THE TAXATION OF ILLEGAL INCOME: AN INTERNATIONAL COMPARISON

by

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I. ABSTRACT

The question of whether income generated from illegal activities should be subject to tax, may raise eyebrows. Some countries may take the view that taxpayers should be taxed on their income regardless of whether the income is tainted with illegality whilst others might be of the opinion that taxing illegal earnings is unethical, due to the fact that the tax flowing to government is sourced from income generated from illegal activities.

South African and Australian tax residents are obligated to declare their worldwide earnings, including earnings derived from illegal sources, in their annual tax return submission to the revenue authorities.

This study provides an in-depth literature review of the South African and Australian tax system in order to: firstly, address the taxation of illegal earnings and the deductibility of expenditure incurred in the production of illegal earnings, and secondly, to discuss the tools and abilities of the SARS and the Australian Tax office to trace and identify illegal income, and thirdly, to provide a comparison between South Africa and Australia in order to determine whether South Africa is in line with global norms.

From the research findings, it can be concluded that South Africa will tax illegal earnings should it fall in the definition of Gross Income, as defined in section 1 of the ITA. On the same note, Australia will also tax illegal income should it constitute assessable income as defined in section 4-15(1) of the Assessment Act.

The findings further indicate a parallel between how South Africa and Australia deal with the deductibility of legal and illegal expenditure. Both countries have incorporated a general deduction formula into their income tax legislation.

The findings also analyses the various tools and processes available to tax authorities, to identify taxpayers who exploit the tax system. Unfortunately, even with tools in place, instances exist where tax authorities only become aware of illegal income that has been generated once the taxpayer is caught out. However, both countries are leading by example through tools and technology that have been implemented in a process to identify illegal income that has been omitted from annual tax returns. An excellent example is the success of project Wickenby. This initiative is definitely something that South Africa can learn from and work towards for future implementation in South Africa.

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IV. LIST OF ABBREVIATIONS

AEOI	Automatic Exchange of Information
ATO	Australian Tax Office
AU	Australia
DIBP	Department of Immigration and Border protection
DTA	Double Tax Agreement
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay As You Earn
SA	South Africa
SARS	South African Revenue Service
TAA	Tax Administration Act No.28 of 2011
The Act	Income Tax Act 58 of 1962
The Assessment Act	Income Tax Assessment Act 1997, No.38 of 1997
the PCCA Act	The Prevention and Combating of Corrupt Activities Act, No. 12 of 2004
VAT	Value Added Tax
TIEA	Tax Information Exchange Agreements

V. KEYWORDS

South African Revenue Service

Australian Tax Office

Income Tax Act

Income Tax Assessment Act

Illegal Income

CHAPTER 1

1. BACKGROUND AND INTRODUCTION

It has become progressively evident that certain taxpayers go to the extreme to avoid paying tax, regardless of the legality of the sourced income. For the purpose of this study the following examples of illegal transactions will be referred to:

- An employer withheld Pay As You Earn ("PAYE") from his employees and failed to pay it over to the South African Revenue Services ("SARS"). The employer was convicted of tax fraud and had to settle the outstanding tax debt with SARS (ENCA, 2014: 1).
- A taxpayer operated an illegal investment scheme where clients made investments into his personal bank account. In return the taxpayer promised irresistible returns on investments. The taxpayer funded the returns with money he received from new investors, but the scheme collapsed and the taxpayer ended up owing his clients R10 million. The taxpayer knew that his actions were fraudulent and that he would not be able to make good on the returns that he had promised. The taxpayer was accordingly taxed on the illegal funds, due to the fact that it was *received* by the taxpayer in terms of the gross income definition (Williams, 2010: 1).
- Businesses that offer illegal online gambling activities will be obligated to declare their illegal earnings to SARS. SARS will raise additional income tax assessments for income earned from illegal activities should SARS establish that a taxpayer regularly receive income from illegal activities (Visser, 2015: 1).

The above scenarios are all examples of illegal income generated by taxpayers. This has become vastly relevant as South African ("SA") tax residents are taxed on their worldwide earnings (Haupt, 2015: 25), irrespective of whether the income received or accrued to the taxpayer was tainted with illegality.

The examples listed above can indicate various other problems such as tax avoidance and tax evasion. This is certainly evident in SA as there are many practices of illegal trade and income-generating activities. Examples include: illegal gambling; money derived from crimes; the sale of drugs and smuggled goods; illegal trade; bribes etc. (Gauteng Gambling Board, 2015: 1; PWC, 2015: 1).

The breakthrough case on taxing illegal income, is the case of MP Finance Group CC (in Liquidation) v SARS, 69 SATC 141, which should be read with section 23(o) of the Income Tax Act, no 58 of 1962, hereafter referred to as "the Act", which speaks to the deductibility of illegal expenditure.

The dissertation analyses how SA, in comparison to Australia ("AU"), deals with the taxation of illegal income and expenditure. The contribution made by the present study is to establish whether SA is in line with global norms and principles relating to the tax treatment of illegal income and expenditure.

The next sections will present the research problem, the set objectives as well as the motivation for the study.

1.1 Research problem

The problem is that there is no specific section in the South African Act that deals with the taxation of illegal earnings and the deductibility of expenditure incurred in the production of illegal income. Therefore, clarity needs to be provided on how to approach the tax treatment of illegal earnings and expenditure.

It is also not known whether SA is in line with the international tax treatment of illegal earnings and expenditure, especially that of AU

The South African Act mirrors the Australian Income Tax Assessment Act, No.38 of 1997, hereafter referred to as the Assessment Act, in the sense that both countries tax resident taxpayers' on their worldwide earnings. Thus, AU was selected as the comparison country for the purposes of this study.

The taxation of illegal income has become a real life problem, as courts around the world are faced with the issue of determining the taxability of illegal income, especially in scenarios where the taxpayer did not carry on a trade. For a detailed discussion on cases that had to deal with this topic please see the article by Black: "Taxing Crime: The application of income tax to illegal activities" (Black, 2005).

SA and AU have both implemented various data collection techniques in order to identify and verify income that has been declared as well as omitted in taxpayers' annual tax returns. Some of the tools include: Tax Information Sharing Agreements; Double Taxation Agreements; 3rd party data collection; access to taxpayers' bank accounts; risk profiling etc.

Unfortunately, in most cases tax authorities only become aware illegal income that has been generated once taxpayers are caught. AU has been leading by example with the success of a project that was launched, called project Wickenby. The main purpose of the partnerships that underpin project Wickenby was to prevent taxpayers' from abusing secrecy havens and has assisted in making AU less attractive for international tax fraud and tax evasion. This initiative is definitely something that SA can learn from and work towards for future implementation in SA. More information on the Project Wickenby initiative will be discussed, later on, in the section regarding the tools and abilities of the tax authorities to trace illegal earnings.

The next section will address the research objectives and sub-objectives of the dissertation.

1.2 Primary research objective

The primary research objective is to do a comparative study on the similarities/differences in the tax treatment and detection of illegal transactions in SA compared to those in AU in order to conclude on the appropriateness of the SA tax system in this regard.

In order to achieve the above objective, the following sub-objectives need to be addressed:

- to analyse the taxability of illegal income in SA and AU;
- to analyse the deductibility of expenses incurred to acquire illegal income in SA and AU;
- to explore the means (tools) and abilities of the SA and AU tax authorities to detect illegal transactions; and
- to compare and conclude on the findings on the taxation of illegal income and expenditure in both countries.

1.3 Motivation for the study and expected contributions

By comparing how different countries tax illegal income and expenditure incurred in the production of the taxpayer's illegal income, principles and guidelines can be established on the taxation of illegal income and the deductibility of expenses relating to illegal activities.

This dissertation aims to determine whether SA is in line with international standards, in respect of the taxation of illegal income and the deductibility of expenditure, by comparing it to the sample country e.g. AU that has been selected. This study will also contribute to the debate on the taxation of illegal income, by reviewing existing literature and providing a commentary.

1.4 Brief chapter overview

The dissertation is structured as follows:

- Chapter 2 addresses the research design and methodology applied in the dissertation and comments on the validity of the study.
- Chapter 3 reviews the literature and provides an analysis of the tax treatment of illegal income and the deductibility of expenditure in SA. This chapter also explores the tools available to SARS to identify and verify income that has been declared or omitted from annual tax return declarations.
- Chapter 4 reviews the literature and provides an analysis of the tax treatment of illegal income and the deductibility of expenditure in AU. This chapter also explores the tools available to the ATO to identify and verify income that has been declared or omitted from annual tax return declarations.
- Chapter 5 provides a critical analysis of the research findings and addresses the research objectives in order to determine whether SA is in line with global norms.

CHAPTER 2

2. RESEARCH DESIGN AND METHODS

2.1 Introduction

The present research can be described as a qualitative study. According to Collins & Hussey (2010: 7), a qualitative study is the process of analysing qualitative data through the use of interpretive methods.

The study involves the interpretation and analysis of secondary data with the purpose of presenting an overview of the tax treatment of illegal income and expenditure in SA and to draw a functional comparison with similar provisions legislated in AU.

The research philosophy, method and strategy used to conduct the study in order to achieve the set objectives, will be discussed thereafter.

2.2 Research philosophy

The research is conducted from an interpretive philosophy. According to Collins & Hussey (2010: 57) interpretivism is reinforced by the belief that social reality is influenced by people's perceptions and therefore it is very subjective. Accordingly, the dissertation focuses on exploring the complexity of the research problem in order to obtain a subjective understanding of the taxation of illegal income and expenditure in SA and AU.

2.3 Research approach

The study follows an inductive approach which is appropriate according to Lewis, Saunders & Thornhill (2013: 163) for developing a bigger perspective to what already exists in the current literature.

Lewis, et al. (2013: 145) explain that an inductive approach commences with known principles and then progresses to collating data, in order to explore the research problem. In the present research, principles as set out by various court cases and expert opinions on the interpretation of legislation related to the tax treatment of illegal income and expenditure are presented systematically to enable the researcher to draw a conclusion on the similarities (or differences) between SA and AU in this respect.

2.4 Research strategy

A variety of studies can be used when following the qualitative approach. For purposes of this dissertation an exploratory study was used. Exploratory studies include, among other strategies, a literature review, which in principle is a review of all secondary data available on the research problem.

According to Collins & Hussey (2010: 5) exploratory studies are used in scenarios where very little or no research has been conducted on a specific research topic. Instead of testing or confirming a hypothesis, exploratory studies aim to identify hypotheses, patterns or ideas.

Once the review of literature, case law and legislation relating to illegal income and associated expenditure has been completed the data will be analysed to:

- determine the taxability of illegal income in SA and AU;
- determine the deductibility of expenses incurred to acquire illegal income in SA and AU;
- identify tools and abilities by SA and AU tax authorities to trace illegal income
- identify the similarities/differences in the tax treatment of illegal income and the expenditure incurred between SA and AU.

2.5 Method of analysis and data sources

The method used in the present research is an in-depth literature review of the tax system of SA as well as the tax system of AU. The method was selected with a view to do a functional comparison of the tax treatment of illegal income and the expenditure incurred to generate such income. It also aims to evaluate and compare the tools used by both countries in order to identify illegal income that has been omitted from annual tax return submissions.

According to Avi-Yonah, Sartori & Marian (2011: 145) a researcher would normally undertake a functional comparison study to identify similarities between countries, with the purpose of harmonizing tax laws.

Avi-Yonah, et al. (2011: 145) further explains that functionalism is based on the assumption that although each country has its unique way to address problems facing society, their end results are often the same.

Secondary data were of great importance in this study. Some of the data might have originally been collected for other purposes, but utilising this approach the research problem is addressed using fewer resources. According to Lewis, et al. (2013: 318) using secondary data can result in unforeseen discoveries which will provide the researcher with comparative and contextual data in order to find potential solutions to the research objectives.

The study collated data from the following sources: South African Income Tax Act; Australian Income Tax Assessment Act; relevant case law; established theories; published opinions on the internet; relevant books on Taxation and Law; UJ library databases; published information from SARS; published information from the Australian tax office (ATO); rulings on the tax treatment of illegal income; published articles in popular and academic journals in the Accountancy, Taxation and Law disciplines; the Tax Administration Act of SA; opinions from tax professionals and input from the researcher's counsellor.

2.6 Ethics

Lewis, et al. (2013: 245) are of the opinion that it is very important that the researcher remains objective when analysing the data he/she has collected, in order to avoid any misrepresentation that might occur.

Due to the above, the researcher ensured that the following ethical principles as described by Lewis, et al. (2013: 231) were adhered to: integrity; objectivity; respect for others and avoidance of any harm to others. All the data analysed for the present research are available in the public domain, thus the privacy or anonymity of sources cited and opinions used are not an ethical concern.

In addition to the above, the researcher also ensured that proper referencing techniques were applied when another author's work was used in the dissertation, in order to avoid plagiarism.

2.7 Validity

The research findings from the dissertation will be valid as the following principles have been applied:

- interpreting existing tax legislation by adhering to the rules of legal interpretation, as established by common law;

- placing greater evidential weight on legislation and case law and the writings of acknowledged experts in the field which will either create a precedent or provide results that are of a persuasive value; and
- discussing opposing viewpoints and reaching a conclusion, based on credible evidence.

According to Lewis, et al. (2013: 193) the research of this dissertation will be valid research, should the research measure exactly what was intended to be measured.

2.8 Research sample

The study of taxing illegal income and expenditure is a broad field across the world. Globally every country will be challenged with the concept of taxing illegal earnings at some point in time.

Due to the sample constraints of this study the researcher, in a process of elimination, first identified countries that runs on a similar tax system as SA e.g. where tax residents are taxed on their world–wide income and non-residents are taxed on a source basis. From the list of countries identified, the researcher was intrigued by the tax system in AU for a number of reasons: firstly – the first income tax legislation in South Africa had its origins in the New South Wales Act of 1895 (Haupt, 2015:5) and therefore provides a good basis for comparing legislation pertaining to a specific type of transaction. Further, the revenue bodies of both countries operate similarly and strategies or projects for combatting tax avoidance or evasion used by one country could be adopted by the other country. The revenue bodies of SA and AU are similar in the following aspects: both operate as semi-autonomous bodies and administer similar major tax types. Both revenue authorities also have a similar internal organisational structures (Forum on Tax Administration, 2010). AU was thus selected as the sample country for purposes of the comparison, as such the scope of this dissertation is limited to a SA and AU perspective, even though the study can be extended to all countries world-wide.

2.9 Brief chapter overview

The present chapter documented the research design that was applied in order to achieve the research objectives for the study. In the next chapter, an exposition of the tax treatment of illegal income and expenditure in SA is presented.

CHAPTER 3

3. TAX TREATMENT OF ILLEGAL INCOME AND EXPENDITURE IN SA

3.1 Introduction

In order to analyse the taxability of illegal income as well as the deductibility of expenditure incurred in the production of income, we first need to determine when income will constitute taxable income, in terms of the gross income definition, as defined in section 1 of the Act.

In a process to verify income that was declared and income that was omitted from taxpayers' annual tax return declarations, with the use of technology, SARS has implemented various tools to assist them in collating data on taxpayers' affairs. Some of these methods include: Double Taxation agreements; Tax Information Sharing Agreement and access to 3rd party information etc.

The next section will provide an overview of taxable income and the deductibility of expenditure incurred in the production of income. Thereafter, the taxability of illegal income and the deductibility of expenditure incurred in the production of illegal earrings will be discussed with reference to the Act, SARS Interpretation notes and case law pertaining to this topic. Lastly, the various methods available to SARS to identify illegal income that has been omitted from income tax returns will be discussed.

3.2 What constitutes a taxable amount?

Gross income is defined in section 1 of the Act as follows: "Gross Income, in relation to any year of assessment, means:

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of a resident;

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts of a capital nature.

Haupt (2015: 18) clarifies that in order for income to be classified as gross income, all of the above criteria, as defined in the gross income definition, must be present.

It should be noted that the terms used in the gross income definition, such as *received by*; *accrued;* and *in favour of* a person are not defined in the Act and reference is, therefore made

to case law for guidance on the definition and meaning of the words, as reconfirmed by Classen (2007: 55).

For the purpose of this study the next section highlights case law dealing with the above terms and is not by any means a full comprehensive summary of all court cases dealing with this topic.

3.2.1 Total amount

The words *total amount* have not been defined in the Act. For purposes of this dissertation the below court cases were used as reference points in order to obtain guidance on the meaning of the term *total amount*.

In Lategan v CIR, 2 SATC 16, Watermeyer J states:

> The word amount must be given a wider meaning and must include not only money, but the value of every form of property, whether corporeal or incorporeal which has a money value.

In summary, the court had to determine what would constitute an *amount*. It was agreed that the word *amount* must not be given a literal definition to only mean a monetary amount of money, but also includes any form of property that has a monetary value.

In the Commissioner for Inland Revenue ("CIR") v People Stores (Walvis Bay) (Pty) Ltd, 52 SATC 9, the court accepted the above statement from the Lategan case and it was confirmed that in the event that the income received is in a form other than money, it will only be regarded as income in the event that a money value can be attached to it or in the event that it can be turned into money.

In CIR vs Butcher Brothers (Pty) Ltd, 13 SATC 21, it was upheld by the court that although the amount might be difficult to quantify, it does not automatically mean that no amount exists. The court held that the onus is on the Commissioner to establish the amount.

From the above, it can be deduced that a wider definition has to be applied when determining whether an amount was received by or accrued to a taxpayer. When applying the above principle to illegal income, it is evident that any form of property e.g. drugs, illegal tobacco products, or smuggled goods received by a taxpayer constitute an amount received as it can be turned into money and a monetary value can be attached to the property.

3.2.2 In cash or otherwise

The words *in cash or otherwise* have not been defined in the Act. For purposes of this dissertation the below court cases were used as reference points in order to obtain guidance on the meaning of the term *cash or otherwise*.

In CSARS v Brumeria Renaissance, 69 SATC 205, it was confirmed that a right to an interest free loan constitutes an amount. This is due to the fact that no interest was payable by the taxpayer on the loan. The court held that this right had a monetary value, due to the fact that the loan was not immediately repayable. Based on the above the court held that the amount will accrue to the taxpayer for purposes of calculating his/her taxable income.

In Lace Property Mines Ltd v CIR, 9 SATC 349, it was upheld that should a taxpayer receive an amount in a form other than money, the value of the amount that has to be included in the taxpayer's gross income will be the market value of the right, on the date that the taxpayer becomes entitled to the right.

According to Haupt (2015: 19) the amount just needs an ascertainable monetary value. Once it has an ascertainable monetary value, it will fall into gross income.

When applying the above principles to illegal income, it is clear that should a taxpayer receive an amount in a form other than money e.g. a drug smuggler receiving free stock in the form of drugs, for rendering services as a drug dealer, the drugs/stock received will still constitute an amount received as it can be turned into money and a monetary value can be attached to the trading stock.

3.2.3 Received by or accrued to

The words *received by or accrued to* have not been defined in the Act. These terms have been subjected to judicial interpretation through various case law. For purposes of this dissertation the below court cases were used as reference points in order to obtain guidance on the meaning of the term *received by or accrued to.*

In CIR V Delfos, 6 SATC 92, it was established that an amount will be included in a taxpayer's gross income on the earlier of receipt of the amount or the accrual of the amount.

In Geldenhuys v CIR, 14 SATC 419, it was held that an amount will only be regarded as received should the taxpayer receive the amount for his/her own benefit and on his/her own behalf.

Should a taxpayer receive an amount that has not yet accrued to him/her, the amount will still form part of the taxpayer's gross income. This was confirmed in Ochberg v CIR, 5 SATC 39, as well as CIRr V People Stores (Walvis Bay), 52 SATC 9. In both cases the court upheld their view that the timing of a receipt does not delay the accrual. On these grounds, *accrue* means that one becomes unconditionally entitled to a payment.

From the above it is clear that the concept of *received* by *or accrued to* was established as a timing rule. This assists taxpayers to correctly identify the correct tax year in which the amount has to be declared.

In order to identify the correct tax year of the receipt or accrual, the taxpayer has to identify the point in time when he/she became unconditionally entitled to the amount (Classen, 2007: 536; Haupt, 2015: 20).

For this reason, a stolen amount of money can never accrue to a thief. This is due to the fact that the thief will never become unconditionally entitled to the stolen money. Olivier (2008: 1) is of the opinion that an amount of stolen money can only be taxed on a receipt basis.

In addition to the above, it should be noted that an amount of money would not constitute a receipt, in the event that the taxpayer is legally obligated to pay the amount over to a third party. This principle was confirmed in CIR v Genn and Co Pty Ltd, 20 SATC 113. According to Classen (2007: 535) this is due to the fact that the amount was not received by the taxpayer for his/her own benefit or own behalf.

Based on the above, it is clear that the taxability of illegal income generated by taxpayers will have to be evaluated on a case-by-case basis. This is due to the fact that various forms exist in which taxpayers can generate illegal income. Examples include: once off thefts, illegal pyramids schemes, illegal tobacco trading; drug trading etc. Once the facts have been established one would have to apply the various principles established in the gross income definition contained in section 1 of the Act, in order to determine whether the total amount of illegal income, whether received in cash or otherwise, was received by or accrued to or in favour of the taxpayer, and that the amount is not of a capital nature.

3.2.4 Capital in nature

The words *not capital in nature* have not been defined in the Act and the Act does not provide any guidance on when an amount will be regarded as capital in nature. However, the term has been subjected to judicial interpretation through various case law. For purposes of this dissertation the below court cases were used as reference points in order to obtain guidance on the meaning of the term *not capital in nature*.

In Pyott v CIR, 13 SATC 121, the court supported the principle that there is no halfway house. This means that an amount cannot be classified as partially income and partially capital; therefore, the amount will either be classified as income or capital.

In CIR v Stott, 3 SATC 253, it was made clear by the court that the first step in determining whether the amount is capital or income in nature is to analyse the taxpayer's Ipse Dixit, e.g. what was the taxpayer's true intention when the taxpayer acquired the asset.

Haupt (2015: 45) advises that once intention has been established, the next step would be to determine whether the taxpayer acquired the asset for profit-making purposes or investment purposes.

For purposes of this study, reference can be made to the leading case of CIR v Pick-n-Pay Employee Share Purchase Trust, 54 SATC 271, where the court had to determine whether the intentions of the taxpayer were to carry on a scheme of profit making. The outcome of the case identified the following factors/principles that apply when determining whether an amount will be revenue or capital in nature:

- Firstly, determine whether the taxpayer conducted a business; and
- Secondly, determine whether it was the intention of the taxpayer to conduct a business.

Olivier (2012: 173) and Haupt (2015: 45) are both of the opinion that a receipt will be regarded as revenue in nature should the gain derived by the taxpayer be as a result of the operation of a business or a scheme for profit making.

According to Olivier (2012: 172) it is very important to classify an amount correctly as income or capital. This is owing to the fact that income that is of a capital nature will not be included in the taxpayer's gross income and accordingly, capital expenditure will also not be deductible in terms of section 11(a).

The above principles form the stepping stones to determine whether income, or in this study illegal income, form part of taxpayers' taxable earnings and whether expenditure incurred in the production of income will qualify for deduction in terms of section 11(a).

From the above, it is clear that should a taxpayer conduct an illegal business e.g. drug smugglers/syndicate, illegal tobacco business operations or an illegal pyramid scheme etc. any amount received with the intention of making a profit or whilst conducting a business will be regarded as revenue and not capital in nature, and will be included in the taxpayer's taxable income.

3.2.4.1 Fortuitous gains

Based on the above a question arises whether a once off scheming/fortuitous stolen amount would be capital in nature? According to the draft Interpretation Note, issued by SARS, one would have to evaluate the facts and circumstances of each case in order to establish whether the gain would be capital or revenue in nature. SARS advises that fortuitous gains will be revenue in nature in the event that the taxpayer conducted an income-producing operation (SARS, 2013a: 13).

The principles established in the CIR v Pick 'n Pay Employee Share Purchase Trust, 54 SATC 271, confirm that receipts or accruals from an income-producing operation will be revenue in nature, and therefore taxable, in the event that the taxpayer is carrying on a business or a business operation.

SARS issued Interpretation Note 80, on 5 November 2014, which emphasises that a scheme that is thought of before the theft occurs is not the same as an incidental theft, as it requires planning and execution. Based on this it is unlikely that income derived from a theft, as a result of a scheme, will be capital in nature (SARS, 2014b: 13).

It is submitted by Visser (2015: 1) that the same principles will also apply to any earnings from illegal online gambling as a taxpayer who wins an amount once-off, would not be taxed on the profits since the amount would be regarded as capital in nature. On the other hand, the taxpayer will definitely be taxed on his/her illegal earnings should he/she run a business of providing illegal online gambling services to clients or in the event that the taxpayer is a professional gambler who gambles for the purpose of generating income.

3.2.4.2 Change in intention

There are various factors that have to be considered in order to establish whether an amount is income or capital in nature. In as much as a taxpayer's intention can change during the period that an asset is held. Haupt (2015: 45) stresses the importance of re-evaluating a taxpayer's intention at the sale of an asset.

It is important to note that every taxpayer is entitled to sell his/her assets for the highest profit obtainable. It was established in CIR v Stott, 3 SATC 253, that the sale of an asset for a significant profit does not necessarily mean that the taxpayer changed his/her intention.

For this reason, it is important to evaluate the taxpayer's true intention on the date of acquisition and the date of disposal. This assists in identifying whether the asset remained an investment asset or whether it has changed to an income-producing asset.

The principle of crossing the Rubicon was established in the case of Natal Estates Ltd v SIR, 37 SATC 193 Holmes JA states that:

> From the totality of the facts one has to enquire whether it can be said that the owner had crossed the Rubicon and gone over to a business, or embarked upon a scheme of selling such land for profit, using the land as his stock-in trade.

The principles as set out above, are supported by the case of John Bell and Co (Pty) Ltd v SIR, 38 SATC 87, where Wessel JA states that:

> …the mere change of intention to dispose of an asset hitherto held as a capital does not per se subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and to render its proceeds gross income. For example, the taxpayer must already be trading in the same or similar kinds of asset and he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is used as his trade-in-stock.

In applying the above principles to the taxation of illegal income, we can refer to the example of a taxpayer smuggling illegal goods (e.g. drugs) into SA. If it is the taxpayer's intention to keep the goods for his/her private use, the goods will not attract personal income tax. However, in the event that the taxpayer acquired the goods with the view of conducting a business and with the intention of making a profit from the sale of the goods, the goods will be reclassified as income-producing goods/trading stock and the illegal generated from the sale of the goods will have to be declared as taxable earnings.

In the next section, the concept of taxing illegal receipts will be discussed in more detail with reference to the Act and the interpretation notes issued by SARS.

3.3 Taxing illegal receipts

3.3.1 Extracts from the Income Tax Act and SARS Interpretation Notes

There is no specific provision in the Act addressing the tax treatment of illegal income and the deductibility expenditure incurred to produce illegal income in SA. Consequently illegal income is not defined in the Act and the ordinary meaning of the word will apply:

- *Income* is defined in section 1 of the Act as follows: "the amount remaining of gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax…" ; and
- *Illegal* is not defined in the Act. According to the online Oxford Dictionary *illegal* means: "contrary to or forbidden by law" (Oxforddictionaries.com, 2013).

On 3 April 2013, SARS (2013a: 1) released a draft interpretation note on the deductibility of expenditure and losses arising from theft of money. The draft note, although not binding, provides the public with guidance regarding the taxation of stolen money and highlights the following: "a thief will be taxed on embezzled or stolen money if it falls within the thief's gross income".

The draft interpretation note suggests that SARS will apply the principles laid down in the gross income definition, as contained in section 1 of the Act. Should a taxpayer receive illegal income and the amount received constitutes gross income, the amount will be included in the taxpayer's taxable income and taxed in the taxpayer's hands accordingly.

In addition to the above, SARS (2014b: 1) issued Interpretation note 80 on 5 November 2014. The interpretation note defines the following key terms:

- Embezzlement: the misappropriation of funds entrusted to a person for care or management;
- Fraud: the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another;
- Stolen money: money obtained from embezzlement, fraud or theft; and
- Theft: the act or crime of stealing money.

3.3.2 Taxability of illegal income – application of legal principles

Based on the research cited in section 3.2 above, an amount of income will fall into the thief's taxable income should it constitute a receipt or an accrual that he/she has received for this/her own benefit and own behalf, provided that the amount is not capital in nature.

When applying the gross income definition, as contained in section 1 of the Act, it is clear that illegal income derived from participating in *fraudulent activities* will constitute a receipt in terms of the gross income definition and will therefore be regarded as taxable income in the taxpayer's hands.

A grey area exists when analysing whether *stolen amounts* of money constitute taxable income. In the scenario of stolen amounts of money, it is clear that there is no transaction between the thief and the victim.

According to Interpretation note 80, SARS (2014b: 1) is of the view that a receipt will include *stolen money* and will be taxed in the thief's hands accordingly. SARS relied on the case of MP Finance Group CC (in Liquidation) v SARS, 69 SATC 141, where the deposits were viewed as a receipt on behalf of the taxpayer even though, in law, the taxpayer had to refund the deposits to the investors.

Olivier (2008: 814) postulates that an amount of *stolen money* can never *accrue* to a thief due to the fact that the thief will never become unconditionally entitled to an amount of stolen money. Therefore, a thief can only be taxed on a *receipt* basis.

In addition to the above it is also important to establish whether the thief has an obligation to repay the amount of money or whether he/she has an obligation to pay it to a third party as the amount of stolen money will be regarded only as taxable income in the event that it was received by the thief for his/her own benefit and own behalf, as established in Geldenhuys v CIR, 14 SATC 419.

Prior to the findings of the MP Finance Group CC (in Liquidation) case, this precedent on how to treat *stolen money* were the facts as established in the Commissioner of Taxes v G, 4 SA 167, where the court held that the ordinary meaning of the term *received* should be applied. After analysing the ordinary meaning of what constitutes a *receipt*, the court held that *stolen money* could never constitute a *receipt* because *stolen money* can never be regarded as the thief's property.

Subsequent to the above, *stolen money* was perceived as a unilateral taking by the thief and the money did not form part of the thief's taxable earnings. The court advised that it is important to analyse the intention of the thief as well as the intention of the person from whom the money was taken in order to determine whether there was a *receipt*.

The breakthrough case in taxing illegal income and receipts was decided in the Supreme Court, in MP Finance Group CC (in Liquidation) v SARS, 69 SATC 141. The court had to decide whether deposits from an illegal pyramid scheme would constitute an amount 'received' in terms of the gross income definition of the Act. The taxpayer argued that the deposit was not 'received' by her, as she was legally obligated to repay the deposits to the investors. The court established that 'an illegal contract is not without all legal consequences, it can indeed have fiscal consequences'. The true question was to determine whether the illegal income from the deposits fell under the literal meaning of gross income as defined in the Act. The court held that the amount did in fact fall within the taxpayer's gross income, due to the fact that the operators of the scheme accepted the money with the intention to keep it for their own benefit and own behalf. The money is therefore considered as being *received* even though in law, it was repayable.

Haupt (2015: 21) disagrees with the grounds SARS cites in the interpretation note. He advises that the MP Finance case had two transactions: one giving and one receiving. In the case of theft no transactions takes place. He is of the view that the MP Finance case is not sufficient support that a one-sided theft will constitute a receipt in terms of the gross income definition contained in section 1 of the Act.

According to Cliffe Dekker Hoffmeyer (2015: 1) the interpretation note confirms that *stolen money* will form part of the thief's taxable earnings in the year of receipt and the thief will not be able to deduct any expenditure incurred as the theft, even in situations where the theft has elements of trade such as intention to make a profit; repeat activities; planning and organizing etc. does not constitute a trade.

Cliffe Dekker Hoffmeyer (2015: 1) is of the opinion that theft lacks the commercial elements of trade, due to the fact that stolen money is not obtained in return for services rendered or goods sold. Accordingly embezzlement, fraud or theft does not constitute a trade.

Haupt (2015: 22) further states that should a taxpayer receive money on behalf of a third party and the taxpayer does not honestly pay the money over to the third party, the amount will be included in the dishonest taxpayer's taxable income.

Vanek (2008: 1) is in agreement with the point of view taken by SARS: 'If you derive illegal income from prostitution, selling pirated software to your friends, stealing or borrowing money without the intention of returning it you will need to state this in your tax return as it is taxable'.

For additional background on the taxation of illegal income reference can be made to the following cases:

In ITC 1624, 59 SATC 373, it was confirmed that should a taxpayer receive money from fraudulent activities, and it is the taxpayer's intention to receive the money for the purpose of carrying on a trade, the illegal income generated by the taxpayer will be regarded as taxable income, even if the taxpayer refunds the victim at any point in the future. The court also confirmed that the taxpayer will not be allowed to claim a section 11(a) deduction, should a liability to repay the amounts arise.

According to Classen (2007: 540) and Oliver (2008: 1) this is because the amounts will not constitute expenditure or losses incurred in the production of income.

In ITC 1789, 67 SATC 205, it is claimed that amounts that were taken illegally by the operators of a pyramid scheme were included in the taxpayers gross income. The court based its decision on the fact that there was a scheme of profitmaking; an in-depth infrastructure; and the taxpayer had the intention of benefiting and did benefit from the scheme of stealing money from the investors. The court held that the amounts were received within the definition of gross income and therefore would be regarded as taxable even though the transaction was illegal and the taxpayer would be dispossessed of the benefits once he/she repaid the investors.

In ITC 1792, 67 SATC 236, reference is made to a taxpayer who acted as an agent, buying and selling shares on behalf of his principal. The taxpayer became aware of shares that the principal wanted to buy and bought the shares, which he later on sold to his principal for a profit. In this case the illegal profits from this scheme of arrangements were found to be taxable in the hands of the principal. The court incorrectly examined the legal relationship between the agent and the principal and concluded that based on agency law, the agent was not allowed to make secret profits and therefore the profits belonged to the principal. This case was overturned in the case

of MP Finance Group CC where it was held that the court should have looked into the legal relationship between the agent and the fiscus.

A further reference can also be made to the case of CIR v Delegoa Bay Cigarette Co Ltd, 32 SATC 47, where the taxpayer ran an illegal lottery. It was established that income derived from trade is subject to tax in SA, regardless of whether the income is tainted with illegality.

3.3.2.1 Conclusion on the application of legal principles

There are mixed perceptions held by SARS and tax professionals, which will be set out below.

According to Interpretation Note 33, SARS (2014b: 1) is of the view that a receipt will include stolen money and will be taxed in the thief's hands accordingly.

Olivier (2008: 818) is of the opinion that the outcome of the MP finance case is not a one size fits all solution to taxing illegal income and therefore, is not the authority on classifying all illegal income to always be taxable. She further advises that the facts and circumstances of each case have to be to be reviewed in order to establish whether an unconditional obligation exists to repay the money at the point in time that the thief receives the money.

Haupt (2015: 21) opines that the MP Finance case is not sufficient support that a one-sided theft will constitute a receipt in terms of the gross income definition contained in section 1 of the Act.

3.3.3 Involuntary receipt of illegal earnings

The question arises whether a person will be liable for tax in the event that stolen money is deposited into his/her account involuntarily and without him/her having any knowledge of or involvement in the theft.

This can be answered by considering the case of CIR v Genn & Co (Pty) Ltd, 20 SATC 113, where it was confirmed that holding physical control over money, on behalf of someone, does not constitute a receipt.

The above principle was confirmed in Geldenhuys v CIR, 14 SATC 419, where *received by* was interpreted to mean: 'received by the taxpayer on his own behalf and for his own benefit'.

Based on the above literature, it is submitted that the amount does not accrue to the taxpayer as there was no transaction between the thief, the victim or the taxpayer who received the

amount in his/her bank account. However, the taxpayer is morally obligated to report the amount to his/her bank in order for the bank to investigate and to try and reverse/reallocate the amount.

In the event that the money cannot be reallocated to the correct taxpayer and the money is utilised by the taxpayer, the taxpayer could possibly argue that the amount was a fortuitous gain for tax purposes and therefore, capital in nature.

3.4 SARS's ability and tools to trace illegal income

From the above literature, it is submitted that illegal income would be subject to tax if it meets the requirements of the gross income definition. According to Classen (2007: 536) SARS, in most cases, is unaware of the illegal activities that taxpayers conduct on a day to day basis and the illegal income generated from their activities. For this reason, SARS will, in some instances, be able to identify and assess whether the illegal income should be taxed, only after the thief has been caught.

It is understandable that taxpayers who earn their income from illegal activities, will try to avoid paying tax as far as possible. It is also highly unlikely that they would declare their illegal earnings on their annual tax return submissions to SARS, as they want to avoid self-incrimination and subsequent prosecution.

According to Interpretation note 80 issued by SARS, all one's taxable earnings should be declared in one's annual tax return submission, regardless of the legality of the income. It should be noted that failure to declare all one's earnings can lead to penalties being levied by SARS for the omission of income and might introduce a recurring loop for tax evasion (SARS, 2014b:1).

Classen (2007: 536) reiterates the importance of declaring all one's earnings to SARS and reminds taxpayers that should SARS identify that a taxpayer received undeclared taxable earnings, SARS will issue additional assessments retrospectively for the affected tax years, in order to collect the taxes due to SARS.

In a process to identify income that was omitted in annual tax returns SARS has implemented tools to assist them in collating data from third parties. Some of these tools will be discussed below.

3.4.1 Access to bank accounts

Government Gazette nr 35090 ("The Gazette"), published on 29 February 2012, gives SARS access to all taxpayers' bank account information in terms of section 69 of the Act (Government Gazette, 2012: 3).

In terms of the Gazette notice (2012: 3) all reporting institutions are required to submit bi-annual returns for individuals, companies and trusts to SARS in respect of: any money invested with the reporting institution; any money loaned to the reporting institution; any money deposited with the reporting institution; and any interest the taxpayer received from the reporting institution.

The Gazette (2012: 3) confirms that the following reporting institutions are subject to this notice: banks; financial institutions; companies listed on the JSE and connected persons in relation to the companies that issue bonds; debentures or similar financial instruments; state-owned companies that issue bonds; and organs of state that issue bonds or similar financial instruments.

According to Seccombe (2012: 1) this will assist SARS in identifying people who should be registered for Income Tax and Value Added Tax ("VAT"). In addition to the above, it will also assist SARS to identify any non-disclosure of local and foreign receipts and accruals.

3.4.2 Third party data collection

In terms of section 26 of the Tax Administration Act No.28 of 2011 ("TAA") and Government Gazette nr 36346, issued on 5 April 2013 (Government Gazette, 2013), the following people are required to submit third party data returns to SARS on a bi-annual basis: banks; financial institutions; companies listed on the JSE; state-owned companies; organs of state; any person who purchases any livestock, produce, timber, ore, mineral or precious stones from a primary producer other than on a retail basis; any medical scheme; and any person who practices for his/her own account as an estate agent or attorney.

According to SARS (2013b: 1) the third parties listed above are required to submit the following data types on a bi-annual basis to SARS: withholding tax on interest; Automatic Exchange of Information (AEOI), IT3(b), IT3(c), IT3(e), IT3(s); medical scheme contributions; insurance payments; dividends tax and VAT-supporting data.

From the tools listed above it is evident that SARS's aim is to expand its network of obtaining data by sourcing data from external parties. The above tools allow SARS to verify income declared in annual tax returns against the third party data. The data also assist SARS to identify income that has been omitted from annual tax returns, thus assisting SARS in closing the loop of tax evasion.

3.4.3 Double Taxation Agreements

SA has signed numerous Double Taxation Agreements ("DTA") with various countries, including AU (SARS, 2015: 1).

The DTA between SA and AU includes an article for the exchange of information. This is encapsulated in Article 25 of the said DTA and reads as follows: "The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic law of the Contracting States concerning taxes to which the Agreement applies insofar as the taxation under that law is not contrary to the Agreement" (SARS, 1999: 23).

For a real life example of how Article 25 is applied, reference can be made to the unreported case of the Commissioner for the South African Revenue Service v Werner van Kets, ZAWCHC 435, where the courts had to decide on the exchange of information article in terms of the DTA between SA and AU. The facts of the case were as follows:

- The ATO requested information from SARS, in terms of Article 25 of the DTA. The information requested related to Mr DP Saville, who resided in SA. The taxpayer had possible offshore wealth and was involved in a Malaysian entity which transferred about 62 Million Australian dollar into AU.
- SARS relied on sections 74A and 74B of the Act and requested a third party, Mr van Kets, to provide SARS with the information he had in his possession in respect of Mr DP Saville.

- Mr Van Kets refused to provide SARS with the requested information, and argued that the above sections made reference to "any taxpayer" who is liable for SA income tax or who is required to submit a return relating to SA income tax. Mr Van Kets argued that Mr Saville was not a "taxpayer" and therefore SARS could not invoke the abovementioned sections upon him to force him to provide SARS with the information that he had access to in respect of Mr Saville.
- SARS argued that they had the power to invoke section 74A & section 74B of the Act in order to obtain the information requested by the ATO, by virtue of the fact that SARS was obligated to provide the information to the ATO in terms of the DTA SA has with AU.
- The court held that SARS was entitled to invoke these sections of the Act. Therefore, SARS could insist that Mr van Kets, as well as any other person in SA who held such information, furnish SARS with the information requested in order to comply with its obligations under the SA/AU DTA or in terms of any exchange of information treaty.
- In addition to the above the court also clarified that: "a taxpayer, as contained in sections 74A and 74B of the Act, must be interpreted to be consistent with SA's obligations under any DTA for the provision of information or any treaty concluded for the exchange of information".
- Mr Van Kets was ordered by the court to provide the information relating to Mr Saville to SARS for onward submission to the ATO.

In summary, DTA agreements contain various articles that assist SARS and taxpayers with various tax subjects. For purposes of this study, the main focus is on article 25, dealing with the exchange of information. It is important to note that both countries can call upon the sharing of information article contained in the DTA in the event that they suspect a taxpayer is dealing in illegal business operations. This assists governments in collating intelligence on taxpayers' affairs and can be used to identify transgressors.

Although all the tools discussed above are being implemented by SARS, there are still instances where SARS will not be able to trace income generated from illegal activities in the tax year that the income should have been declared, in the taxpayer's annual tax returns. This having been stated, SARS can still review a taxpayers' annual tax return or launch a full audit at any point in time, if they suspect anything untoward. Once undeclared illegal income is identified,

SARS can issue tax assessments to the taxpayer for the tax years effected retrospectively in order to collect the tax due to SARS.

In the next section the deductibility of expenditure in SA for income tax purposes, will be discussed.

3.5 Deductibility of expenditure

3.5.1 The general deduction formula

Section 11(a) of the Act allows for a general deduction of expenditure and reads as follows:

> For the purposes of determining the taxable income derived by any person from carrying on a trade, there shall be allowed as deductions from the income of such person so derived:
>
> (a) expenditure and losses actually incurred in the production of income, provided the expenditure and losses are not of a capital nature.

Section 23 should be read with section 11(a) of the Act as it negatively provides for amounts that are not deductible and reads as follows:

> Deductions not allowed in determination of taxable income – No deduction shall in any case be made in respect of the following matters:
>
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.

The general deduction formula is best set out in Port Elizabeth Electric Tramway Ltd v Cir, 8 SATC 13. According to SAICA (1999: 1) the general deduction compromises of two main sections: section 11(a) which details what can be deducted and section 23(g) which details what cannot be deduced.

Haupt (2015: 113) advises that both sections must be complied with before an amount can be allowed as a deduction.

Next, it is evident that it is necessary to provide clarity on what exactly constitutes *trade*.

3.5.2 What constitutes a trade?

Trade is defined in section 1 of the Act and Haupt (2015: 115) has summarised it as follows:

> Trade includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of, or grant of permission to use any patent, or any design, or any trademark, or copyright, or any other property of a similar nature.

The term *trade* has been analysed in detail in Burgess v CIR, 55 SATC 185, where the following key principles were established: should a taxpayer carry on in a way, which on its own would be seen as carrying on a trade, his/her intention in carrying on with the trade will be irrelevant, even if it were to obtain a tax benefit.

In addition to the above, SARS issued Interpretation note 33, on 4 July 2005, in which SARS (2014a: 1) expressed its view on what will constitute trade and what will constitute income from trade. The note highlights the following important factors relating to trade:

- Something more is required than just the intention to carry on a trade. The taxpayer must have actually carried on a trade during the year of assessment, as established in SA Bazaars (Pty) Ltd v CIR, 18 SATC 240.
- In order to prove that a taxpayer is practising a trade, it should be established whether the taxpayer took active steps to prove that he/she was actually carrying on a trade. This 'step' involves something more than just watching over one's existing investments as confirmed in ITC 1476, 52 SATC 141. Based on this, something more is required then just laying out one's plans to trade.
- Non-trading income such as income from interest and dividends will never constitute a trade. In ITC 1275, 40 SATC 197, it was held that merely watching over investments does not constitute a trade; and
- Amounts disguised as trading income, such as commission from a single transaction, will not constitute a trade. This principle was established in SARS v Contour Engineering (Pty) Ltd, 61 SATC 447, where it was held that a taxpayer will struggle to prove that commission from a single transaction constitutes a trade (SARS, 2014a: 1).

In order to determine whether an illegal operation will constitute a trade, SAICA (2010:3) refers to an old case that was brought before the English court of appeal, which will be discussed below:

In the case of Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd, Griffiths, 058 ITR 0328 (PC), the court had to determine whether criminals would be taxed on illegal earnings they had derived from *carrying on a trade*. Lord Denning was of the following opinion:

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

Lord Denning further advises that the consequences a taxpayer has to face for the crimes committed and the illegal income generated, should be dealt with under a country's criminal law system and that the fiscus should not allow itself to be caught up in this process by taxing illegal proceeds generated by taxpayers.

Unfortunately, the SA courts have not yet dealt with such a case and the only guidance is interpretation note 54, issued by SARS on 26 February 2010. According to the Interpretation Note (SARS, 2010), unlawful activities negatively affect SA's democratic processes, good governance, sustainable development and fair business practices. For this reason the Prevention and Combating of Corrupt Activities Act, No. 12 of 2004 (the PCCA Act) exists with its main purpose being to strengthen measures of preventing and combatting corruption and corrupt activities in SA.

In applying the guidance provided by SARS in the Interpretation Note, an illegal business operation will constitute trade in the event that there is sufficient evidence that:

- The taxpayer carried on business operations in such a way that it would constitute a trade, regardless of whether the taxpayer's intentions were to carry on legal or illegal business operations.
- It was the taxpayer's intention to carry on an illegal trade and the taxpayer actually carried on a trade during the course of the tax year.

- There is sufficient evidence to prove that the illegal income generated was not from a single transaction.
- The taxpayer did not just preside over his/her illegal operations but took active steps to prove that he was conducting a trade (SARS, 2010: 1).

3.5.3 Deductibility of illegal expenditure

This gives rise to a new question: should taxpayers who derive illegal income be entitled to claim their expenditure e.g. bribes; fines; penalties and stock purchases etc. as deductions against their taxable illegal earnings, if the expenditure was incurred in the production of their illegal/tainted income?

To counter the deductibility of illegal expenditure SARS issued Interpretation note 54, on 26 February 2010, that should be read with section 23(o) of the Act, which prohibits the deduction of expenditure in a situation where the activity is illegal.

Section 23(o) of the Act reads as follows:

> Deductions not allowed in determining taxable income – No deduction shall in any case be made in respect of the following matters namely – any expenditure incurred:
>
> (i) where the payment of the expenditure or the agreement or offer to make the payment constitutes an activity contemplated in chapter 2 of the Prevention and Combating of Corruption Activities Act, 2004 (act No.12 of 2004); or
>
> (ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the republic or in any other country if that activity would be unlawful had it been carried out in the Republic.

SAICA (2010: 3) provides the following criticism against SARS's interpretation note 54 as well as the judgement of the MP finance case. Unfortunately, both have remained silent on the following key aspects of taxing illegal earnings:

- No clear indication is given whether income derived from illegal activities has the same characteristics as "income" as defined in the Act. However, it is submitted from the judgement in the MP Finance case, that the entities made their money by acting deceitfully and the money generated was, therefore, their income.

- SARS did not address the moral and ethical aspect of taxing illegal receipts. This is a potential ethical dilemma, as the question arises whether SARS is complicit to fraud when illegal earnings that are generated by tax payers are being taxed by SARS.
- No consideration is given to the constitutional values that form the foundation of SA's legal systems and whether taxing illegal proceeds are unconstitutional.
- The judgement in the MP Finance case lead to SARS, by virtue of their legislative preferential claim, to be the first in line in claiming its portion of taxes from the insufficient funds that remained from the taxpayer's pyramid scheme dealings. Consequently, the majority of the funds was deleted and almost no funds were left to reimburse the victims who invested in the pyramid scheme.

SAICA (2010: 3) concludes its argument by posing the following statement:

> Given the public concern about the prevalence of crime and corruption in South Africa, it is unfortunate that the Supreme Court of Appeal confined its decision to the particular facts of the case, and did not give the country the benefit of its view on the larger question of the taxability of the proceeds of crime. It is believed that SARS takes the view that the proceeds derived from (for example) illicit sales of liquor and from drug-dealing are taxable. There is nothing in the Supreme Court of Appeal's judgment in MP Finance to suggest that the court would regard this practice as not sanctioned by the tax laws.

3.6 Brief chapter overview

This chapter documented the tax treatment of legal and illegal income in SA, the deductibility of expenditure incurred in the production of legal and illegal income in terms of the Act, interpretation notes and leading case law on this topic. In addition to the above the methods available to SARS in order to track and trace illegal income were also analysed, in order to achieve the research objectives for the present study.

From the review it appears that SA will tax illegal earnings generated by taxpayers, should the illegal income generated meet the requirements of taxable income. Furthermore, expenditure incurred in the production of illegal income is not deductible for tax purposes in SA.

With regards to SARS's ability and tools to trace illegal income in SA, it has been established that SA has implemented various data collection techniques in order to identify illegal income that has been omitted in taxpayers' annual tax returns. Unfortunately, there are still cases where

tax authorities will only become aware of illegal income that has been generated once taxpayers are caught.

SA can definitely look into additional measures to identify illegal income and to make SA less attractive for international tax fraud and tax evasion..

This being said, SARS can review a taxpayer's annual tax return or launch a full audit, at any point in time, in the event that it suspects anything untoward. Once undeclared illegal income is identified, SARS can issue tax assessments to the taxpayer for the tax years affected, retrospectively, in order to collect the tax due to SARS.

In chapter 4, the focus will be on the taxability of illegal income and expenditure in terms of AU's income tax legislation.

CHAPTER 4

4. TAX TREATMENT OF ILLEGAL INCOME AND EXPENDITURE IN AUSTRALIA

4.1 Introduction

Some taxpayers engage in illegal activities in order to obtain tax benefits or to avoid paying taxes. According to the ATO (2013a: 1), the most common tax crimes in AU relate to: identity crime; secret offshore dealings; credit and refund fraud; and illicit tobacco growing and trading.

In order to analyse the taxability of illegal income as well as the deductibility of expenditure incurred in the production of income, one first has to determine whether the income constitutes taxable income in terms of the section 4-15(1) of the Assessment Act.

The next section will provide an overview of when an amount constitutes taxable income as well as an overview of when expenditure incurred qualifies for deduction. Thereafter, the concept of illegal income, the taxability of such amounts and the deductibility of expenditure incurred in the production of illegal earrings will be discussed with reference to the Assessment Act, tax rulings and case law in terms of AU case law. A brief discussion of the ATO's ability and tools to detect illegal income will also be presented.

4.2 What constitutes a taxable amount?

In terms of section 4-15(1) of the Assessment Act, taxable income is calculated as one's assessed income less deductions.

Assessable Income is in turn defined in section 6-5 of the Assessment Act as follows:

(1) Assessable income includes income according to ordinary concepts, which is called ordinary income.
(2) If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year.
(3) If you are a foreign resident, your assessable income includes:
    (a) the ordinary income you derived directly or indirectly from all Australian sources during the income year; and
    (b) other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source.

(4) In working out whether you have derived an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct.

According to section 6-10 of the Assessment Act, one's assessable income also includes any statutory income.

Thus it is evident that resident taxpayers are taxed on assessable income from all sources, whilst non-residents are taxed on assessable income that is of an AU source.

The definition of taxable income is relatively broad, as no reference is made to the legality or illegality of the income. It would appear that the authorities are simply concerned about whether the income will fall into the AU tax net.

Tax is payable on one's taxable income, which is defined as accessible income in accordance with the Assessment Act. This includes any ordinary income. Black (2005: 439) is of the opinion that taxable income must be determined by applying the ordinary concepts, unless the statutes state that income should specifically be included or excluded as taxable income.

4.2.1 Ordinary income

The words *ordinary income* have not been defined in the ITAA. For purposes of this dissertation the below court cases were used as reference points in order to obtain guidance on the meaning of the term ordinary income.

The principles of what constitutes *ordinary income* have been addressed in numerous court cases, with each case providing progressively more insight on the concept of ordinary income.

In the case of Scott v Commissioner of Taxation, 35 SR (NSW) 215, the court had to decide whether certain amounts had any characteristics of what constitutes income. Jordan CJ, of the New South Wales Supreme Court concluded that:

> The word 'income' is not a term for art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usage of mankind, except in so far as the statutes state or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts.

Although there is no complete set of rules the courts have developed principles that can be followed. The principles are found in the words "income according to ordinary concepts" (ATO, 1996: 1).

Based on the above, in order to determine whether an amount constitutes *ordinary income* one has to apply ordinary concepts that the man on the street would use to decide whether income would constitute ordinary income.

According to Carbone (2010: 1) it is impossible to determine whether income will constitute ordinary income in every possible transaction or scenario, this is due to the fact that the courts have never adopted a detailed definition of what will constitute income.

The following cases where key examples that contributed to the debate of whether income constitutes *ordinary income:*

- In Scott v Commissioner of Taxation, 117 CLR, 514 the taxpayer received prize money and the court had to decide whether the amount will be classified as income based on the character of the income in the taxpayer's hands. Even though the amount was determined not to be ordinary income the amount would still be taxable as statutory income as the prize money was linked to the taxpayer's employment relationship.
- In Federal Coke Co Pty Ltd v FCT, 34 FLR 375 the court had to determine whether a payment was income or capital in nature, it was established that one should establish the character of the amounts in the hands of the recipient and that the character of the amount in the hands of the person paying the amount is irrelevant
- In Squatting Investment Co Ltd v FCT, 86 CLR 570, the courts determined that all the facts and circumstances have to be evaluated in order to determine whether an amount constitutes income.
- In MIM Holdings Ltd v Commissioner of Taxation, 363 FCA 13, it was confirmed that amounts received as consideration for services rendered will almost always be regarded as income.

Another example is the Binding Private Ruling 87930 (ATO: 2007), issued by the ATO on 1 July 2007, the taxpayer entered into a 10 year agreement with government to provide services on land that the taxpayer owned in exchange for payment. The property was only managed for conservation purposes. The taxpayer had to provide an annual report to government and no business was conducted in the property. The ATO held that government offered the payment

as a reward for rendering the services and the taxpayer engaged in providing the services knowing that he will receive an amount of money in return for the services rendered. The ruling, therefore, concludes that the taxpayer received the amount in respect of services rendered and the amount is therefore ordinary income.

For an example of case law that specifically dealt with the term *income in accordance with ordinary concepts* we can refer to the case of FCT v Montgomery:

In the case of FCT vs Montgomery, 35 ATR 416: the taxpayer was a partner in a firm that spent $3.8 million refurbishing the business premises that they were leasing. It was their intention to occupy the premises up until the expiry of the lease agreement in 1994.

In September 1988 the owner of the building informed the firm that the premises had to be gutted and cleansed of asbestos and it was anticipated that this process would take three or more years to complete. The owner offered to relocate the tenants of his premises whilst the work was being carried out to a premises close by.

The firm was concerned about the disruption that this would have on their business as well as the potential danger of the asbestos dust and, therefore, entered into a 12 month lease at a premises nearby.

At this point in time it was a common practice for landlords to offer lease incentives to new tenants and the firm new that they would receive a good inducement to the new premises that they would lease.

At the same time that the new lease was entered into the partners of the firm also entered into an inducement agreement amounting to $29.35 million that would be paid to the firm over a 3 year period. The lease and move to the new premises as well as the early termination of their existing lease involved expenditure amounting to $24.2 million.

The Commissioner included the inducement as assessable income and no deductions were allowed for the relocation costs, new lease etc. The taxpayer was in disagreement with this assessment and lodged an appeal to the Federal court.

In the Federal court Jenkinson, J held that the payment was correctly included in the taxpayer's assessable income as the incentive payment paid to the firm was regarded as consideration for committing the firm to the new 12 month lease. The court held that although the amount would not be regarded as a profit it was still a gain that arose in the course of the firm's business and

the payment was received by the firm during the course of conducting their business operations. It was also the taxpayers' intention to benefit from the incentive payment.

In the Full Federal Court, in the case of Montgomery v FCT, 38 ATR 186, the judges: Heerey J, Davies J and Lockhart J in separate judgements allowed the taxpayers' appeal agreeing that the amount was not income but a capital receipt.

The taxpayers' argument was that it was not the firms business to receive lease incentives and that their only intention was to obtain a suitable premise in order to continue with their business practice. The judges, therefore, found that the income from the lease incentive was not ordinary business income.

On the Commissioner's appeal to the High court of Australia, in the case of Montgomery v FCT, HCA 34, the Commissioner argued that the lease incentive payment/inducement agreement was assessable income, based on the following reasons:

- the receipts were an incident of a transaction that occurred in the course of the taxpayers business activity (even though it was not in the ordinary course of that business);
- the receipts were a gain from a profit-making undertaking or scheme and that a significant purpose of the firm in entering the transaction was to derive a gain;
- it was an amount, received in business, as an incentive to pay greater (deductible) rental payments than the taxpayer would have been prepared to pay. The incentive was negotiated in the normal course of carrying on their business.

In Summary, it was confirmed in the High court that the lease was acquired as part of the firm's business structure whilst the inducement amounts were not. The induced amounts where regarded as income from the use of the firm's capital, which occurred during the course of carrying on a business and the amount is therefore ordinary income and assessable.

The Montgomery case is authority that a single transaction undertaken in the course of carrying on a business will be regarded as income and will be included as assessable income in terms of section 6-5 of the ITAA

4.3 Taxing illegal receipts

4.3.1 Extracts from the Assessment Act and case law

Illegal income is not defined in the Assessment Act and the ordinary meaning of the word has to be applied.

Black (2005: 439) is of the opinion that the facts and circumstances of each case should be evaluated on a case-by-case basis. Before proceeds from illegal activities can be classified as assessable income, it first needs to be determined whether the illegal activities can be classified as income derived from a business.

According to the ATO (1993: 2), when determining whether income from illegal activities constitutes assessable income, the same principles used to determine whether income from legal activities constitutes assessable income, has to be applied.

Based on the above, income from illegal activities will be assessable should the taxpayer engage in systematic activities to generate the income and the elements of a business are present e.g. repetition; regularity; the view of making a profit and organisation (Black, 2005: 440; ATO, 1993: 2).

The taxation of illegal income has been dealt with in various international courts. For purposes of this dissertation the following cases, dealing with the taxability of illegal receipts can be referred to and are not by any means a full comprehensive summary of all court cases dealing with this topic:

In the Irish case of Hayes v Duggan, IR 406, the court confirmed that income from illegal activities was considered as taxable income. This was due to the fact that the state did not want to share in any earnings that were generated illegally by taxpayers.

According to Campbell (2006: 2) the taxability of illegal earnings in Ireland was later amended through the implementation of statutory law, to state that income (whether illegally obtained or from an unknown source) can be regarded as taxable.

It is international cases such as the case of Hays v Duggan, IR 406, which were used to establish whether illegal earnings would be treated as taxable earnings in AU. The first case to deal with the taxability of illegal earnings in AU was the case of the Commissioner of taxes v La Rosa, FCAFC 125 where the court confirmed that any receipts from a systematic activity where

elements of business are present are to be regarded as income, irrespective of the legality of the business activities.

4.3.2 Tax rulings issued by the ATO on the taxability of illegal income

4.3.2.1 Tax Ruling 93/25

The ATO issued Ruling TR93/25 on 12 August 1993. The ruling (ATO, 1993: 1) provides clear guidelines that should be followed to determine whether income generated from illegal activities constitutes accessible income in terms of the Assessment Act.

The ruling makes reference to illegal activities which include: "any activities not permitted by law such as those related to drug dealing, insider trading, misappropriation, prostitution etc." (ATO, 1993: 1).

According to this ruling no regard should be given to the legality of income when determining if the income is assessable in terms of the Assessment Act. Therefore, the same principles apply to income generated from legal or illegal sources (ATO, 1993: 1).

The ruling further explains that illegal income will be classified as income should the taxpayer systematically operate a business and the following elements are present: repetition, regularity, view to make a profit and organisation (ATO, 1993: 1).

In accordance with the ruling, income derived from isolated transactions should be dealt with on a case by case basis. The taxability of isolated transactions will, therefore, depend on the facts and circumstances of each case/transaction (ATO, 1993: 1).

The ruling also discusses the tax treatment of stolen goods by referring to the case of Patridge v Mallandaine, 2 TC 179. In this case the court had to consider the tax treatment of stolen goods and after some debate, Denman concluded:

> If a man were to make a systematic business of receiving stolen goods and do nothing else, and he thereby systematically carried on a business and made a profit of 2000 per year, the Income Tax Commissioner would be quite right in assessing him if it was his vocation. There is no limit as to its being a lawful vocation, nor do I think that the fact that it is unlawfully can be set up in favour of these persons as against the rights of the revenue to have payment i.r.o. the profits that were made.

This court case reconfirms the understanding that there is no requirement for a transaction or act to be lawful before it constitutes assessable income.

Black (2005: 445) advises that in later cases the courts extended their view to examine whether the taxpayer activities constituted trade rather than vocation.

The interpretation note (ATO, 1993: 1) provides the following key examples of additional cases that debated the concepts of trade and the taxability of illegal income:

- The Minister of Finance (Canada) v Smith, AC 193, where the taxpayer received income from bootlegging liquor;
- The case of Lindsay v IRC, 18 TC 43, where whiskey was smuggled out of Scotland and sold in the USA; and
- Finally, a case on whether the proceeds from illegal bookmarking operations would be taxable in the case of Southern (Hm Inspector of Taxes) v A.B. 1933 18 TC 59.

Tax Ruling 92/3 will now be discussed. The purpose of this ruling is to provide taxpayers with guidance on the tax treatment of isolated cases.

4.3.2.2 Tax Ruling 92/3

Tax Ruling 92/3 issued on 30 July 1992, provides guidance on whether income derived from isolated transactions can be regarded accessible income, in terms of the Assessment Act.

The ruling (1992: 1) explains that an isolated transaction refers to a transaction outside the ordinary course of a taxpayer's business operation as well as any transaction entered into by non-business taxpayers.

The ruling (1992: 1) details the ATO's view by referring to the case of FC of T v The Meyer Emporium Ltd, 163 CLR 199, where the company made an interest-free loan to a subsidiary of the company. A few days later, as intended from the start of the transaction, the company assigned the right to receive the interest on the loan in return for a lump sum payment.

Upon review of the facts, the court held that the above transaction resulted in an amount being received by the taxpayer and that the amount should, therefore, be treated as income. The decision was based on the following key income tax principles: the transaction, although not in the taxpayer's ordinary course of business, was entered into with the purpose of making a profit. In addition to this, the company sold a right that basically converted the future income

that it would have received in future tax years from the interest on the loan to the subsidiary, to income in the form of a lump sum that the company would receive in the current tax year.

The ruling (1992: 1) explains that profit from isolated transactions will be regarded as income, when the transaction has a profit-making element or purpose. Therefore, it needs to be established whether the following elements are present: was it the intention/purposes of the taxpayer to make a profit when the transaction was entered into and was the transaction that was entered into and the profit made from the transaction, done in the course of carrying on a business, business operation or commercial transaction.

According to the ruling (1992: 1) it is important to note that transactions can also take place in the course of carrying on another business separate from the taxpayer's ordinary course of business operations.

The ruling (1992: 1) further explains that in the event that a taxpayer generates a profit whilst not carrying on a business, the profit will still be regarded as income. Provided that: it was the intention of the taxpayer to enter into a profit-making operation or transaction for a profit and the operation or transaction that was entered into, which generates the profit or gain, was in the course of carrying on a business or a commercial transaction.

To illustrate transactions with profit-making purposes, Tax ruling 92/3 provides various examples. For purposes of this dissertation the following example from the tax ruling will be used: Mr X purchased a number of gold bars. Following a sharp rise in the price of gold Mr X sold the bars, in the same week for a huge profit. Although Mr X had no previous dealings with gold and he did not carry on a business, the profit he made would be taxable. The ruling advised that this is due to the following facts and circumstances:

- There was a quick sale following the rise in the price for gold;
- The gold had no use other than being held for trade purposes;
- It can be argued that profit-making was a significant purpose when Mr X acquired the gold bars; and
- The transaction was commercial in nature due to the substantial profit and the nature of the asset (1992: 1)

4.3.3 Theft and fraud

There has been worldwide debate on whether stolen money should be treated as taxable income. According to Gupta (2008: 111), when analysing the intention of the person stealing money or committing fraud – it is highly unlikely that he/she would have committed the acts if he/she did not intend to benefit from their actions.

Black (2005: 437) is of the view that the reality behind illegal activities is as follows:

> The primary motive for organized crime is profit. Each year in Australia drug trafficking, money laundering, fraud, people smuggling and other forms of serious crimes generate billions of dollars. This money is derived at the expense of the rest of the community. It is earned through the harm, suffering and human misery of others, it is used to finance future criminal activity including terrorism. It is tax free. Criminals have no legal or moral entitlement to the proceeds of their crimes.

Based on the above, it is evident that the main motive for theft and fraud is to benefit in the illegal profits that are generated from the illegal activities. The tax ruling confirms that income generated from a systematic activity where elements of a business are present will be treated as accessible income, regardless of the legality of the income.

This is reconfirmed in the case of the Federal Commissioner of Taxation v Walker, ATC 4179, where the court determined a number of tests that have to be applied in order to determine whether the taxpayer was carrying on a business. None of the tests had any requirement specifying that the activities generating the income had to be legal.

According to Black (2005: 444) and Gupta (2008: 112) circumstances may exist where thieves who engaged in a once off act of stealing money, will not be taxed on the funds they have generated due to the fact that the thieves had no intention of making a profit and there was no element of a business operation present.

Gupta (2008: 112) provides the following guidance to determine whether illegal income is of an incidental or isolated nature. He advises that one should compare the transaction to a normal business, with normal business operations. He provides an example of a taxpayer who participates in drug trafficking. Although the act of selling drugs is illegal, it would constitute a trade in the event that it is compared to a normal business with normal business operations. Therefore, the taxpayer would be taxed on the profit generated from the drug sales.

4.3.4 Taxability of illegal income – application of legal principles

The concept of whether illegal earnings are taxable is not always clear-cut and grey areas do exist.

It has been established that the same principles used to determine the taxability of legal income should be used to determine the taxability of illegal income. Consequently, income from illegal activities is assessable should the taxpayer engage in systematic activities to generate income and elements of a business are present such as: repetition, regularity, or a view to make a profit and organization.

In accordance with the rulings, income derived from isolated transactions should be dealt with on a case-by-case basis. Therefore, the taxability of isolated transactions depends on the facts and circumstances of each case/transaction.

In addition to the above, there is also the challenge of a thief planning a burglary. According to Gupta (2008: 113) all the above mentioned elements such as: an intention to make a profit and a well-planned, organised and systematic system might exist, but when comparing it to a legal business, there is no parallel and the profits will, therefore, not constitute income produced in the course of running a business. On these grounds, profits from planning a burglary will not be included in the thief's assessable income.

The above principle can be illustrated by reviewing the facts in the case of Lindsay v IRC, 18 TC 43. In this case the sale of liquor between countries was prohibited. However, countries could trade legally, manufacture or sell liquor domestically. As a result, Scotland was prohibited from selling liquor to America, but continued to sell liquor to America. The profits realised from the illegal sale of liquor to America was regarded as assessable income. The court held that regardless of whether the activity was legal or illegal, the business activity/trade could still be continued in Scotland and the taxpayer would have earned the same income from his trading operations had the taxpayer conducted legal business operations.

4.3.5 Conclusion on the application of legal principles

Income from illegal activities will be assessable should the taxpayer engage in systematic activities to generate the income and the elements of a business are present e.g. repetition, regularity, view to make a profit and organisation.

Certain exceptions do apply such as in the case of a once-off burglary, as no parallel can be drawn to a legal business or in circumstances where thieves who engaged in a once-off act of stealing money might not be taxed on the funds they have generated. This is because the thieves had no intention to make a profit and there was no element of a business operation present.

When dealing with incidental or isolated cases, it is important to note that such transactions will be regarded as income when the transaction has a profit-making element or purpose.

However, the Commissioner will have to look at all the facts and circumstances, on a case-by-case basis, and apply the ordinary concepts of what constitutes a trade to determine whether the amount will be taxable.

4.4 ATO's ability and tools to trace illegal income

With tax evasion becoming more prominent, the ATO relies on various processes to catch taxpayers who exploit the tax system. Some of the methods used, include information sharing agreements with other countries, risk profiling as well as third party data matching technology.

In a process to identify income that was omitted in annual tax returns, the ATO has implemented tools to assist them in collating data from third parties. Some of these tools will now be discussed below.

4.4.1 Access to third party information

According to the ATO (2003: 4) the purpose of this technology is to assist in collating information from third parties. The main purpose of streamlining data is to match the third party data received, against the data submitted by taxpayers in their annual tax return submissions.

Through the implementation of the above data matching and tracking technology, the ATO obtains knowledge about taxpayers' tax affairs, which in return allows the ATO to detect data mismatches and tax crimes (ATO, 2012b: 1; ATO, 2013a: 4).

Recently the department of Immigration and Border protection ("DIBP") announced a data matching program. According to Wright (2015: 2) this technology will be used to identify compliance risks for taxpayers with AU visas.

Wright (2015: 2) further explains that the key tax-related focus points of this technology will address the integrity of tax returns; income tax; good and service tax; non-compliance; as well as fraud.

According to Wright (2015: 2) the data matching program grants the ATO access to the following data: names; address history; contact history for Visa applicants and their sponsors; all visa grants and visa grant status by point in time; and all international travel movements undertaken by the visa holders.

This technology assists the ATO to review data captured on this system, in order to identify cases of non-compliance and fraud that can be flagged for further investigation.

4.4.2 Risk profiling

As part of the process of determining whether taxpayers declare all their earnings, the ATO also undertakes risk profiling. According to the ATO (2012b: 1) the purpose of risk profiling is to identify taxpayers who have overstated their deductions or omitted income. Should a taxpayer be flagged through the risk profiling process, the ATO will lodge an in-depth investigation into the taxpayer's affairs.

4.4.3 Project Wickenby

The ATO entered into numerous partnerships with a variety of government offices and law enforcement agencies in order to protect the integrity of AU's financial and regulatory systems. The purpose of the team is to prevent taxpayers from abusing secrecy havens and to prevent people from facilitating, participating in and promoting illegal offshore schemes (ATO, 2012a: 5; ATO, 2013b: 8).

The ATO (2012a: 5) provides the following list of activities that is affected by Project Wickenby: civil audits; risk reviews; criminal investigations; prosecutions and other legal action; administrative actions such as banning people from the financial services industry; tracking money flow in and out of AU; and proceeds of crime action.

Although the project is led by the ATO, the ATO (2012a: 5) advises that project Wickenby's effectiveness is built on the cooperation of the partnerships that they have formed with the following federal departments and agencies: Australian Crime Commission; Australian Federal Police; Australian Transaction Reports and Analysis Centre; Australian Securities and

Investments Commission; Attorney General's department; Australian Government Solicitor; and Commonwealth Director of Public Prosecutions.

The ATO (2013b: 7) is of the opinion that Project Wickenby is changing taxpayers' views of tax evasion. According to ATO Deputy Commissioner Greg Williams (2013: 7): "Wickenby has been instrumental in shifting attitudes and changing behaviour. It has helped raise the community's awareness about tax evasion. People recognise that their taxes fund vital government services and that those who avoid tax, cheat the community. This understanding adds to the integrity of our systems.

The positive influence of the project is evident in numerous ways. The ATO (2013b: 7) confirms that there has been a reduced number of secrecy jurisdictions as well as a decrease in tax evasion in the AU Tax system, due to this initiative.

The Australian National Audit Office (ATO: 2012a: 5) agrees that this project has assisted in making AU less attractive for international tax fraud and tax evasion.

4.4.4 Tax Information Sharing Agreements

According to the Organisation for Economic Co-operation and Development ("OECD") (2015b: 1), the purpose of a Tax Information Exchange Agreement ("TIEA") is to promote the exchange of information between countries in order to improve transparency of taxpayers' affairs. The ATO (2015b: 1) advised that these agreements were developed by the OECD for the effective exchange of information between countries and were also developed as one of their objectives on harmful tax practices.

By entering into TIEAs the ATO protects AU's revenue base. TIEAs provide governments with access to offshore information, improve the integrity of a country's tax system and it assists in identifying tax crimes (ATO, 2012a: 8; ATO, 2015b: 1).

In summary, by using the above technology the ATO can collate information across governments as well as third parties. This led to increased intelligence on taxpayers' affairs.

According to the ATO (2013a: 1) serious cases of fraud and tax evasion are addressed by identifying gaps in the tax system that pose a risk or threat to the fiscus. Once the threats are identified, they then identify and investigate suspicious taxpayers and suspicious transactions with a view of prosecuting the taxpayer.

The ATO (2013a: 1) advises that they work with the AU Federal Police and Commonwealth Director of Public Prosecutions to confiscate assets which have been obtained in tax crimes.

In addition to the above, community awareness is also important to the ATO. The ATO raises awareness by publishing the work they have done to combat tax crime, in order for the community to see the achievements (ATO, 2013a: 1).

Next, a discussion will follow on the deductibility of expenditure in in AU.

4.5 Deduction of expenditure in Australia

4.5.1 The general deduction formula

The Assessment Act allows taxpayers to deduct from their assessable income, losses or outgoings incurred in carrying on of a business. According to the ATO (2015a: 1) a deduction will generally be allowed should there be a sufficient link between the income produced and the expenditure or losses incurred, provided that the expenditure is not capital in nature.

In terms of section 8-1(1) of the Assessment Act, taxpayers are allowed a general deduction from their assessable income for any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or
(b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

This rule holds provided that, in terms of section 8-1(2), taxpayers are not allowed to deduct expenditure or losses to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature ; or
(b) it is a loss or outgoing of a private or domestic nature; or
(c) it is incurred in relation to gaining or producing your exempt income or your non-assessable non-exempt income; or
(d) a provision of this Act prevents you from deducting it.

According to the ATO (2015a: 1) taxpayers will be denied a deduction against their assessable income, should their business activities be illegal and they have been convicted of an indictable offence. However, should a taxpayer conduct a lawful business and he/she is convicted of an illegal activity, in the ordinary course of carrying on his/her lawful business, the expenditure

that will be disallowed as a deduction will be the portion of the expenditure that is directly related to/in the furtherance of the illegal activity.

The ATO (2015a: 1) advises that an indictable offence is an offence that is 'punishable by imprisonment for at least one year and includes offences such as drug trafficking, tax evasion, extortion, illegal gambling, people smuggling, forgery and piracy'.

In summary, generally expenditure incurred in the production of illegal income is not tax deductible. Yet there are certain circumstances where illegal expenditure can be claimed as a deduction. For purposes of this study, an example of this can be illustrated in the following scenario: In the event that a taxpayer conducted a lawful business operation and incurred expenditure on the side in respect of an illegal transaction, the amount would still be allowed as a deduction in the event that the amount would have constituted an expense regardless of the legality.

The ATO (2015a: 1) explains that the reason the deduction is allowed, is because the expenditure incurred does not directly relate to the illegal activity and it can, therefore, be argued that the expenditure was not incurred for the furtherance of the illegal activity.

Next, it is evident that it is necessary to provide clarity on what exactly constitutes a *business*.

4.5.2 What constitutes a business?

A business is defined in section 995-1(1) of the Assessment Act to include: 'any profession, employment, vocation or calling, but does not included occupation as an employee'.

According to Tax Ruling 97/11 issued by the ATO on 4 June 1997, the above statutory definition is very limited as no guidance is provided on whether the extent, nature and manner in which activities are undertaken constitutes the carrying on of a business (ATO, 1997: 1).

In terms of the Private Ruling on deductibility issued by the ATO on 6 August 2003, the courts will turn to dictionary definitions and common law on what constitutes a business in the event that the definition provides limited guidance (ATO, 2003: 1).

Tax Ruling 97/11 (ATO: 1997, 1) advises that the facts and circumstances of each case have to be evaluated individually, in order to determine whether the taxpayer's primary production activities constitute carrying on of a business.

Tax Ruling 97/11 (ATO: 1997, 1) provides guidance on key indicators that have been accepted by courts which will assist taxpayers in identifying whether they are carrying on a business of primary production. Some of these key indicators listed in the ruling are as follows:

> whether the activity has a significant commercial purpose or character; whether the taxpayer has more than just an intention to engage in business; whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity; whether there is repetition and regularity of the activity; whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business; whether the activity is planned, organized and carried on in a business-like manner such that it is directed at making a profit; the size, scale and permanency of the activity; and whether the activity is better described as a hobby, a form of recreation or a sporting activity.

In addition to the above, Tax Ruling 97/11 highlights key factors which support the main indicators listed above. According to the ruling, the key factors suggesting that a business is being carried on are as follows:

- significant commercial activity;
- purpose and intention of the taxpayer in engaging in the activity;
- an intention to make a profit from the activity;
- the activity is or will be profitable;
- repetition and regularity of activity;
- activity is carried on in a similar manner to that of the ordinary trade;
- activity is organised and carried on in a business-like manner and systematic records are kept;
- size and scale of the activity;
- not a hobby, recreation or sporting activity;
- a business plan exists;
- commercial sales of product; and
- the taxpayer has knowledge or skill (ATO, 1997: 1).

Tax Ruling 97/11 (ATO: 1997: 1) advises that the above indicators cannot be analysed in isolation, when determining whether a taxpayer is carrying on a business. There might be

instances where there is a significant overlap with the indicators. The Tax Ruling provides the following example:

> An intention to make a profit, will often motivate a person to carry out the activity in a systematic and organized way, so that the cost are kept down and the production and the price obtained for the produce is increased.

Thus, based on the facts and circumstances of each case, the bigger and broader the scale of a taxpayer's activities across the indicators listed above, the more likely it would be that the taxpayer is operating a business. In addition to the above, Tax Ruling 97/11 confirms that in the event that the taxpayer has no motive to realise a profit and it is unlikely that the activities undertaken by the taxpayer will ever realise a profit, it is highly unlikely that the taxpayer's activities will constitute a business.

4.5.3 Losses and outgoings

The word *loss* is self-explanatory in the sense that the taxpayer has suffered/lost something. According to the Private Ruling on deductibility, an *outgoing* can best be described as the expenditure of an amount of money incurred/suffered by the taxpayer (ATO, 2003: 1).

4.5.4 Necessarily incurred in the production of income/trade

In order for expenditure or losses to qualify for deduction in terms of section 8-1 of the Assessment Act, the expenditure or loss had to be *incurred* in the production of taxable income.

According to the Private Ruling on deductibility, there must be a sufficient link between any expenditure or loss and the income generated by the taxpayer.

For purposes of this dissertation the following case, analysing the concept of *necessarily incurred* can be referred to. In the case of the Federal Commissioner of Taxation v Snowden and Wilson Pty (Ltd), 99 CLR 431, it was confirmed that *necessarily incurred* means: 'The expenditure must be dictated by the business ends to which it is directed, those ends forming part of or truly incidental to the business'.

Based on the above, an amount will be regarded as necessarily incurred should it have been an appropriate business expense, or should it have been directed towards the taxpayer's business

activities. In other words, there should be a close link between the income generated and the loss or outgoing incurred.

4.5.5 To the extent that

According to the Private Ruling on deductibility, the term *to the extent that* implies that the amount incurred can be apportioned. This is due to the fact that a taxpayer can incur an expense that partly relates to his/her income-producing activities and partly relate to other non-income-producing activities.

Given the above literature, amounts incurred in the production of accessible income qualify for a deduction. Consequently, the amount incurred will have to be apportioned between one's income-producing and non-income-producing activities. Accordingly, the portion relating to the non-income-producing activities will be denied as a deduction.

4.5.6 Deductibility of illegal expenditure

To counter the deductibility of illegal expenditure in AU, the Assessment Act contains section 26-45(1) which reads as follows:

> You cannot deduct a loss or outgoing to the extent that it was incurred in the furtherance of, or directly in relation to, a physical element of an offence against an Australian law of which you have been convicted if the offence was, or could have been, prosecuted on indictment.

In addition to the above, section 26-5(1), confirms that taxpayers are not allowed to deduct fines and penalties from their assessable income, and reads as follows:

> Penalties:
>
> (a) an amount (however described) payable, by way of penalty, under an Australian law or a foreign law; or
> (b) an amount ordered by a court to be paid on the conviction of an entity for an offence against an Australian law or a foreign law.

4.5.6.1 Case law on the deductibility of illegal expenditure

For purposes of this dissertation the following cases, dealing with the taxability of illegal receipts can be referred to and are by no means a full comprehensive summary of all court cases dealing with this topic:

The first case in AU to deal with the deductibility of illegal expenditure and losses was the case of the Commissioner of taxes v La Rosa, FCAFC 125.

The facts of this case will now be discussed below. The Commissioner had to decide on two issues, namely the taxability of illegal income, and the deductibility of expenditure incurred in the production of the taxpayer's illegal drug dealing business operations.

In considering whether the income from the illegal drug operations was taxable, the court relied on taxation ruling 93/25 issued by the ATO. The court concurred with the view of the Commissioner that "receipts from a systematic activity where the elements of a business is present, are income irrespective of whether the activities are legal or illegal". The court argued that the taxpayer carried on a drug dealing business with the intentions to make a profit and the taxpayer was assessed on his earnings from his drug operations accordingly.

In addition to the above, the court also had to determine whether Mr La Rosa was entitled to claim a deduction for his money that was stolen in the robbery. The taxpayer argued that he should be entitled to a deduction as the money would have been used to purchase new trading stock (drugs) for his business.

The court relied on the case of Charles More & Co (WA) Pty Ltd v Federal Commissioner of Taxation, 95 CLR 344. The court allowed a deduction for the money that was stolen at gunpoint whilst the taxpayer was on his way from his business to the bank to deposit the monies. The court ruled that the money lost during the robbery was deductible as it was directly connected to the production of the taxpayer's illegal business income. This is due to the fact that the money was intended to purchase new stock. The court held that the deduction was allowed regardless of whether the business operations were illegal.

The Commissioner appealed the decision by the court and argued that the above case was not accurately concluded. He argued that a deduction should only be allowed for legal business expenditure, not stolen funds and that taxpayers should not benefit from their illegal activities.

The Federal Court disallowed the Commissioner's objection and allowed the taxpayer the deduction. The court held that the purpose of the Assessment Act is to establish whether income is assessable and not to punish taxpayers for their wrongdoings, arguing that this would be dealt with separately in the process of criminal law.

In conclusion, questions were raised whether this case was correctly decided. If the facts of the case are referenced back to the Assessment Act, it clearly states that no deduction is allowed for illegal expenditure, including penalties and bribes as set out in section 26-5(1).

Lund (2003: 117) is of the opinion that the court first had to establish whether the taxpayer in the La Rosa case was carrying on a trade and they refer us to the court case of Brajkovich v Federal Commissioner of taxation, 89 ATC 5227. Here it was established that one should firstly determine if a trade was carried on, and in the La Rosa case, no trade was conducted. Accordingly, no deduction could have been claimed.

Lund (2003: 113) is of the opinion that future taxpayers engaging in illegal business operations might rely on the La Rosa case to deduct their expenditure against their illegal business operations owing to the precedent this case has set.

Lund (2003: 123-127) further advises that the decision in the La Rosa case does not prohibit the Commissioner to disallow expenditure and losses incurred in an illegal business operation. The Assessment Act can be amended in respect of the deductibility of illegal business activities. This is to ensure that criminals are not rewarded in the form of tax benefits for their illegal business activities.

4.6 Brief chapter overview

This chapter documented the tax treatment of legal and illegal income in AU and the deductibility of expenditure incurred in the production of legal and illegal income in terms of the Assessment Act, tax rulings, private rulings and leading case law on this topic. Furthermore, the methods available to the ATO in order to track and trace illegal income were also analysed in order to achieve the research objectives for the present study.

From the review it appears that AU will tax illegal earnings generated by taxpayers, should the illegal income generated meet the requirements of assessable income. Further, expenditure incurred in the production of illegal income is not deductible for tax purposes in AU. However, should a taxpayer conduct a lawful business operation and incur expenditure in respect of an illegal transaction, the expenditure incurred will be allowed as a deduction in the event that the amount would have constituted an expense regardless of the legality.

With regards to the ATO's ability and tools to trace illegal income in AU, it has been established that AU has implemented various data collection techniques in order to identify

illegal income that has been omitted in taxpayers' annual tax returns. The ATO is leading by example with the launch of Project Wickenby, and the ATO has received confirmed results that the project has made AU less attractive for tax evasion and tax fraud.

Unfortunately, there will always be cases where tax authorities will only become aware of illegal income that has been generated once taxpayers are caught. This being said, the ATO can do a risk review and flag a taxpayer's annual tax return or launch a full audit at any point in time in the event that it suspects anything.

In the next chapter, the research findings are synthesised and a conclusion on the similarities in the tax treatment of illegal income and expenditure between SA and AU are presented.

CHAPTER 5

5. CONCLUSION AND RESEARCH FINDINGS

5.1 Introduction

The taxation of illegal income is a sensitive topic across the world. Some governments avoid taxing criminals' illegal earnings, due to the fact that they do not want a tax cut from the illegal proceeds generated and they also do not want honest taxpayers to perceive the government to be supporting criminals in their activities.

Every person has his/her own moral compass in life. For some people the line between what is legal and what is illegal can become blurred. Thus, each person's perception of what is moral and what is ethical depends on his/her life experiences and the type of person he/she has chosen to be.

This chapter presents an analysis of the facts and opinions set out in chapters three and four in order to determine whether the research objectives for this study have been met.

5.2 Comparative evaluation and conclusion in order to establish whether SA is in line with global norms.

The limited scope of the dissertation proposes that a parallel can be drawn between how SA and AU approach the concept of taxing illegal earnings.

5.2.1 Income

Firstly, both countries tax resident taxpayers on their worldwide earnings, whilst non-resident taxpayers are taxed on a source basis. SA and AU agree that should taxpayers generate income from illegal activities, the income so generated will be taxed should it fall into the countries' tax net.

The breakthrough case on the taxability of illegal earnings in SA is the case of MP Finance Group CC (in Liquidation) v SARS, 69 SATC 141, where the taxpayer ran an illegal pyramid scheme. The taxpayer recorded the illegal profits generated, as deposits. The court established that the illegal proceeds were taxable even though the taxpayer had a legal obligation to refund the deposits to the investors.

From the research findings, it can be concluded that SA will tax illegal earnings should it fall within the definition of Gross Income, as defined in section 1 of the ITA. Similarly, AU will

also tax illegal income should it constitute assessable income as defined in section 4-15(1) of the Assessment Act.

5.2.2 Tools and abilities to detect illegal activities

With tax evasion progressively becoming more prominent, both countries have implemented various processes to catch taxpayers who exploit the tax system. Some of these processes include DTAs; TIEAs; third party data collection techniques; and project Wickenby.

It is the researcher's opinion that both AU and SA are doing their best to identify taxable illegal earnings through the various tools discussed in this document. However, the methods used do not seem to be comprehensive enough to track and identify all sources of illegal income generated by taxpayers. It is thus submitted that the methods followed by project Wickenby are an excellent example of how forming partnerships with various other departments can assist in catching taxpayers who conduct illegal activities. This is certainly something that SARS can strive towards implementing in the near future.

5.2.3 Deductions

The limited scope dissertation also proves that there is a parallel between how SA and AU deal with the deductibility of legal and illegal expenditure. Both countries have incorporated a general deduction formula into their income tax legislation.

As can be concluded from the literature review, in both countries an amount will qualify as a deduction should it meet the following criteria:

- In SA, an amount of expenditure will be allowed as a deduction, in terms of section 11(a) of the ITA, should the taxpayer carry on a trade and the taxpayer can prove that the expenditure and losses were actually incurred in the production of income, provided the expenditure/losses are not of a capital nature.
- In AU, an amount of expenditure will be allowed as a deduction, in terms of section 8-1(1) of the Assessment Act, should the taxpayer conduct a business and the taxpayer can prove that outgoings or losses were incurred in the production of the taxable income and that the expenditure was *necessarily incurred* in carrying on the business, provided the outgoings or losses are not of a capital nature

The main difference lies in the fact that SA's general deduction formula refers to the term *trade* whilst AU refers to the term *business.* Although the terms might seem to be different, when analysing the terms it can be concluded that they are quite similar in nature.

Should a taxpayer's operations constitute a business in AU it is highly likely that it will also constitute a trade in SA. This is due to the fact that AU applies a broad scope to the term business: if it is the taxpayer's intention to make a profit from their activities, the activities will be regarded as a business. In SA the definition of trade is also quite wide and includes a business.

With regards to the deductibility of illegal expenditure incurred in the production of illegal income, the two countries have similar outcomes as summarised below.

- In SA, SARS issued Interpretation note 54 that should be read with section 23(o) of the ITA. The note prohibits the deduction of expenditure in a situation where the activity is illegal.
- The first case in AU on the deductibility of illegal expenditure was the case of the Commissioner of taxes v La Rosa, FCAFC 125, where the court dealt with the deductibility of illegal expenditure. The court ruled that Mr La Rosa was entitled to claim a deduction for money that was stolen from him during a robbery, as the money would have been used to purchase new trading stock i.e. drugs. The court held that the deduction would be allowed regardless of whether the business operations was illegal.
- AU has subsequently addressed this topic in more detail and their view is currently that taxpayers will be denied a deduction against their taxable income, should their business activities be illegal and they have been convicted of an indictable offence.

In addition to the above, AU has gone one step further and has confirmed that there are certain circumstances where one would be able to deduct one's illegal expenditure should it have been incurred in the production of income. The following examples illustrate how this will be applied:

- Should taxpayers conduct a lawful business and they are convicted of an illegal activity in the ordinary course of carrying on their lawful business, the expenditure that will be disallowed as a deduction will be the portion of the expenditure that is directly related to/in the furtherance of the illegal activity.

- Where taxpayers conduct a lawful business and they incur expenditure in an illegal activity and the amount would have been expended, regardless of the legality of the transaction, the amount will still be deductible. This is due to the fact that the expenditure incurred does not directly relate to the illegal activity. Therefore, it can be argued that the expenditure was not incurred for the furtherance of the illegal activity.

The researcher is of the opinion that should SARS adopt the above approach in respect of the deductibility of certain illegal expenditure, taxpayers might more openly share information about their tax affairs with the tax authorities.

5.3 Future work

As in the case of all research documents, this dissertation is by no means an all-inclusive document. There will always be additional literature which can be reviewed which contains other areas that synchronise with this dissertation's research topic.

Listed below are potential areas where the current research can be augmented in future:

- The establishment of an academic framework which could assist in the implementation of a formal section in the Income Tax Act, No. 58 of 1962, specifically dealing with the taxation of illegal income in SA.
- The establishment of a framework for SARS to implement a project such as project Wickenby in SA. This will serve as a supplementary tool for collating third party information by forming partnerships with various departments.

5.4 Final comments

In discussions above, the results of the research topic have been compared and it can be concluded that SA and AU tax illegal earnings generated by taxpayers, should the illegal income generated meet the requirements of taxable/assessable income.

Both countries also disallow expenditure incurred in the production of illegal income. However, AU is ahead of SA, in the sense that should taxpayers conduct lawful business operations and incur expenditure in respect of an illegal transaction, the expenditure incurred will be allowed as a deduction if the amount constitutes an expense, regardless of the legality.

SARS is doing its best to identify illegal transactions that generate taxable illegal earnings. Both SA and AU have implemented various tools in order to trace illegal earnings that have been omitted from annual tax declarations. It is submitted that, although effort is made to identify illegal transactions, the methods currently available to SARS are not comprehensive enough to track and identify all sources of illegal income generated by taxpayers. It is also submitted that the methods follow by project Wickenby are an excellent example of how forming partnerships with various other departments can assist in identifying taxpayers who carry out illegal activities. This is something that SARS could strive towards implementing in the near future.

Based on the results of the current limited study, in comparing the SA tax system with the AU tax system, it is clear that SA is in line with global norms in so far as the tax treatment of illegal transactions is concerned.

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