CSARS' decision as they were of the view that the funds which the original entities had received were not received by the entities within the meaning and context which was envisaged in section 1 of the Act.⁷³ The liquidators of MP Finance Group CC were of the view that since the original entities were supposed to promptly refund the investors in the scheme as the entities had obtained the funds fraudulently, the funds had not been received by MP Finance Group CC within the meaning of gross income which is envisaged in the Act.⁷⁴

The SCA, however, ruled against the taxpayer as it was of the view that as it was the subjective intention of the taxpayer to defraud the investors, and as the entity was insolvent, the taxpayer intended to beneficially receive the funds as its own income.⁷⁵ The SCA thus brought some finality to the issue by holding that such funds which are received by pyramid schemes are indeed received within the meaning of the definition of gross income as envisaged in section 1 of the Act.

The decision in the *MP Finance Group CC*⁷⁶ case is in line with the legal positions in other jurisdictions. For example, in the United States, the income of a taxpayer, whether legal or illegal, falls under the gross income of a taxpayer.⁷⁷ In Australia and New Zealand, any income or profits which a taxpayer earns from trade form part of the gross income of the taxpayer, regardless of whether such income has been earned legally or illegally, as long as there is some element of business.⁷⁸ In

⁷² *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 2.

⁷³ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 3.

⁷⁴ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 3.

⁷⁵ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 11.

⁷⁶ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141.

⁷⁷ Brackney, ML. *When crime doesn't pay: the income tax consequences of criminal conduct* (2005) *Journal of Taxation* 303 at pg. 303.

⁷⁸ Gupta, R. *Taxation of Illegal activities in New Zealand and Australia* (2008) *Journal of the Australasian Tax Teachers Association* Vol. 3 No. 2 106 at pg. 111.



addition, according to *Black*,⁷⁹ in Canada, income tax is assessed on all incomes, regardless of whether such incomes are earned legally or illegally. *Gallant*⁸⁰ also emphasized that the importance of taxing illegally obtained income in Canada enables “...all enterprises, whether lawful or not, [to] contribute to the national purse.”

Some authors have, however, expressed reservations about the court’s findings in the *MP Finance Group CC*⁸¹ case. *Venter et al*⁸² argue that the decision by the court to allow for the taxation of illegal receipts may violate investors’ constitutional rights to the extent that the taxation arbitrarily deprives the investors the ownership of their properties as enshrined in section 25 of our Constitution.⁸³ *Venter et al*⁸⁴ argue that taxing the receipts of illegal schemes creates a preferential claim for the SARS in line with insolvency and tax laws, and thus infringes the investors’ rights to their properties as SARS will get its funds first, and this despite the fact that the original investments were void.⁸⁵ *Venter et al*’s⁸⁶ contentions are in line with the views contained in a 1974 article by *Bittker*.⁸⁷ Whilst *Bittker*’s⁸⁸ article agreed that illegally obtained income should be subject to income tax, the article however argued that the government’s income tax claim should not rank above the rights of embezzlement victims to recoup the losses which they will have suffered.

The court in the *MP Finance Group CC*⁸⁹ case did however not make a finding as to whether the losses which an investor incurs as a result of investments which are

⁷⁹ Black, CM. *Tax Crime: the application of Income Tax to illegal activities* (2005) Australian Tax Forum, 435 at pg. 453.

⁸⁰ Gallant, M. *Tax and the proceeds of crime: a new approach to tainted finance* (2013) Journal of Money Laundering Control, Volume 16, number 2 119 at pg. 120.

⁸¹ *Supra*.

⁸² Venter, JMP. Uys, WR. & van Dyk, MC. *MP Finance Group CC (In Liquidation) v C:SARS: Adding to the financial hardship of victims of illegal schemes* (2015) South African Business review Special Edition Tax Stories 121.at pg. 132-137.

⁸³ Constitution of the Republic of South Africa, 1996.

⁸⁴ *Supra*.

⁸⁵ Venter, JMP. Uys, WR. & van Dyk, MC. *MP Finance Group CC (In Liquidation) v C:SARS: Adding to the financial hardship of victims of illegal schemes* (2015) South African Business review Special Edition Tax Stories 121.at pg. 135.

⁸⁶ Venter, JMP. Uys, WR. & van Dyk, MC. *MP Finance Group CC (In Liquidation) v C:SARS: Adding to the financial hardship of victims of illegal schemes* (2015) South African Business review Special Edition Tax Stories 121.

⁸⁷ Bittker, BI. *Taxing Income from unlawful activities* (1974) Case Western Law Review 130.

⁸⁸ Bittker, BI. *Taxing Income from unlawful activities* (1974) Case Western Law Review 130 at pg. 137.

⁸⁹ *Supra*.



made in a pyramid scheme are tax-deductible. The position which was taken in the United States which sought to ameliorate the financial distress which is experienced by investors in Ponzi schemes is supported. According to *Perez*,⁹⁰ the United States Internal Revenue Commission announced in March 2009 that losses which taxpayers suffer as a result of investments in fraudulent schemes will be allowable for deduction, but that the allowable losses will be limited to the “...*initial investments, plus any additional sums put in, less amounts withdrawn, if any, reduced by reimbursements and other recoveries.*”⁹¹ Thus, an investor will not be able to claim a deduction on any interest which the investors may have been promised by the operators of the pyramid schemes. In addition, according to *Perez*⁹² losses will however only be allowed if there are no prospects that the taxpayer will recover some of the funds from the operators of the Ponzi schemes.

According to *Perez*,⁹³ *Coleman and Newsom*⁹⁴ and *Lehman*,⁹⁵ in 2009 the United States also established by means of Revenue Procedure 2009-20⁹⁶ an optional “*safe harbor [harbour]*” approach which permits taxpayers to claim deductions for tax losses which arise from investment activities if the perpetrators will have been criminally charged for embezzlement crimes. According to *Perez*⁹⁷ and *Lehman*,⁹⁸ if a tax payer opts to claim a deduction using the “*safe harbour*” approach, there are less administrative procedures as the loss is “*deemed*” and the taxpayer can claim for the deduction in the year in which the loss is discovered. According to *Colbert*,⁹⁹ in terms of the “*safe harbour*” approach, investors who lose funds in fraudulent schemes can claim theft loss deductions for close to the whole amount invested (and

⁹⁰ Perez, DL. *New Tax relief for Victims of Ponzi Schemes* (2009) Los Angeles Lawyer 10.

⁹¹ Perez, DL. *New Tax relief for Victims of Ponzi Schemes* (2009) Los Angeles Lawyer 10 at pg. 11.

⁹² Perez, DL. *New Tax relief for Victims of Ponzi Schemes* (2009) Los Angeles Lawyer 10 at pg. 11.

⁹³ Perez, DL. *New Tax relief for Victims of Ponzi Schemes* (2009) Los Angeles Lawyer 10 at pg. 11.

⁹⁴ Coleman, JP. & Newsom, J *Can an Investment Become a Theft for Tax Purposes?* (2010) The Florida Bar Journal 27 at pg. 30.

⁹⁵ Lehman, RS. *Ponzi Scheme Tax Losses* (2011) Tax Management Real Estate Journal 103 at pg. 111.

⁹⁶ Revenue Procedure 2009-20

<https://www.irs.gov/pub/irs-drop/rp-09-20.pdf> (Accessed 25 July 2015).

⁹⁷ Perez, DL. *New Tax relief for Victims of Ponzi Schemes* (2009) Los Angeles Lawyer 10 at pg. 11.

⁹⁸ Lehman, RS. *Ponzi Scheme Tax Losses* (2011) Tax Management Real Estate Journal 103 at pg. 111.

⁹⁹ Colbert, MS. *Can IRC 1341, Claim of Right, Relieve the pain of Madoff-Related losses?* 2009 The CPA Journal 56 at pg. 57.



also reinvested amounts on which the investor will have paid income tax) adjusted for withdrawals which the taxpayer might have made.

*Stocks*¹⁰⁰ was of the view that South Africa would be unlikely to adopt the American approach as it might lead to investors making investments which are of a reckless nature with the full knowledge that they will be compensated by the fiscus if the investments later turn out to be unwise. The arguments of *Stocks*¹⁰¹ are supported in this regard as it is not desirable for investors to use the fiscus as “insurance” for their (reckless) investment activities.

Muller,¹⁰² in an article which was written before the SCA decision in *MP Finance Group CC*,¹⁰³ pointed out that the major confusion which caused disparities as to whether funds which taxpayers earn as a result of embezzlement or fraud should form part of the taxpayer’s gross income or not lies in the fact that sometimes courts are not able to interpret the differences between the concepts of “accrual” and “beneficial receipt”.¹⁰⁴ *Muller*¹⁰⁵ was of the view that the concept of beneficial receipt should only apply in the instances in which the taxpayer earns funds which are meant for his or her own use, and in this case the fact whether the funds had been earned legally or illegally should not be relevant.

*Muller*¹⁰⁶ held that the concept of “received by” with regards to the gross income of a taxpayer should be interpreted to mean the income which a taxpayer will have intended to benefit from, and in this case the subjective intention of a taxpayer is crucial. *Muller*¹⁰⁷ was thus of the view that the funds which a taxpayer earns through fraud or embezzlement should be included in the taxpayer’s gross income as the taxpayer would have intended to benefit from those funds (from the embezzlement).

¹⁰⁰ *Stocks, J. Tax implications for Ponzi scheme investors* (2010) Moneyweb’s Tax Breaks 1 at pg. 2.

¹⁰¹ *Stocks, J. Tax implications for Ponzi scheme investors* (2010) Moneyweb’s Tax Breaks 1 at pg. 2.

¹⁰² *Muller, E. The taxation of illegal receipts: a pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)* (2007) 17 *Obiter*, vol. 28 Issue 1 166.

¹⁰³ *Supra*.

¹⁰⁴ *Muller, E. The taxation of illegal receipts: a pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)* (2007) 17 *Obiter*, vol. 28 Issue 1 166 at pg. 176.

¹⁰⁵ *Muller, E. The taxation of illegal receipts: a pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)* (2007) 17 *Obiter*, vol. 28 Issue 1 166 at pg. 176.

¹⁰⁶ *Muller, E. The taxation of illegal receipts: a pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)* (2007) 17 *Obiter*, vol. 28 Issue 1 166 at pg. 176.

¹⁰⁷ *Muller, E. The taxation of illegal receipts: a pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)* (2007) 17 *Obiter*, vol. 28 Issue 1 166 at pg. 176.



This is the same conclusion which was latter reached by the SCA when the case was finally argued before that court.¹⁰⁸

According to *Olivier*,¹⁰⁹ illegally obtained income should form part of the gross income of the embezzler if the embezzler's intention was to derive benefit from the income. *Classen*¹¹⁰ welcomed the decision of the SCA in the *MP Finance Group CC*¹¹¹ case and argued that income which is illegally obtained by a taxpayer should form part of the gross income of a taxpayer if the taxpayer intended to benefit from it.

2.5 Conclusion

This chapter looked at the inclusion of funds earned by taxpayers under gross income. The study first looked at the inclusion under gross income of funds earned legally by a taxpayer. The decisions in the *Brookes Lemos Limited*¹¹² and *Witwatersrand Association of Racing Clubs*¹¹³ cases applied the objective approach and concluded that funds legally obtained by a taxpayer are included under the gross income of a taxpayer if the taxpayer received the funds without the obligation to return them or to hand them over to another party.

The study the analysed the inclusion of funds which a taxpayer may earn as a result of embezzlement or other illegal activities under the taxpayer's gross income. The objective approach was previously followed. For example, in terms of the objective approach the court in *CoT v G*¹¹⁴ held that funds which a taxpayer defrauded the Zimbabwe government were not beneficially received by the taxpayer with the context of the definition of gross income.

In 2007, in *MP Finance Group CC*¹¹⁵ the SCA rejected the objective approach and applied the subjective approach. In relying on the subjective intention of the taxpayer, the court held that funds which the taxpayer had defrauded investors in a

¹⁰⁸ In *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 11.

¹⁰⁹ *Olivier, L. The taxability of illegal income* (2008) TSAR 4 814 at pg. 819.

¹¹⁰ *Classen, LG. Legality and Income Tax – Is SARS 'entitled to' Levy Income on illegal amounts received by a taxpayer?* (2007) SA Merc LJ 534.at pg. 553.

¹¹¹ *Supra.*

¹¹² 1947 2 SA 976, SATC 295 at pg. 299-300.

¹¹³ 1960 3 SA 291 at pg. 398-399.

¹¹⁴ 1981 (4) SA 167 (ZA), 43 SATC 159 at 163.

¹¹⁵ *Supra.*



pyramid scheme indeed formed part of the gross income of the taxpayer as envisaged in section 1 of the Act.¹¹⁶

In holding that illegally obtained funds indeed formed part of the gross income of a taxpayer, the SCA brought our tax jurisprudence in line with approaches followed in other jurisdictions. For example, in the United States, Canada, New Zealand and Australia illegally obtained funds form part of the gross income of the taxpayers. The United States is very unequivocal [and vocal] that it taxes incomes from all sources, whether legal or illegal.¹¹⁷

¹¹⁶ *MP Finance Group CC v CSARS* [2007] SCA 71, 69 SATC 141 at para 11.

¹¹⁷ Brackney, ML. *When crime doesn't pay: the income tax consequences of criminal conduct* (2005) *Journal of Taxation* 303 at pg. 303.



CHAPTER 3: THE GENERAL DEDUCTION FORMULA

3.1 Introduction

The deductibility of expenditure and losses which are incurred by a taxpayer is provided for in terms of the provisions of section 11(a) of the Act. Section 11(a) of the Act makes provision for the deduction of “*expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.*”

3.1.1 The general deduction formula (section 11(a) of the Act)

For the expenditure and losses to be allowable for deduction, the taxpayer must be able to prove that it carried on trade in the year of assessment. The word “trade” furthermore excludes activities which are of a passive nature. For example, the taxpayer will not succeed in claiming a deduction for expenses and losses which are incurred in things such as the generation of interest income or the generation of dividends.

Section 11(a) of the Act is dissected into its constituent parts as follows:

(a) Expenditure and losses

The Act does not proffer a definition for what is meant by “expenditure and losses.” Various court cases have over time tried to distil what is meant by the term “expenditure and losses.”

In *Joffe and Company (Pty) Ltd v CIR*,¹¹⁸ the court sought to distinguish between the terms “expenditure” and “losses.” The court held that the term “expenditure” reflects payments made by a taxpayer freely towards something.¹¹⁹ On the other hand, losses reflect instances in which a taxpayer pays for something which arises as a result of activities which are outside the taxpayer’s control.¹²⁰ Such payments are thus made by the taxpayer involuntarily. The court, however, alluded to the fact that

¹¹⁸ 1946 AD 157, 13 SATC 354.

¹¹⁹ 1946 AD 157, 13 SATC 354 at pg. 360.

¹²⁰ 1946 AD 157, 13 SATC 354 at pg. 360.



in some instances it could be plausible for the distinction between expenditure and losses to be blurred.¹²¹

In *CSARS v Labat*,¹²² the SCA had to determine the meaning of the word “expenditure” and whether the issuing of own shares by a taxpayer in return for intellectual property rights could be regarded as expenditure within the context of section 11(a) and section 11(gA)¹²³ of the Act.

In this case, the taxpayer, Labat Africa Limited (previously known as Acrem Holdings Limited), purchased the business enterprise of Labat-Anderson South Africa (Pty) Ltd. The parties agreed that the taxpayer would pay a purchase price of R120 million. Of the R120 million purchase price, R44.5 million represented a payment for the “Labat” trademark. The taxpayer subsequently claimed a deduction in terms of section 11(gA) of the Act for the shares it issued as payment for the trademark. The Commissioner disallowed the claim on the basis that the issue of a taxpayer’s own shares fell outside the scope of expenditure as contemplated in section 11(a) or section 11(gA) of the Act. The Pretoria Income Tax Special Court and the North Gauteng High Court disagreed with the Commissioner and held that the issue by a company of its own shares fell within the definition of expenditure.¹²⁴ The Commissioner subsequently appealed to the SCA.

The SCA upheld the Commissioner’s appeal and held that an allotment and issue by a taxpayer of its own shares, even though it may lessen the value of the shareholders’ shares in the company, does not shrink the assets of the company and as such cannot qualify as expenditure as envisaged in section 11(a) or section 11(gA) of the Act.¹²⁵ The SCA thus was of the view that the estate of the taxpayer must have shrunk or lessened for there to have been expenditure as envisaged in terms of the provisions of section 11(a) and section 11(gA) of the Act.¹²⁶

¹²¹ 1946 AD 157, 13 SATC 354 at pg. 360.

¹²² *Commissioner of the South African Revenue Service v Labat* (669/10) ZASCA 157.

¹²³ Section 11(gA) allowed taxpayers to amortise the cost of acquiring intellectual property rights at a rate of 4% per annum.

¹²⁴ *Commissioner of the South African Revenue Service v Labat* (669/10) ZASCA 157 at para. 4.

¹²⁵ *Commissioner of the South African Revenue Service v Labat* (669/10) ZASCA 157 at para. 14.

¹²⁶ *Commissioner of the South African Revenue Service v Labat* (669/10) ZASCA 157 at para 14.



*Van Zyl*¹²⁷ was of the view that the SCA misconstrued the discharge of an obligation with expenditure by holding that the incurring of a liability for an obligation can be classified as expenditure, and that the expenditure discharges the liability or obligation.¹²⁸ *Van Zyl*¹²⁹ was of the view that the SCA's judgment "confused the meaning of expenditure" to mean "actual payment" and that it is not necessary for a taxpayer to discharge an obligation for there to be expenditure.¹³⁰

Whilst *Van Zyl*¹³¹ disagreed with the decision of the SCA and its interpretation of "expenditure", the SCA's interpretation of expenditure found support from *Legwaila*.¹³² *Legwaila*¹³³ was of the view that the definition of expenditure in terms of section 11(a) or section 11(gA) of the Act did not take into consideration whether losses or expenditure were in fact incurred.¹³⁴ *Legwaila*¹³⁵ argued that contracts which do not stipulate how the payment will be made result in the expenditure not being incurred as it would be conceivable that the methods which are elected to settle the liability may not be eligible to be classified as expenditure.¹³⁶ In addition, *Legwaila*¹³⁷ argued that it is also important to determine the identity of the party which incurs the expenditure.¹³⁸ He argued that an issue and allotment of shares diminishes the existing shareholders' values, but does not amount to expenditure by

¹²⁷ Van Zyl, SP. *The meaning of expenditure for purposes of section 11(a) and (gA) of the Income Tax Act 58 of 1962: CSARS v Labat* [2011] ZASCA 157 2012 Obiter 33(1).

¹²⁸ Van Zyl, SP. *The meaning of expenditure for purposes of section 11(a) and (gA) of the Income Tax Act 58 of 1962: CSARS v Labat* [2011] ZASCA 157 2012 Obiter 33(1) at pg 188.

¹²⁹ Van Zyl, SP. *The meaning of expenditure for purposes of section 11(a) and (gA) of the Income Tax Act 58 of 1962: CSARS v Labat* [2011] ZASCA 157 2012 Obiter 33(1).

¹³⁰ Van Zyl, SP. *The meaning of expenditure for purposes of section 11(a) and (gA) of the Income Tax Act 58 of 1962: CSARS v Labat* [2011] ZASCA 157 2012 Obiter 33(1) at pg 188.

¹³¹ Van Zyl, SP. *The meaning of expenditure for purposes of section 11(a) and (gA) of the Income Tax Act 58 of 1962: CSARS v Labat* [2011] ZASCA 157 2012 Obiter 33(1).

¹³² Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130.

¹³³ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130.

¹³⁴ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130 at pg. 329.

¹³⁵ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130.

¹³⁶ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130 at pg. 324.

¹³⁷ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130.

¹³⁸ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130 at pg. 329.



the company.¹³⁹ In addition, *Legwaila*¹⁴⁰ also argued that when a company declares a dividend, this diminishes the assets of the company, although this does not diminish the assets of the shareholders (as this merely results in a shift of a company's assets to shareholders).¹⁴¹

(b) Actually incurred

The very important and unequivocal meaning which can be derived from the term "actually incurred" is that for an expense to be allowable as a deduction in terms of section 11(a) of the Act such an expense must not be conditional on anything. In this regard, it is also paramount to note that an expense or loss which is conditional on the happening of a future event can only be allowed for deduction once that event has actually taken place – that is the point in time when the loss or expense is actually incurred.¹⁴² In *Edgars Stores Ltd v CIR*,¹⁴³ the court disallowed the inclusion of turnover rental under deductions for tax purposes as the actual turnover rental could only be ascertained after the end of the taxpayer's financial year. The court held that since the liability relating to the payment of the turnover rental was contingent until such a time that the turnover for the lease had been ascertained, the amount could not be allowed for deduction for tax purposes.¹⁴⁴ As such, the amount could not be regarded as having been actually incurred.

In *Port Elizabeth Electric Tramway Company Ltd v CIR*,¹⁴⁵ the court emphasized that the expense does not need to have been paid for, and that expenses will still be allowed for deduction as long as or once the liability to pay for those expenses has been incurred.

¹³⁹ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130 at pg. 324.

¹⁴⁰ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130.

¹⁴¹ Legwaila, T. *The issue of shares is not 'expenditure' for the purpose of the Income Tax Act: CSARS v Labat Africa* 2013 The South Africa Law Journal 130 at pg. 324.

¹⁴² *Edgars Stores Ltd v CIR* 2000 50 SATC 81 (A) at pg. 90.

¹⁴³ 2000 50 SATC 81 (A).

¹⁴⁴ 2000 50 SATC 81 (A) at pg. 90.

¹⁴⁵ 1936 CPD 241, 8 SATC 13 at pg. 15.



The issue of what is meant by the term “actually incurred” also came before the court in the case of *Kommissaris van Binnelandse Inkomste v Nasionale Pers Bpk.*¹⁴⁶ In this case the taxpayer made provision for the payment of holiday bonuses to staff. The bonus payments were contingent on the staff members not giving notices of termination of their service before a certain date. The court disallowed the inclusion of the holiday bonuses in the taxpayer’s expenses as the payments were contingent on the happening of events which fell outside the taxpayer’s financial year, and as such the payment could not be regarded as having been actually incurred in the year of assessment.¹⁴⁷

In *CIR v Golden Dumps (Pty) Ltd*,¹⁴⁸ the issue of when an expense is actually incurred by the taxpayer also came before the courts. In this case, the issue in dispute related a disagreement between a taxpayer and an employee which resulted in the taxpayer withholding the delivery of shares which the taxpayer had previously undertook to give to the employee. The court held that liability only arose when the dispute had finally been settled, and that contingent expenses could not be allowed for deduction for tax purposes.¹⁴⁹

(c) In the production of Income

For an expense to be allowable as a deduction under section 11(a) of the Act, the expense has to be incurred in the production of income. For a claim for a deduction to succeed in terms of section 11(a) of the Act, the taxpayer has to prove that the expense or loss was essential and sufficiently closely related to the taxpayer’s trade. In *Port Elizabeth Tramway Company Ltd*,¹⁵⁰ the taxpayer, who operated a tramway business, incurred expenses when it compensated a driver who had been injured whilst on duty. The taxpayer subsequently claimed a deduction for tax purposes for the expenses so incurred. The court held that section 11(a) of the Act allowed for the deduction of all the expenses which are incurred in the production of income, provided that such expenses are sufficiently connected with “*that the provisions of the law contemplate the allowance as deductions of all expenses attached to the*

¹⁴⁶ 1984 (4) SA 551(C), 46 SATC 83.

¹⁴⁷ 1984 (4) SA 551(C), 46 SATC 83 at pg. 84 and pg. 88.

¹⁴⁸ 1993 55 SATC 198(A).

¹⁴⁹ 1993 55 SATC 198(A) at pg. 206.

¹⁵⁰ *Supra*.



*performance of a business operation bona fide performed for the purpose of earning income, whether such expenses are necessary for its performance or attached to it by chance, provided they are so closely connected with it that they may be regarded as part of the cost of performing it.*¹⁵¹ The court further held that the employment of drivers was an expense which was necessarily involved in the tramway business, and any expense which might have been incurred by the taxpayer in compensating drivers injured in the course of their duties was deductible for tax purposes as it would have been incurred in the course of producing income for the taxpayer.¹⁵²

In *Joffe and Company (Pty) Ltd*,¹⁵³ the issue of whether the expenses which were incurred by a taxpayer were so incurred in the production of income also came before the court. In this case, the taxpayer had an engineering business and dealt with reinforced concrete. An employee of the taxpayer was struck and killed by a concrete tower at a power station where they were working on. It was subsequently discovered that the taxpayer had been negligent, and it was the negligence which led to the death of the taxpayer's employee. The court subsequently disallowed the claim for a deduction of the expense for tax purposes. The court held that no evidence had been adduced to the effect of proving that negligent construction necessarily accompanied the business of reinforced concrete engineering.¹⁵⁴ The damages which were paid to the relatives of the deceased employee by the taxpayer were thus held not to have been incurred in the production of the taxpayer's income.¹⁵⁵

(d) Not of a capital nature

A taxpayer can only succeed in claiming a deduction in terms of section 11(a) of the Act if the taxpayer can prove that the expense which was incurred was not of a capital nature. The Act does not however proffer a definition of when expenditure is of a capital nature. It has been left to the courts to determine when expenditure is of a revenue or of a capital nature.

¹⁵¹ 1936 CPD 241, 8 SATC 13 at pg. 13.

¹⁵² 1936 CPD 241, 8 SATC 13 at pg. 13.

¹⁵³ *Supra*.

¹⁵⁴ 1946 AD 157, 13 SATC 354 at 355.

¹⁵⁵ 1946 AD 157, 13 SATC 354 at 361.



In *New State Areas v CIR*,¹⁵⁶ the issue of whether expenditure which had been incurred by the taxpayer was revenue or capital in nature came before the court. In this case the taxpayer was involved in gold-mining activities. In terms of the law, the taxpayer had to install water-borne sewerage systems which would be connected to the local authority's sewerage system. The sewer system was connected at the cost of the local authority, with the taxpayer having to reimburse the local authority over a period of five years for the system which was incurred on the taxpayer's property and over a period of fifteen years for the system which was installed outside the taxpayer's property. The sewer system which was installed on the taxpayer's system would become the property of the taxpayer and the sewer system which was located outside the taxpayer's property would continue to belong to the local authority. The issue in dispute in this case was whether the instalments which were paid by the taxpayer with regards to the sewer system could be claimed as deductions. The court allowed the claim for deduction for the sewer system which was located outside the taxpayer's property as the sewer system remained the property of the local authority and the instalments were thus regarded as expenses of a revenue-generating nature.¹⁵⁷ The court however disallowed the claim for deduction for the expenditure which was made by the taxpayer with regards to the sewer system which was installed on the taxpayer's property and held that it was of a capital nature as the taxpayer acquired ownership of the asset.¹⁵⁸

The question as to whether expenditure which had been incurred by a taxpayer had been incurred pursuant of income-generating activities or whether it was of a capital nature was the subject of inquiry in *Palabora Mining Company Limited v SIR*.¹⁵⁹ In this case, the taxpayer erected a barrage which would allow it to retain water for its construction project. The responsibility for the building of the barrage fell on the statutory water board. The taxpayer decided to erect the barrage and incur the expenditure for the barrage because delays in the erection of the barrage by the statutory water board would also have negatively impacted on its business. The construction of the barrage by the taxpayer led to the taxpayer starting to earn profits

¹⁵⁶ 1946 AD 610, 14 SATC 155.

¹⁵⁷ 1946 AD 610, 14 SATC 155 at pg. 414.

¹⁵⁸ 1946 AD 610, 14 SATC 155 at pg. 414.

¹⁵⁹ 1973 (3) SA 819 (A), 35 SATC 159.



eight months earlier than it would have had it not erected the barrage. Even though the taxpayer erected the barrage, the barrage however belonged to the statutory water board and the taxpayer was not at any time given preference by the statutory water authority when using the barrage. Whilst the SIR had disallowed the claiming of a deduction by the taxpayer, the court held that the expenditure was directly related to the company's income-generating activities and thus was not capital in nature.¹⁶⁰ The court held that since the erection of the barrage fell on the statutory water board, the erection of the barrage enabled the company to secure the supply of water and enabled the taxpayer to start earning profits earlier than been initially anticipated, and could not be taken to be of a capital nature.¹⁶¹

(e) In the year of assessment

For expenditure and losses to be allowable for deduction they must be claimed for deduction in the year in which they were incurred. The taxpayer will not succeed if it claims for a deduction for an expenditure or a loss in a year which is different from the year of assessment in which the loss or expenditure was incurred.¹⁶² In *Concentra v CIR*,¹⁶³ the taxpayer claimed in the 1940 year of assessment expenditure which it had incurred in previous tax years. The court held that taxpayers do not have the option to claim for deductions or to declare their tax liabilities when it is convenient for them.¹⁶⁴ Taxpayers rather ought to claim for deductions or declare their tax liabilities in line with the requirements of the law. However, according to *Barnett*,¹⁶⁵ determining the correct year in which deduction of embezzlement losses is however sometimes difficult.

In *Baxter v CoT*,¹⁶⁶ the issue of when a taxpayer can claim deductions for expenditure incurred was also the subject of inquiry. In this case the taxpayer claimed for deductions in later years for interest payments which had been incurred

¹⁶⁰ 1973 (3) SA 819 (A), 35 SATC 159 at pg. 161.

¹⁶¹ 1973 (3) SA 819 (A), 35 SATC 159 at pg. 161.

¹⁶² Also see Palmer, G. *Stolen money can be taxing* (2014) Without Prejudice 10 at pg. 11.

¹⁶³ 1942 CPD, 12 SATC 95.

¹⁶⁴ 1942 CPD, 12 SATC 95 at pg. 100-101.

¹⁶⁵ Barnett, RS. *Deductibility of theft losses: looking for context for Madoff-Related claims* (2009) The CPA Journal 52 at pg. 52.

¹⁶⁶ 1937 SR 48, 9 SATC 1.



in earlier years. The court held that it could not allow the claiming for deductions of the interest payments as they were not incurred in the year of assessment.¹⁶⁷

3.1.2 Applying the deduction formula to embezzled funds

In the case of *Rendle*,¹⁶⁸ the issue of whether the losses which the taxpayer had incurred as a result of embezzlement which had been committed by a clerk in an accounting firm came before the courts. In this case, the clerk converted for own use funds which were held by the taxpayer in trust and also funds which belonged to the taxpayer.

Whilst the Income Tax Special Court had come to the conclusion that the taxpayer would only be allowed to claim a deduction with respect to the funds which the taxpayer held in trust on behalf of other persons, it had not allowed the taxpayer a deduction with regards to the taxpayer's own funds which had been embezzled by the taxpayer's employee. The court however overruled the decision of the Income Tax Special court and allowed the taxpayer to claim a deduction with regards to the taxpayer's funds which had been embezzled by the taxpayer's employee. The court held that it is not relevant to ascertain whether the embezzlement had been committed by someone in the employ of the taxpayer or by third party.¹⁶⁹ The court was of the view that as the question pertaining to whether there had been an embezzlement and the fact that the loss which the taxpayer had suffered were sufficiently close to the taxpayer's production of income a deduction had to be allowed.¹⁷⁰

In *ITC 952*¹⁷¹ the Rhodesia and Nyasaland Special Court also had to deal with the deductibility of expenditure which had been incurred by a taxpayer as a result of embezzlement. In this case, the taxpayer operated in partnership with a colleague as practising attorneys. The taxpayer's partner misappropriated clients' funds which were held in trust. The taxpayer's partner latter committed suicide and his estate was insolvent. As a result of the taxpayer's partner's insolvency, the taxpayer resolved to

¹⁶⁷ 1937 SR 48, 9 SATC 1 at pg. 1.

¹⁶⁸ *Supra*.

¹⁶⁹ 1965 SA 59, 26 SATC 326 at pg. 334.

¹⁷⁰ 1965 SA 59, 26 SATC 326 at pg. 327.

¹⁷¹ *Supra*.



take a loan so as to repay the money which had been held in trust and which had been misappropriated by his late partner. The taking of the loan by the taxpayer was meant to enable the taxpayer to continue practising as an attorney.

Upon taking the loan, the taxpayer, in his tax returns recorded the expenditure which he had incurred in taking out the loan as an expense and sought to claim a deduction for tax purposes as expenditure which had been incurred in the taxpayer's production of income. The CoT, however, disallowed the deduction. On appeal, the court dismissed the taxpayer's appeal and held that the expenditure which was incurred by the taxpayer was not incurred in the production of the taxpayer's income. The court held that the misappropriation of funds by the taxpayer's partner was not something which was inherent in the business of practising attorneys and could not be held to have been incurred in the taxpayer's trade.¹⁷²

In *ITC 1661*,¹⁷³ two dentists who operated in a partnership unsuccessfully claimed a deduction for the losses which they had suffered as a result of embezzlement which they had suffered as a result of unauthorized transactions which had been effected by an employee of auditors who had been contracted by the taxpayers. In this case the dentists contracted an auditing firm which was responsible for the performance of accounting and selected management functions. In terms of the contract which the taxpayers entered into with the auditing firm, the taxpayers allowed the auditors to sign cheques on behalf of the partnership. After one of the auditors connived with an employee of the firm of auditors to falsify cheques and defraud the taxpayers of considerable amounts of money between 1992 and 1993, the taxpayers then sought to claim deductions for tax purposes for the losses which they had suffered as a result of the fraud, theft and misappropriation.

The CIR disallowed the claim for a deduction which had been claimed by the taxpayers and dismissed the taxpayers' assertion that the suffering of fraud and misappropriation was closely related to their occupations as dentists and that the losses had been incurred in the course of the taxpayers' income. The taxpayers were dissatisfied with the decision of the CIR and launched an appeal with the ITC. On appeal, the ITC upheld the decision of the CIR. The ITC contended that since the

¹⁷² 1961 24 SATC 547 (F) at pg. 548.

¹⁷³ 1998 61 SATC 353 (G).



theft and fraud were perpetrated by independent contractors (and not employees of the taxpayer), the provisions of section 11(a) of the Act were not wide enough to accommodate the allowing of claims which emanated from the actions of individuals not in the employ of the taxpayers as having been incurred in the production of income.¹⁷⁴

The ITC further held that whilst the provisions of section 11(a) of the Act accommodate the allowing of deductions if the losses and expenses are incurred in the production of income, in the present case the loss was rather incurred after the production of income and thus the taxpayers could not succeed with the claim.¹⁷⁵

In *Lockie Bros v the CIR*,¹⁷⁶ the case involved the misappropriation of funds and defrauding by the manager of a South African subsidiary of a United Kingdom based company. The company engaged in the business of selling rice. The manager, who was responsible for operating the company's South African bank account defrauded the company by making withdrawals from the company's bank account to cover for alleged supplies which had however not been made. The company usually sold rice which it would have imported from outside South Africa. The window for the manager to withdraw funds for fictitious supplies arose because in the year of assessment the taxpayer allowed the South African office to sell rice which would have been sourced in South Africa.

The CIR disallowed the taxpayer's attempts to include the losses which it suffered as a result of the misappropriations by its manager for deductions for tax purposes. The case was then heard in the Income Tax Special Court in which two judges reached the same conclusion by dismissing the taxpayer's appeal for a deduction for tax purposes. Mason J held that for a deduction to be allowed, the expense or the loss must have been incurred for the purposes of "*conducting the business*" of the taxpayer.¹⁷⁷ Mason J thus dismissed the taxpayer's appeal due to the reason that the embezzlement of funds was not something which had been conducted for the purposes of furthering or in the course of the business of the taxpayer.¹⁷⁸ De Waal J,

¹⁷⁴ 1998 61 SATC 353 (G) at pg. 354.

¹⁷⁵ 1998 61 SATC 353 (G) at pg. 353, 354 and 356.

¹⁷⁶ *Supra*.

¹⁷⁷ 1922 TPD 42, 32 SATC 150 at pg. 150.

¹⁷⁸ 1922 TPD 42, 32 SATC 150 at pg. 150.



on the other hand dismissed the taxpayer's appeal on the basis that the losses which the taxpayer incurred were not related or supplementary to the production of the income of the taxpayer. De Waal J held that the manager had been hired by the company so that he could manage and advance the business of the taxpayer and not hired for the purposes of defrauding the taxpayer.¹⁷⁹ In dismissing the taxpayer's appeal, De Waal J went further and held that as soon as the taxpayer's products had been sold, the proceeds of the sales became embedded in the taxpayer's capital and thus the loss would in any case have been a loss of a capital as opposed to the loss of a revenue nature.¹⁸⁰

In *ITC 1242*,¹⁸¹ the issue in dispute was whether a loss which the taxpayer had suffered as a result of misappropriations and fraud which were perpetrated by two clerks whom it employed were incurred in the production of income and whether it would be deductible for tax purposes. The taxpayer conducted the business of wholesale publishing. The two clerks who defrauded the taxpayer were responsible for maintaining the cash book and reconciling entries which would have been entered into the cash book and reconciling petty cash entries and managing the petty cash for the department which they were in control of. The two employees misappropriated the funds of the taxpayer by stealing petty cash funds, taking funds and converting for own use monies which would have been paid by the other members of the staff of the taxpayer, fraudulently drawing cheques using the taxpayer's cheque book and proactively destroying the cheques which will have been honoured by the bank upon their return from the bank.

The CoT denied the taxpayer a deduction in terms of section 11(a) of the Act. On appeal, the court overturned the CoT's decision and allowed the taxpayer a deduction in terms of section 11(a) of the Act. The court held that the losses which the taxpayer incurred were not detachable from the business of the taxpayer and were concomitant and necessary for the taxpayer's business and thus were incurred in the production of income.¹⁸² In addition, the court held that the losses which the

¹⁷⁹ 1922 TPD 42, 32 SATC 150 at pg. 150.

¹⁸⁰ 1922 TPD 42, 32 SATC 150 at pg. 155.

¹⁸¹ 1975 37 SATC 306(C).

¹⁸² 1975 37 SATC 306(C) at pg. 307.



taxpayer incurred were losses of floating capital and thus were not capital in nature and thus were allowable for a deduction in terms of section 11(a) of the Act.¹⁸³

In *ITC 1383*,¹⁸⁴ the issue of deductibility as a result of a taxpayer being defrauded by a member of its staff came before the courts. In this case, the employee was a fairly senior member of staff of the taxpayer. The employee was authorised by the taxpayer to sign-off on staff salaries. The employee fraudulently authorized entries which resulted in him withdrawing money which he utilized for his own personal purposes.

The SIR disallowed the inclusion of the losses which the taxpayer suffered as a result of the fraudulent transactions by its employee. The SIR argued that losses which arise as a result of the fraudulent activities of employees (save only for small amounts as a result of theft by junior employees) are not allowable for deduction.¹⁸⁵ On appeal to the Transvaal Special Court, the court overturned the SIR's decision and held that as the loss which the taxpayer suffered was not detachable from the taxpayer's income-producing activities and thus incurred in the taxpayer's activities of producing income, the loss ought to be allowed for deduction for income tax purposes.¹⁸⁶

3.2 Conclusion

The purpose of this chapter was to set out the elements of the general deduction formula as contained in section 11(a) of the Act. For losses and expenses to be allowed for deduction, they must meet all the elements of the general deduction formula which stipulates that they must be incurred in the production of income and that the expenditure and losses are not of a capital nature. Section 23(g) of the Act which sets the trade requirement is also examined. Particular attention is paid to the leading cases with respect to deductions, i.e. the *Joffe and Company (Pty) Ltd*¹⁸⁷ and the *Port Elizabeth Electric Tramway Company Ltd*¹⁸⁸ cases. The *Joffe and Company*

¹⁸³ 1975 37 SATC 306(C) at pg. 311.

¹⁸⁴ 1978 46 SATC 90 (T).

¹⁸⁵ 1978 46 SATC 90 (T) at pg. 90.

¹⁸⁶ 1978 46 SATC 90 (T) at pg. 91.

¹⁸⁷ *Supra*.

¹⁸⁸ *Supra*.



*(Pty) Ltd*¹⁸⁹ case sought to distinguish losses from expenditure while the *Port Elizabeth Electric Tramway Company Ltd*¹⁹⁰ case explained that a deduction can be allowed once the liability to pay for the losses and expenditure has been incurred, even though the payment might not have been done.

The chapter then proceeded to apply the deduction formula to the expenses and losses which are incurred as a result of embezzlement. The courts have generally held that for losses and expenditure incurred as a result of embezzlement to allowable for deduction, the expenditure and losses ought to be sufficiently close to the production of income, e.g. the *Rendle*¹⁹¹ case, *ITC 952*,¹⁹² and *ITC 1383*.¹⁹³

¹⁸⁹ 1946 AD 157, 13 SATC 354 at pg. 360.

¹⁹⁰ 1936 CPD 241, 8 SATC 13 at pg. 15.

¹⁹¹ 1965 SA 59, 26 SATC 326 at pg. 327.

¹⁹² 1961 24 SATC 547 (F) at pg. 548.

¹⁹³ 1978 46 SATC 90 (T) at pg. 91.



CHAPTER 4: NECESSITY OF RISK FOR INCURRING EMBEZZLEMENT LOSSES AND EXPENDITURE

4.1 Introduction

According to the Interpretation Note, the SARS' current position is that it expects to allow for deduction for expenditure and losses which are incurred by a taxpayer in the production of income (excluding those of a capital nature), if the claim for expenditure and losses satisfies the requirements which are set in section 11(a) of the Act.¹⁹⁴ The Interpretation note also adds that:

*"...an important factor in determining the deductibility of the expense or loss will be whether the risk of its incurral [incurring] was a necessary incident of the taxpayer's trade."*¹⁹⁵

The inclusion in the Interpretation Note of the fact that SARS will consider (and in fact may be able to convince the courts) whether the risk of incurring expenses and losses which a taxpayer would have incurred would have been necessary suggests that a taxpayer may fail to convince the courts to be allowed to deduct some losses and expenditure even though they might have been incurred in the production of income and also even though they might not have been of a capital nature. The Canadian Income Tax Folio S3-F9-C1 which was published on 09 December 2014 (thereafter referred to as the Income Tax Folio)^{196,197} also pointed out that there are instances (in terms of Canadian Income Tax Law) in which deductions may not be deducted even though the losses and expenses may have been incurred in the production of income. According to the Income Tax Folio, losses and expenditure may not be deducted for tax purposes if they are incurred as a result of

¹⁹⁴ SARS Interpretation Note Number 80: The Income Tax treatment of stolen money (2014) SARS. <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2014-05%20-%20IN80%20Income%20Tax%20Treatment%20of%20Stolen%20Money.pdf> at para 6 (Accessed 06 February 2015).

¹⁹⁵ SARS Interpretation Note Number 80: The Income Tax treatment of stolen money (2014) SARS. <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2014-05%20-%20IN80%20Income%20Tax%20Treatment%20of%20Stolen%20Money.pdf> at para 6 (Accessed 06 February 2015).

¹⁹⁶ Canadian Income Tax Folio S3-F9-C1 (2014). <http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

¹⁹⁷ The Income Tax Folio replaced Interpretation bulletin IT-185R which had been in operation since 11 September 1991.



embezzlement by partners, proprietors, shareholders and senior managers of a company.¹⁹⁸ When and if the matters relating to the deductibility of embezzlement losses and expenditure come before South African courts, it is hoped that South African courts will provide guidance and also give due prominence to whether the losses and expenses which are incurred as a result of the embezzlement activities of directors, proprietors, partners, shareholders and other senior managers should be allowed for deduction.

4.2 Embezzlement of funds by employees of a partner of the taxpayer

In *ITC 952*,¹⁹⁹ the court refused to allow a deduction which a taxpayer had sought to claim as a result of the embezzlement of partnership funds by the taxpayer's partner. The court held that it is paramount for distinctions to be made between an embezzlement which is perpetrated by an ordinary servant of a taxpayer and an embezzlement which is perpetrated by a person who is in a senior position of a business enterprise such as a partner and held that it did not believe that "*...the defalcations of a partner in an attorney's firm can be said to be the kind of casualty, mischance or misfortune which is a natural and recognized incident of the business.*"²⁰⁰ The court thus put a partner of a business enterprise at a higher level of responsibility as partners of businesses do exercise or are supposed to exercise their fiduciary duties in the best interests of the company, and not for them to abuse their positions by embezzling the funds of a company or business enterprise. This is also in line with the position in the Canadian jurisdiction in which the Income Tax Folio also stipulates that defalcations and embezzlements which are perpetrated by partners or owners of business enterprises should not be allowed for income tax deduction.²⁰¹

¹⁹⁸ Canadian Income Tax Folio S3-F9-C1 (2014)
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> at para 1.36 (Accessed 23 August 2015).

¹⁹⁹ *Supra*.

²⁰⁰ 1961 24 SATC 547 (F) at pg. 550.

²⁰¹ Canadian Income Tax Folio S3-F9-C1 (2014)
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> at para 1.36.
(Accessed 23 August 2015).



The court further held that the risk of the taxpayer incurring the payments was not incidental to the operations of the business and the production of income.²⁰² The court held that the taxpayer incurred the payments because he had been compelled to make them.²⁰³ The court distinguished between circumstances in which a taxpayer makes payments voluntarily and circumstances in which a taxpayer makes certain payments so as to avoid or escape legal liability.²⁰⁴ In the present case, the taxpayer's liability arose as a result of the actions of the partner with whom the taxpayer was in a business enterprise with, and the nature of partnerships is that partners' actions do affect and bind the business and the other partners in their personal capacities. In this case the taxpayer made the payments so as to avoid being sequestrated and so that he could continue practising as an attorney.²⁰⁵ If the taxpayer had chosen not to settle the liability which arose as a result of the actions of his partner, it would have had dire consequences for his career and business.

4.3 Embezzlement of funds by junior employees

In the *Rendle*²⁰⁶ case, the court was faced with having to deliberate on whether the risk of embezzlement of funds which belonged to a taxpayer's clients by junior employees (clerks) who were employed by the taxpayer was a risk which was incidental to the business operations of the taxpayer.

The taxpayer sought to deduct the losses which it had suffered as a result of the embezzlement by its employees of its own funds and also funds belonging to its clients. In addition, the taxpayer (as a partner in a firm of chartered accountants) also sought to deduct a proportionate share of the expenses which the partnership had used in an investigation which was conducted by other independent accountants. The taxpayer contented that the embezzlement or the pilferage of funds from a business was a risk which was incidental to the operations of the business and thus

²⁰² 1961 24 SATC 547 (F) at pg. 548.

²⁰³ 1961 24 SATC 547 (F) at pg. 548.

²⁰⁴ 1961 24 SATC 547 (F) at pg. 552.

²⁰⁵ 1961 24 SATC 547 (F) at pg. 548.

²⁰⁶ *Supra*.



should be allowed for deduction, and in addition advanced that the level of honesty and truthfulness amongst employees had deteriorated.²⁰⁷

In its assessments, the COT refused to allow deductions for the expenses and losses which the taxpayer had incurred. When the taxpayer appealed to the Income Tax Special Court, the court allowed the taxpayer deductions with regards to the expenses which the taxpayer had incurred with regards to the commissioning of the investigation by other independent accountants into the embezzlement which had been perpetrated by the employees and also for the losses which the taxpayer incurred as a result of the embezzlement of the funds belonging to the taxpayer's clients.²⁰⁸ The Income Tax Special Court, however, refused to allow the taxpayer a deduction with respect to the losses which the taxpayer had incurred as a result of the embezzlement of its own funds "*...on the grounds that the taxpayer had not discharged the onus of showing that this amount was a deductible expense or loss in respect of the year in question.*"²⁰⁹

On appeal to the Zimbabwean (then Rhodesian) High Court, the court acknowledged that whilst the deduction of funds which would have been voluntarily expended by a taxpayer is unambiguous as such expenditure is deductible if it is expended within the context of the production of income (and provided that it is not of a capital nature), the deductibility of expenditure of a fortuitous or accidental nature is shrouded in uncertainties. The court held that it was difficult to assign to a taxpayer or business enterprise the risk of incurring expenses of a fortuitous or an accidental nature.²¹⁰

In its arguments, the CoT contended that the expenses of a fortuitous nature which were incurred by the taxpayer should not be allowed for deduction "*...because the expenditure itself was not necessarily (in the sense of practically inevitably) attached to the performance of the operation which constituted the carrying on of the business.*"²¹¹ The court contended that in terms of the CoT's arguments "*...attention*

²⁰⁷ 1965 SA 59, 26 SATC 326 at pg. 328.

²⁰⁸ 1965 SA 59, 26 SATC 326 at pg. 327.

²⁰⁹ 1965 SA 59, 26 SATC 326 at pg. 329.

²¹⁰ 1965 SA 59, 26 SATC 326 at pg. 329.

²¹¹ 1965 SA 59, 26 SATC 326 at pg. 329.



*is focused on the fortuitous expenditure itself and not the mere risk of that expenditure being incurred.*²¹²

The court dismissed (with costs) the CoT's arguments and allowed the taxpayer a deduction for the expenditure of a fortuitous nature which the taxpayer had incurred. The court held that in terms of the nature of the business of the taxpayer, there was an integral risk which existed of the funds of the taxpayer being embezzled.²¹³ The court furthermore held that the investigations which were made by the taxpayer were closely related to the risk of the embezzlement of the taxpayer's funds and thus such expenses were also necessarily incurred within the production of the taxpayer's income.²¹⁴ The court held that in the business of an accountant, the risk of embezzlement of funds is always present and is also closely related to the production of an accountant's income that the associated expenditure must be allowed for deduction.²¹⁵ In addition, the court held that the risk of embezzlement which exists, and any actual embezzlement which may befall the business enterprise of accountants is not dependent on whether the embezzlement is perpetrated by employees of the company or by third parties who are unrelated to the company.²¹⁶

4.4 Embezzlement of funds by senior employees

In *ITC 1383*,²¹⁷ the court was faced with having to decide whether the embezzling of funds by a senior manager who was in the employ of the taxpayer was a risk which was incidental to the business operations of the taxpayer and thus inseparable from the income-earning activities of the taxpayer.

In its arguments before the court, the taxpayer (a bank) contended that the senior manager was stationed in the processing department of the bank.²¹⁸ The processing department of the bank was charged with verifying the authenticity of signatures which were contained on payment vouchers.²¹⁹ The taxpayer argued that the

²¹² 1965 SA 59, 26 SATC 326 at pg. 330.

²¹³ 1965 SA 59, 26 SATC 326 at pg. 333.

²¹⁴ 1965 SA 59, 26 SATC 326 at pg. 336.

²¹⁵ 1965 SA 59, 26 SATC 326 at pg. 334.

²¹⁶ 1965 SA 59, 26 SATC 326 at pg. 334.

²¹⁷ *Supra*.

²¹⁸ 1978 46 SATC 90 (T) at pg. 91.

²¹⁹ 1978 46 SATC 90 (T) at pg. 91.



processing department of the bank was responsible for the processing of an enormous amount of vouchers, and as such it was not possible for the taxpayer to have been able to verify whether the payments which would end up reflecting on individual vouchers indeed were due to the given payees.²²⁰ The taxpayer further contended that it had to rely on the honesty and truthfulness of its employees who worked in the processing department.²²¹ The taxpayer in this particular instance had relied on the truthfulness of its senior manager who had an impeccable sixteen years' experience in the banking sector. The taxpayer did not have a reason to doubt the honesty of the particular senior manager. No evidence was adduced before the court which pointed to any negligence on the part of the taxpayer with regards to the embezzlement.²²²

When the taxpayer attempted to claim a deduction the SIR disallowed the claim. Subsequently, the SIR argued before the court that losses which are incurred by taxpayers as a result of embezzlement, "...*save for petty pilferings by junior employees...*"²²³ are not deductible for tax purposes. Alternatively, the SIR argued that any losses of a fortuitous nature must only be allowed for deduction if the taxpayer is able to convince the court that "...*risk of the mishap which gives rise to the loss must be inseparable from or a necessary incident to the carrying on of the particular business.*"²²⁴

The court accepted the taxpayer's arguments and allowed the taxpayer a deduction with respect to the losses which it had incurred as a result of the embezzlement by the senior manager. The court held that the taxpayer, as a commercial bank, had to deal with enormous amounts of money always and as such, it was reasonable that the taxpayer would rely on people from within its employ to conduct its business.²²⁵ As the taxpayer had to rely on its employees, it also followed that "...*the risk of theft*

²²⁰ 1978 46 SATC 90 (T) at pg. 91.

²²¹ 1978 46 SATC 90 (T) at pg. 91.

²²² 1978 46 SATC 90 (T) at pg. 92.

²²³ 1978 46 SATC 90 (T) at pg. 90.

²²⁴ 1978 46 SATC 90(T) at pg. 92.

²²⁵ 1978 46 SATC 90 (T) at pg. 94-95.



*is [was] an ever-present factor in the administration of its business and must be regarded as inseparable from it.*²²⁶

4.5 Conclusion

This Chapter examined the circumstances regarding the risk of a taxpayer incurring losses and expenses. For a loss or expenditure to be allowed for deduction, the risk of a taxpayer incurring the said loss or expense must have been a necessary incident in the taxpayer's trade. The chapter began by analysing the Canadian position in which the Income Tax Folio spells out that the risk of partners, shareholders, proprietors and senior managers is not inherent in the operations of most business and thus deductions may not ordinarily be allowed.²²⁷

The chapter also looked at case law which has paid attention to the risk of taxpayers incurring losses and expenditure as a result of embezzlement in their trades. In *ITC 952*,²²⁸ the court held that embezzlement of funds by a partner in a firm is not a risk which is incidental to the taxpayer's trade and disallowed the claim for deduction. In *ITC 1383*,²²⁹ the court allowed a claim for a deduction after a senior manager of the taxpayer (a bank) embezzled funds belonging to the taxpayer. The court held that in the nature of the business of banking the embezzlement of funds was a risk which was inherent in the very nature of the taxpayer's business.²³⁰

²²⁶ 1978 46 SATC 90 (T) at pg. 95.

²²⁷ Canadian Income Tax Folio S3-F9-C1 (2014)

<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> at para 1.36 (Accessed 23 August 2015).

²²⁸ 1961 24 SATC 547 (F) at pg. 550.

²²⁹ 1978 46 SATC 90 (T) at pg. 95.

²³⁰ 1978 46 SATC 90 (T) at pg. 95.



CHAPTER 5: INTERNATIONAL EXPERIENCE – THE TAX-DEDUCTIBILITY OF EMBEZZLEMENT LOSSES AND EXPENDITURE

5.1 Introduction

This chapter analyses how other jurisdictions have approached the contentious issue of allowing or disallowing tax deductions for losses and expenditure which are incurred as a result of embezzlement. Legislation, case law and commentary are analysed for Canada, Australia and the United States.

5.2 Canada

The tax treatment of losses which are incurred as a result of embezzlement or defalcations in Canada is provided for in the Income Tax Folio. Income Tax Folios in Canada are equivalent to interpretation notes issued by SARS in South Africa, and they are issued by the Canadian Customs and Revenue Agency to provide technical interpretations of the law. Income Tax Folios do not however have the force of law.

The Income Tax Folio is very comprehensive on the tax treatment of embezzlement losses in the hands of the victim of the embezzlement covering the losses of trading assets, losses as a result of embezzlement by persons unrelated to a taxpayer, losses as a result of the embezzlement by partners, proprietors and shareholders and embezzlement by senior managers.

According to the Income Tax Folio, the embezzlement of assets of a trading nature like stock or cash is usually allowable for deduction by the taxpayer.²³¹ For a deduction to be allowed, the taxpayer however must show that the losses suffered as a result of the embezzlement represent a risk which is concomitant to the carrying out of the business and that the losses are substantially connected to the income-generating activities of the business.²³²

The Income Tax Folio suggests that losses which are incurred as a result of pilferage and robberies by strangers are usually inherent in most businesses and that they are

²³¹ Canadian Income Tax Folio S3-F9-C1 (2014) para. 1.33
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

²³² Canadian Income Tax Folio S3-F9-C1 (2014) para. 1.33
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).



likely to be allowable for deduction.²³³ The Canadian Income Tax Folio also suggests that embezzlement by junior employees of a taxpayer is usually a risk which is inherent in most businesses, and as such losses are usually allowed for deduction.²³⁴

The Income Tax Folio is quite comprehensive with regards to the tax-treatment of embezzlement by partners, proprietors and shareholders. In instances where embezzlement has been perpetrated by a partner, proprietor or shareholder, the usual approach is not to allow deduction of the losses which result from the embezzlement. This is because in such cases the embezzlement is treated as if it were the drawings by the said owner, proprietor or shareholder.²³⁵

In *Hammill v the Queen*²³⁶ the question of the treatment of expenses incurred by a taxpayer as a result of fraud came before the Canadian Tax Court. In this case, the taxpayer who had caved success as an entrepreneur was induced into buying precious gems with the hope that he would realize a profit upon reselling them. The taxpayer contacted the company from which he had bought the gems from so that he could be assisted in securing a market for the precious gems. The taxpayer subsequently gave the precious gems to the company which ostensibly was going to buy the precious gems. In addition, the taxpayer was induced into paying substantial amounts of money supposedly as expenses to cover commissions, insurance and administration fees.

After handing over the precious gems and paying the huge upfront fees to the company which had promised to buy the precious gems, the taxpayer subsequently realised that he had been scammed of the precious gems and the upfront fees which he had paid.²³⁷ The taxpayer claimed a deduction for the stock which he had lost (the precious gems) and for the upfront fees. The Canadian Minister of National

²³³ Canadian Income Tax Folio S3-F9-C1 (2014) at para 1.34
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

²³⁴ Canadian Income Tax Folio S3-F9-C1 (2014) at para 1.35
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

²³⁵ Canadian Income Tax Folio S3-F9-C1 (2014) at para 1.36
<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

²³⁶ 2004 DTC 3271; 2004 5 CTC 2310 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015).

²³⁷ 2004 DTC 3271; 2004 5 CTC 2310 at para. 11 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015).



Revenue allowed the taxpayer to claim a deduction for the lost stock, but disallowed a claim for the upfront fees which had been paid by the taxpayer.²³⁸

In denying the claim for a deduction for the upfront fees which had been paid by the taxpayer, the Canadian Tax Court held that there was no secondary market for the sale of the precious gems and thus there was no reasonable prospect of the taxpayer deriving any income from the selling of the precious gems.²³⁹ The Canadian Tax Court held that as there was no business, the claim for deduction could not be sustained.²⁴⁰ The court furthermore held that all the transactions were fraudulent right from the outset – and that the fraudulent activities actually started before the taxpayer had bought the precious gems.²⁴¹ The court went on to condemn the taxpayer for not having done enough research so as to reasonably know that the market for precious gems in fact did exist.²⁴²

The Canadian Tax Court's decision to deny a deduction to the taxpayer was criticised by *Aiken*.²⁴³ *Aiken*²⁴⁴ was of the view that the court erred in concluding that the transactions were not of a business nature when in fact evidence had been presented in court to the effect that the taxpayer had previously sold precious gems and thereby making a profit in the process.²⁴⁵ *Aiken*²⁴⁶ also held that the court had misdirected itself by focussing on the (lack of) reasonableness of the taxpayer instead of focussing on the most important issue which is whether “... *the taxpayer was engaged in gaining or producing income from a business or property, whether he incurred the expenses in connection with that activity, and whether such*

²³⁸ 2004 DTC 3271; 2004 5 CTC 2310 at para. 178 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015).

²³⁹ 2004 DTC 3271; 2004 5 CTC 2310 at para. 123 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015).

²⁴⁰ 2004 DTC 3271; 2004 5 CTC 2310 at para. 123 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015).

²⁴¹ 2004 DTC 3271; 2004 5 CTC 2310 at para. 123 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015)

²⁴² 2004 DTC 3271; 2004 5 CTC 2310 at para. 123 <http://decision.tcc-cci.gc.ca/tcc-cci/decisions/en/item/26069/index.do> (Accessed on 1 August 2015).

²⁴³ Aiken, CE. *A reasonable victim, Case comment Hammill v the Queen 2004 DTC 3271* (2005) Canadian Tax Journal Volume 53 number 1.

²⁴⁴ *Ibid.*

²⁴⁵ Aiken, CE. *A reasonable victim, Case comment Hammill v the Queen 2004 DTC 3271* (2005) Canadian Tax Journal Volume 53 number 1 at pg. 2.

²⁴⁶ *Ibid.*



*expenses were reasonable in the circumstances, thus meeting the tests for deductibility.*²⁴⁷

5.3 United States of America

In the United States of America, the deduction of losses which are incurred as a result of embezzlement is provided for in terms of section 165 of the Internal Revenue Code²⁴⁸ (hereinafter the IRC). In terms of section 165(a) of the IRC, taxpayers can deduct for any losses of whatever nature which the taxpayer is not compensated for by insurance.²⁴⁹ According to section 165 of the IRC, the taxpayer can only claim for a deduction in the year in which the loss is discovered.²⁵⁰ According to the decisions in *Alison v United States*²⁵¹ and *United States v Stevenson-Chislett Inc*,²⁵² “the Government reads this section as requiring a taxpayer to take a deduction for loss from embezzlement in the year in which the theft occurs, even though inability to discover in time might completely deprive the taxpayer of the benefit of this statutory deduction.”²⁵³

In the tax law jurisprudence of the United States, there have been two conflicting judgments on the tax treatment of losses which were incurred by taxpayers as a result of embezzlement of funds by employees. In *Alsop v ACIR*,²⁵⁴ the court was of the view that money that is embezzled by an employee of a taxpayer before it has

²⁴⁷ Aiken, CE. *A reasonable victim, Case comment Hammill v the Queen 2004 DTC 3271* (2005) Canadian Tax Journal Volume 53 number 1 at pg. 4.

²⁴⁸ Internal Revenue Code (American) https://en.wikipedia.org/wiki/Internal_Revenue_Code (Accessed 26 July 2015).

²⁴⁹ Also see Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 at pg. 741; McMillon, A. & Hollingsworth, D. *Taxation of Theft Losses: A Personal Holding Company Issue* (2005) Corporate Taxation 33 at pg. 34 and Megaard, SL. *Recent Corporate Scandals focus attention on tax treatment of Stock Losses* 2004 Journal of Taxation 101 at pg. 102.

²⁵⁰ Also see Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 at pg. 741 and McMillon, A. & Hollingsworth, D. *Taxation of Theft Losses: A Personal Holding Company Issue* (2005) Corporate Taxation 33 at pg. 32.

²⁵¹ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 2. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

²⁵² *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) at para 2. <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁵³ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 2. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

²⁵⁴ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) (3rd Circuit) <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> at para 10 (Accessed on 31 May 2015).



been received by the taxpayer should not be regarded as losses incurred by the taxpayer. This is because, according to the view of the court, due to the fact that the taxpayer would not in actual fact have received the funds which were subsequently embezzled.²⁵⁵

The issue in *Alsop v ACIR*²⁵⁶ involved an agent who embezzled the funds which belonged to a book author. The taxpayer had given the agent the mandate to collect on her behalf the funds which were due to her from publishing companies. The taxpayer was not aware of the on-going fraud and only realized after 10 years that she was being fleeced by the agent.²⁵⁷ As a result of the taxpayer's ignorance of the fraud which was being perpetrated against her, the taxpayer had not included the royalties which the agent had received from the publishing companies. When the taxpayer attempted to claim a deduction for the losses sustained, the court disallowed the claim on the basis that the royalties never actually accrued to the taxpayer and that the taxpayer could not have lost something which never belonged or became part of her income or property in the first place.²⁵⁸

In *Donohue v ACIR*²⁵⁹ the lower court delivered a judgment which contradicted the decision in *Alsop v ACIR*²⁶⁰ even though the facts were similar. In *Donohue*²⁶¹ the taxpayer operated a tavern business. The taxpayer had given his accountant *carte blanche* with regards to the managing of his financial affairs. The taxpayer's accountant subsequently embezzled a substantial amount of funds from the tavern

²⁵⁵ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) para. 10 <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁵⁶ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) (3rd Circuit) <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁵⁷ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) para. 1 <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁵⁸ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) para. 10 <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁵⁹ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).

²⁶⁰ 1937 92 F.2d 148 (3rd Circuit) <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁶¹ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).



business. The major difference between the *Alsop*²⁶² and *Donohue*²⁶³ cases is that in the latter case the taxpayer's bartender first deposited the funds into the taxpayer's cash register and the funds were first utilised in the taxpayer's business before they were embezzled.

The lower court in *Donohue*²⁶⁴ concluded that the funds were taxable in the hands of the taxpayer and thus allowed the taxpayer a deduction for the funds which had been embezzled. The court held that since the funds were first deposited into the taxpayer's cash register before they were embezzled the taxpayer had derived some economic benefit from the funds first and thus they should be taxed in the hands of the taxpayer.²⁶⁵

The issue of whether a taxpayer is allowed to claim for deduction for losses which arise as a result of embezzlement was also the subject of enquiry in the *Alison*²⁶⁶ and *Stevenson-Chislett Inc*²⁶⁷ cases. In these two similar cases, the taxpayers suffered defalcations which arose as a result of embezzlements which were perpetrated by agents and members of staff whom they had trust in. In both cases the taxpayers only discovered that funds had been embezzled from their businesses after a number of years.

In the *Alison*²⁶⁸ case, investigations revealed the identity of the embezzler as well as the quantum of the funds which were embezzled and the exact years in which the embezzlements took place.²⁶⁹ On the other hand, in *Stevenson-Chislett Inc*,²⁷⁰ the

²⁶² *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) (3rd Circuit) <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁶³ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).

²⁶⁴ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).

²⁶⁵ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) para. 5 <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).

²⁶⁶ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁶⁷ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

²⁶⁸ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁶⁹ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).



exact details of when the embezzlement took place or of who embezzled the taxpayer's funds were difficult to disentangle to the extent that the identity of the embezzler was never known.²⁷¹ Both taxpayers claimed for deductions in the years in which the losses were discovered.

In the *Stevenson-Chislett Inc*²⁷² case, the lower court reached the conclusion that since it was difficult to ascertain the exact years in which the defalcations took place, the taxpayer could claim for the deductions in the years in which the losses were discovered.²⁷³ On the other hand, the lower court in *Alison v United States*²⁷⁴ came to a contrary decision that the taxpayer could not claim the deduction in the years in which the loss was discovered. The court was of the view that since the years in which the embezzlements took place could be determined with the certainty, the claims for deductions should be done in those years in which the losses were incurred.²⁷⁵

The challenge for the taxpayer in the *Alison*²⁷⁶ case was that the IRC stipulated that a taxpayer could ordinarily claim for deductions for embezzlements suffered in the year in which the embezzlements take place, meaning that taxpayers would not succeed in claiming a deduction and would probably suffer prejudice as embezzlement is usually shrouded in secrecy and as such it may take long for it to

²⁷⁰ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 1. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

²⁷¹ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 1. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

²⁷² *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

²⁷³ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁷⁴ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁷⁵ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁷⁶ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).



be discovered.²⁷⁷ Notwithstanding what the IRC stipulates, the United States Treasury's approach to the matter was that the law must not be interpreted or applied in such a manner that there is substantial injustice on taxpayers.²⁷⁸

The United States Treasury's position was motivated by the fact that the crime of embezzlement is a secretive crime and one that may be known only to the embezzler and that a taxpayer may take long to discover that funds were being embezzled by its employees.²⁷⁹ In addition, according to the United States Treasury position, it is not always easy to determine or to ascertain whether there is a loss as a result of embezzlement.²⁸⁰ It is possible for the taxpayer not to suffer a loss as a result of embezzlement if the embezzler quickly returns the funds embezzled before the embezzlement is discovered.²⁸¹ In some instances the taxpayer may discover the embezzlement but may pursue initiatives which are intended on recovering the embezzled funds from the embezzler to the extent that the actual loss to the taxpayer is not necessarily the same as the quantum of the embezzled funds.²⁸²

When both the *Alison*²⁸³ and the *Stevenson-Chislett Inc*²⁸⁴ cases came before the Court of Appeals, the higher court came to the conclusion that the taxpayers in both cases should be treated similarly, and thus upheld the decision in *Stevenson-Chislett Inc*²⁸⁵ and overturned the decision in *Alison*.²⁸⁶ The court furthermore held that since the law did not compel the deduction to be only allowed for in the year in which the

²⁷⁷ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 1 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁷⁸ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 2-3 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁷⁹ *Alison v United States, United States v Stevenson-Chislett Inc* para 3. United States Court of Appeals (3rd circuit 1952) <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸⁰ *Alison v United States, United States v Stevenson-Chislett Inc* para 3. United States Court of Appeals (3rd circuit 1952) <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸¹ *Alison v United States, United States v Stevenson-Chislett Inc* para 3. United States Court of Appeals (3rd circuit 1952) <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸² *Alison v United States, United States v Stevenson-Chislett Inc, United States Court of Appeals (3rd circuit 1952) para. 3* <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸³ *Alison v United States, United States v Stevenson-Chislett Inc* para 3. United States Court of Appeals (3rd circuit 1952) <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸⁴ *Alison v United States, United States v Stevenson-Chislett Inc* para 3. United States Court of Appeals (3rd circuit 1952) <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸⁵ *Alison v United States, United States v Stevenson-Chislett Inc* United States Court of Appeals (3rd circuit 1952) para. 5 and 7 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸⁶ *Alison v United States, United States v Stevenson-Chislett Inc, United States Court of Appeals (3rd circuit 1952) para. 5 and 7* <http://openjurist.org/344/us/167> (Accessed 31 July 2015).



loss is incurred there was need for flexibility as practically taxpayers may take many years to realize that funds were being embezzled.²⁸⁷

5.3.1 Criticisms of the courts' approach in the *Alsop*²⁸⁸ and *Donohue*²⁸⁹ cases

The courts' contrasting decisions in the *Alsop*²⁹⁰ and *Donohue*²⁹¹ cases for taxpayers whose were in similar circumstances solicited a sharp rebuke from commentators. *Vaughn*²⁹² argued that the contrasting decisions in *Alsop*²⁹³ and *Donohue*²⁹⁴ for taxpayers who were in similar circumstances was at odds with the essential tax principle of the need to achieve horizontal equity with similarly placed taxpayers.²⁹⁵ *Vaughn*²⁹⁶ argued that the fact that in *Donohue*²⁹⁷ the stolen funds were held to constitute income to the taxpayer because they were in the taxpayer's cash drawer whereas in *Alsop*²⁹⁸ the court held that the funds never accrued to the taxpayer was inconsistent with the principle of horizontal equity as the differences in treatment of the two taxpayers did not have any income tax relevance.²⁹⁹

*Vaughn*³⁰⁰ also further argued that the court's decision to hold that the funds which were embezzled from a taxpayer in *Alsop*³⁰¹ did not really accrue to the taxpayer was at variance with the need to encourage efficiency in the ways in which taxpayers

²⁸⁷ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd circuit 1952) para. 4 <http://openjurist.org/344/us/167> (Accessed 31 July 2015).

²⁸⁸ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁸⁹ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).

²⁹⁰ *Supra*.

²⁹¹ *Supra*.

²⁹² Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 para. 2A, pg. 736-737.

²⁹³ *Alsop v Commissioner of Internal Revenue*, 92 F.2d 148 (3d Cir. 1937) <http://openjurist.org/290/f2d/726/alsop-v-commissioner-of-internal-revenue> (Accessed on 31 May 2015).

²⁹⁴ *Donohue v Commissioner of Internal Revenue*, 323 f.2d 651, United States Court of Appeals (7th circuit 1963) <http://openjurist.org/323/f2d/651> (Accessed 14 July 2015).

²⁹⁵ Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 para. 2A, pg. 736-737.

²⁹⁶ *Supra*.

²⁹⁷ *Supra*.

²⁹⁸ *Supra*.

²⁹⁹ Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 para. 2A, pg. 736-737.

³⁰⁰ *Supra*.

³⁰¹ *Supra*.



manage their businesses.³⁰² *Vaughn*³⁰³ argued that it should be a taxpayer's responsibility to put into place measures that minimize or reduce the chances of embezzlement and also to obtain insurance to cover for embezzlement by employees if necessary.³⁰⁴ *Vaughn*³⁰⁵ was of the view that the *Alsop*³⁰⁶ decision indirectly recompensed inefficiency and was further of the view that any funds which are paid to a taxpayer or his/her employees should be treated as income of the taxpayer.³⁰⁷

In an earlier article authored in 1949, *Stuetzer Jr*³⁰⁸ also supported, so as to avoid injustices, allowing for a deduction in the year in which the embezzlement loss was discovered.

5.4 Australia

In Australia, the deductions of losses which are incurred by taxpayers as a result of fraud or defalcations are covered in terms of sections 25-45 of the Income Tax Assessment Act 1997.

In *Ash v FCoT*,³⁰⁹ the court disallowed the claim for a deduction in a case when a solicitor made payments meant to settle liabilities which had arisen as a result of his erstwhile partner's fraud. The partner had been declared bankrupt and clients sought to recover their money from the taxpayer.

In this case, the taxpayer's partner fraudulently persuaded the partnership's clients to effect overpayments in respect of several things like stamp duties and counsel fees. Upon the discovery of the defalcations and the prejudicing of the partnership's clients, the fraudulent partner was removed from the roll of solicitors. As the

³⁰² Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 para. 2C, pg. 738.

³⁰³ *Supra*.

³⁰⁴ Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 para. 2A, pg. 736-738.

³⁰⁵ *Ibid*.

³⁰⁶ *Supra*.

³⁰⁷ Vaughn, JS. *Tax Treatment of Embezzlement Victims* (1977) Southern California Law Review 733 para. 2A, pg. 739.

³⁰⁸ Stuetzer, H Jr. *Embezzlement Losses: Time for Deduction* (1949) Tax Law Review 195 at pg. 205.

³⁰⁹ 1938 61 CLR 263 5 ATD 76

<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).



taxpayer's partner was declared bankrupt after the dissolution of the partnership, some clients took the taxpayer to court requesting compensation for the monies which they had given to the taxpayer's partner but which had not been acknowledged by the partnership. The taxpayer conceded and agreed to repay the clients for the funds which had been defrauded by the taxpayer's partner.³¹⁰

It is noted that the taxpayer agreed to compensate the clients because as a partner he was jointly and severally liable to the debts which had been incurred by the partnership. In addition, if the taxpayer had not agreed to a compromise with the creditors of the partnership he would have been liable for larger amounts of money and this probably might also have led to him being declared bankrupt and thus not being able to proceed with his practice as a solicitor from which he derived his livelihood.³¹¹

The court was confronted with the enquiry as to whether the losses which the taxpayer incurred as a result of having to compensate the defrauded clients were incurred in the course of producing income and whether they should be allowed or disallowed for deductions.³¹² The taxpayer's major hurdle in convincing the court that the expenditure which he had incurred had been so incurred in the course of producing income arose due to fact that the payments which he made specifically did not produce income – but were meant to preserve the goodwill of the business and for the taxpayer not to be forced out of business.³¹³

The court disallowed the claim for deduction which was made by the taxpayer. The court held that that the claim for deduction could not be sustained as it had not been

³¹⁰ 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³¹¹ 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³¹² 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³¹³ 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).



incurred in the process of producing income.³¹⁴ The court held that the expenditure was actually of a capital nature and that the payments had been incurred with a view of extinguishing liabilities of a capital nature.³¹⁵ The court held that the reason for the expenditure to the defrauded clients was not to generate income but was rather to preserve or save the business from the brink of collapse and as such the expenditure was of a capital nature.³¹⁶

In *Lean v FCoT*,³¹⁷ the Australian Federal Court disallowed the claim for deduction by a taxpayer for losses which the taxpayer had incurred after being defrauded when he had invested funds in Hong Kong. In this case the taxpayer was introduced to a fraudster who ostensibly had a hugely successful career as a securities trader and fund manager.³¹⁸

The issue before the court was whether the misappropriation of the money by the fraudster satisfied the provisions of section 25-45 of the Australian Income Tax Assessment Act of 1997. According to the provisions of sections 25-45 of the Income Tax Assessment Act of 1997, for a deduction to be allowed, the funds which a taxpayer would have lost through embezzlement or misappropriation must be the same funds which the taxpayer includes in his/her assessable income. However, in this case, the instructions from the taxpayer to the fraudster were couched in general terms to the extent that the fraudster could invest in any kind of activities on behalf of the taxpayer.³¹⁹ As such, the investor could not and was not restricted to investing in

³¹⁴ 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³¹⁵ 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³¹⁶ 1938 61 CLR 263 5 ATD 76
<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³¹⁷ 2010 FCAFC 1 <http://www.iknow.cch.com.au/#!/document/ataqUio1617946sl236059393/lean-v-fc-of-t-federal-court-of-australia-full-court-28-january-2010> (Accessed 29 July 2015).

³¹⁸ 2010 FCAFC 1 para. 9
<http://www.iknow.cch.com.au/#!/document/ataqUio1617946sl236059393/lean-v-fc-of-t-federal-court-of-australia-full-court-28-january-2010> (Accessed 29 July 2015).

³¹⁹ 2010 FCAFC 1 at para. 15-16
<http://www.iknow.cch.com.au/#!/document/ataqUio1617946sl236059393/lean-v-fc-of-t-federal-court-of-australia-full-court-28-january-2010> (Accessed 29 July 2015).



ordinary trading activities only and could even invest in capital projects.³²⁰ The court concluded that since the funds which the taxpayer lost could not be pigeonholed as the same funds which the taxpayer had included in his assessable income, a claim for a deduction by the taxpayer could not succeed.³²¹

In *E.H.L Burgess (Pty) Ltd v FCoT*,³²² the issue of whether deductions which arise as a result of misappropriations made by the directors of a company came before the courts. The courts affirmed the decision which had been made by the FCoT to disallow a claim for deduction.³²³

In this case, the taxpayer owned shares in a company which was engaged in the business of manufacturing and the trading of shares. One of the directors received the advice that selling shares of the company to someone who was interested in buying a company with taxable profits was within the tenets of the law.³²⁴ After the conclusion of the sale of the shares of the company, the directors of the company resigned. After the conclusion of the transactions, the company did not have any assets and its trading and manufacturing activities ground to a halt.

The matter before the court was whether the company was entitled to a deduction as the assets (including profits) of the company had been fraudulently misappropriated by its directors. The applicant relied on section 71 of the Income Tax Assessment Act of 1936 which allowed a claim for deduction in the case where a taxpayer suffered a loss as a result of embezzlement and misappropriation.

The court disallowed the claim for deduction as the misappropriation had been perpetrated by the directors of the company who acted in the interests of the

³²⁰ 2010 FCAFC 1 at para. 16

<http://www.iknow.cch.com.au/#!/document/atagUio1617946sl236059393/lean-v-fc-of-t-federal-court-of-australia-full-court-28-january-2010> (Accessed 29 July 2015).

³²¹ 2010 FCAFC 1 para. 23

<http://www.iknow.cch.com.au/#!/document/atagUio1617946sl236059393/lean-v-fc-of-t-federal-court-of-australia-full-court-28-january-2010> (Accessed 29 July 2015).

³²² 1988 ATC 4517 <http://www.iknow.cch.com.au/#!/document/atagUio545522sl16800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).

³²³ 1988 ATC 4517 at pg. 4523-4524

<http://www.iknow.cch.com.au/#!/document/atagUio545522sl16800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).

³²⁴ 1988 ATC 4517 at pg. 4520

<http://www.iknow.cch.com.au/#!/document/atagUio545522sl16800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).



company and of its shareholders.³²⁵ The court did in fact not want to recognize the misappropriation as such, but rather as some kind of liquidation of the assets and concluded that a claim for deduction would not succeed.³²⁶

5.5 Conclusion

In Canada, the Income Tax Folio provides guidelines on the deductibility of losses and expenditure which might be incurred by taxpayers as a result of embezzlement. The Income Tax Folio suggests that losses and expenditure incurred as a result of embezzlement by strangers and junior employees are inherent in most businesses and should be allowed for deduction.³²⁷ On the other hand, the Income Tax Folio suggests that losses and expenditure incurred as a result of embezzlement by shareholders, owners and proprietors of companies should not be allowed as they should be taken as drawings by the said owners, shareholders and proprietors.³²⁸

In the United States, the deduction of losses and expenditure incurred as a result of embezzlement is provided by section 165 of the IRC. In the *Stevenson-Chislett Inc*³²⁹ and *Alison*³³⁰ the court held that taxpayers should be allowed to claim losses incurred as a result of embezzlement in the years in which the losses are discovered. This is also the position which was taken by the US Treasury. The position in the United States is out of the acknowledgement that embezzlement is quite secretive and that taxpayers may take long to discover it.³³¹

³²⁵ 1988 ATC 4517 at pg. 4523-4524

<http://www.iknow.cch.com.au/#!/document/atagUio545522s116800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).

³²⁶ 1988 ATC 4517 at pg. 4523-4524.

<http://www.iknow.cch.com.au/#!/document/atagUio545522s116800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).

³²⁷ Canadian Income Tax Folio S3-F9-C1 (2014) at para 1.34 and para. 1.35

<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

³²⁸ Canadian Income Tax Folio S3-F9-C1 (2014) para. 1.36

<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015).

³²⁹ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 2. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³³⁰ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 2. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³³¹ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 3. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).



In Australia, the deduction of expenses and losses which are incurred as a result of embezzlement is accommodated by section 25-45 of the Income Tax Assessment Act of 1997. In the *Ash*³³² case, the court disallowed a claim for deduction when the partner in a firm of solicitors was forced to make payments so as to avoid being declared bankrupt. The court held that the forced payments were not made in the production of income and were rather of a capital nature.³³³ In the *E.H.L. Burgess (Pty) Ltd*³³⁴ case, the court refused to allow for a deduction for embezzlement which had been perpetrated by directors in a company. The court held that the embezzlement was in fact a liquidation of the company by the directors.³³⁵

³³² 1938 61 CLR 263 5 ATD 76

<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³³³ 1938 61 CLR 263 5 ATD 76

<https://www.ato.gov.au/law/view/view.htm?DocID=JUD%2F61CLR263%2F00002> (Accessed on 26 July 2015).

³³⁴ 1988 ATC 4517 <http://www.iknow.cch.com.au/#!/document/atagUio545522sl16800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).

³³⁵ 1988 ATC 4517 pg. 4523-4524

<http://www.iknow.cch.com.au/#!/document/atagUio545522sl16800249/e-h-l-burgess-pty-ltd-v-federal-commissioner-of-taxation-federal-court-of-australia-full-court-19-july-1988> (Accessed 29 July 2015).



CHAPTER 6: CONCLUSION

6.1 Introduction

The purpose of the study was to analyse the legal position with regard to whether expenditure and losses which are incurred by taxpayers as a result of embezzlement activities are deductible for tax purposes. Whilst the SCA finally got the chance to affirmatively pronounce that illegally obtained receipts constitute part of the gross income of a taxpayer in the *MP Finance Group CC*³³⁶ case, the issue with regards to the deductibility of expenses and losses which are incurred by taxpayers as a result of embezzlement activities remains the subject of conjecture. It is hoped that the SCA will eventually get the chance to hear the matter and provide much-needed guidance on the matter.

6.2 Summary of findings

In the *Rendle*³³⁷ case, the court held that what is of utmost importance is to establish whether the losses which a taxpayer suffered as a result of embezzlement were sufficiently close to the cost of producing the taxpayer's income, and that it was not relevant whether or not the embezzlement which the taxpayer suffered had been perpetrated by someone who was in the employ of the taxpayer or by someone unconnected to the taxpayer.

In *ITC 952*,³³⁸ the court emphasized that a distinction needs to be made between expenditure which is made in the production of income and expenditure which is not made in the production of income. As required by section 11(a) of the Act, only expenditure which is incurred in the production of income can be allowed for deduction. In this case, the partner of the taxpayer had misappropriated clients' funds held in trust. The taxpayer had to take up a loan after the taxpayer's partner had committed suicide. The court refused to grant the taxpayer a deduction on the basis that the expenditure had not been incurred in the production of income.³³⁹

³³⁶ *Supra*.

³³⁷ 1965 SA 59, 26 SATC 326 at pg. 327 and pg 333.

³³⁸ 1961 24 SATC 547 (F) at pg. 548

³³⁹ 1961 24 SATC 547 (F) at pg. 548.



In *ITC 1661*,³⁴⁰ the court made a ruling which contradicted the decision in *Rendle*.³⁴¹ After the taxpayer had suffered losses as a result of defalcations which had been perpetrated by independent contractors (auditors), the court held that section 11(a) was drafted in such a manner so as to only cater for defalcations perpetrated by employees of the company (and not third parties or independent contractors).³⁴²

In *Lockie Bros*,³⁴³ the court emphasized that a clear distinction should be drawn between expenses of a revenue and capital nature. Only expenses of a revenue nature can be allowed for deduction. This case involved the embezzlement of funds belonging to the taxpayer by a manager in the employ of the taxpayer. De Waal J held that the funds derived from the sale of the taxpayer's products became part of the taxpayer's capital immediately after the sale of the taxpayer's products and therefore the defalcations were capital in nature.³⁴⁴

6.3 Risk of a taxpayer incurring expenditure and losses

For a deduction to be allowed, the risk of the taxpayer incurring the expenditure and losses must be inherent.

In *ITC 952*,³⁴⁵ the court refused to allow for a deduction for a defalcation that had been perpetrated by a partner of the taxpayer. This is because partners are owners of a company and ought to discharge their duties in the best interests of the business enterprise. Thus the court held that the risk of partners embezzling funds from the business was not incidental to the risk of the partnership's business.³⁴⁶ In *Rendle*,³⁴⁷ the court however held that the risk of employees and strangers embezzling from the business was incidental to the business operations of a taxpayer.

In *ITC 1383*,³⁴⁸ the court allowed the taxpayer (a bank) a deduction with respect to a loss which it had suffered as a result of embezzlement which had been perpetrated

³⁴⁰ *Supra*.

³⁴¹ *Supra*.

³⁴² 1998 61 SATC 353 (G) at pg. 354.

³⁴³ *Supra*.

³⁴⁴ 1922 TPD 42, 32 SATC 150 at pg. 155.

³⁴⁵ 1961 24 SATC 547 (F) at pg. 548.

³⁴⁶ 1961 24 SATC 547 (F) at pg. 548.

³⁴⁷ 1965 SA 59, 26 SATC 326 at pg. 327 and pg 334.

³⁴⁸ *Supra*.



by a senior manager of the taxpayer. The court held that the taxpayer, as a bank, dealt with huge amounts of cash, and that it was reasonable for it to rely on its employees to discharge their duties honestly.³⁴⁹ The court held that the risk of embezzlement by employees of the taxpayer was prevalent in the taxpayer's business and as such it was a recognised risk in the taxpayer's business enterprise.³⁵⁰

6.4 Recommendations on issues which South African courts can take in account when the matters come before South African courts

It is hoped that the issues pertaining to the deductibility of losses and expenses which are incurred as a result of embezzlement can once again come before our courts and that the matters can go all the way to the SCA so that the SCA can provide direction and finality on how embezzlement losses and expenses should be treated.

6.4.1 Losses and expenses as a result of embezzlement by partners in a firm

Losses and expenses which are incurred by taxpayers as a result of embezzlement activities by partners of a taxpayer should not be allowed for deduction. This is because a partner of a firm or taxpayer is in a position of ownership of the firm, and as such the embezzlement by a partner should be treated as drawings from the firm by the partner. It is hoped that the courts will follow the approach advanced in the (Canadian) Income Tax Folio which also suggests that losses and expenses incurred as a result of the embezzlement activities of partners and shareholders should not be allowed for deduction.³⁵¹ This is also consistent with the decision which was reached in the *ITC 952*³⁵² case.

³⁴⁹ 1978 46 SATC 90 (T) at pg. 95.

³⁵⁰ 1978 46 SATC 90 (T) at pg. 95.

³⁵¹ Canadian Income Tax Folio S3-F9-C1 (2014)

<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> (Accessed 23 August 2015) at para 1.36.

³⁵² 1961 24 SATC 547 (F) at pg. 548.



6.4.2 Losses and expenses which are incurred as a result of embezzlement by senior managers of a taxpayer

The approach which was proposed by the SARS in the Interpretation Note in which deductions for losses and expenses which are incurred as a result of embezzlement by senior managers may be allowed is supported.³⁵³ It is however proposed that the courts should make a careful enquiry so to ascertain the position of the senior manager in the firm (taxpayer). If the senior manager held a position which is akin to that of a proprietor of the business a tax deduction should not be allowed. This is also consistent with the decision in *ITC 1383*.³⁵⁴

6.4.3 Losses and expenses which are incurred as a result of embezzlement by junior employees and strangers

It is advanced that losses and expenses which are incurred as a result of embezzlement by junior employees of a taxpayer and strangers should be allowed for deduction. The embezzlement and pilferage by junior employees and strangers is a risk which is inherent in most business enterprises and as such deductions should be ordinarily allowed.³⁵⁵ This is consistent with the position advanced in the (Canadian) Income Tax Folio and the judgments in the *Rendle*³⁵⁶ case and in *ITC 1242*.³⁵⁷

6.4.4 Expenses and losses claimed in a different year of assessment

According to the definition which is contained in section 11(a) of the Act, a taxpayer can only claim a deduction in the year in which the expenditure and losses are incurred. The courts in the *Concentra*³⁵⁸ and *Baxter*³⁵⁹ cases reaffirmed the position

³⁵³ SARS Interpretation Note Number 80: The Income Tax treatment of stolen money (2014) SARS. <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2014-05%20-%20IN80%20Income%20Tax%20Treatment%20of%20Stolen%20Money.pdf> at para 4.1.1 (c) pg. 7 (Accessed 06 February 2015).

³⁵⁴ 1998 61 SATC 353 (G) at pg. 354.

³⁵⁵ Canadian Income Tax Folio S3-F9-C1 (2014) <http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s3/f9/s3-f9-c1-eng.html> at para 1.34 and 1.35 (Accessed 23 August 2015).

³⁵⁶ 1965 SA 59, 26 SATC 326 at pg. 327 and pg 333.

³⁵⁷ 1975 37 SATC 306(C) at pg. 307.

³⁵⁸ *Concentra v CIR* 1942 CPD, 12 SATC 95 at pg. 96.

³⁵⁹ *Baxter v CoT* 1937 SR 48, 9 SATC 1 at pg. 2 and pg. 5.



that taxpayers would not succeed if they claimed deductions for expenses and losses which are incurred in a year which is different from the year of assessment.

It is advanced that with respect to losses and expenses which are incurred by taxpayers due to embezzlement the courts should adopt an approach which is similar to that adopted by the US Treasury and the United States Court of Appeals' decisions in *Alison*³⁶⁰ and *Stevenson-Chislett, Inc.*³⁶¹ The US Treasury position and the United States Court of Appeals' decisions in *Alison*³⁶² and *Stevenson-Chislett, Inc.*³⁶³ rightly acknowledge that embezzlement is secretive in its nature and thus may not be known to the taxpayer for a long time. The US Treasury position and the United States Court of Appeals' decisions in *Alison*³⁶⁴ and *Stevenson-Chislett, Inc.*³⁶⁵ enable taxpayers who suffer losses and incur expenses due to embezzlement to claim for deduction in the year in which the expenses and losses are discovered even though the losses might have been incurred in prior years. There thus ought to be flexibility in the interpretation of the law so that taxpayers do not suffer prejudice by being denied deductions as a result of them having incurred losses and expenses as a result of embezzlement. This will also assist in achieving horizontal equity amongst taxpayers in that all taxpayers will be allowed to claim deductions for all losses and expenditure incurred, regardless of whether the losses and expenditure are incurred as a result of embezzlement or otherwise.

³⁶⁰ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 5. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³⁶¹ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 5. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³⁶² *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals United States Court of Appeals (3rd Circuit) at para 3. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³⁶³ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 3. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³⁶⁴ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals United States Court of Appeals (3rd Circuit) at para 5. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).

³⁶⁵ *Alison v United States, United States v Stevenson-Chislett Inc* 1952 Cases 79 and 80 United States Court of Appeals (3rd Circuit) at para 5. <http://openjurist.org/344/us/167> (Accessed on 31 July 2015).



6.5 Conclusion

This Chapter concludes the study. The Chapter first summarizes the main findings as to when expenditure and losses which are incurred as a result of embezzlement are incurred in the production of income. The Chapter also summarized the risks which are inherent in the business operations of taxpayers.

The Chapter concludes the study by proffering recommendations which the courts can consider when the issues of deductions for losses and expenditure incurred as a result of embezzlement come before our courts again.



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