result of these changes. Provisions such as cl 118 of the Companies Bill, 2007, which classifies under an ‘arrangement’ also schemes that may be implemented through other means, and s 57 of the new Co-operatives Act, which makes it harder to implement re-organisation of a co-operative, actually reverse the progress that has been made in this area of the law over the years.

Legality and Income Tax – Is SARS ‘entitled to’ Levy Income Tax on Illegal Amounts ‘received by’ a Taxpayer?

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1 Introduction

Pimps, prostitutes, pyramid schemes and perpetrators of other crimes all have one thing in common: the production of illegal profits. Whether the crime is a once-off prank or is executed after precise planning, the prejudice involved does not only affect an innocent victim. The South African Revenue Service (‘SARS’) is placed in a predicament with regards to the income-tax consequences of crime. It remains a highly controversial issue whether or not such proceeds should be subject to income tax.

The purpose of this analysis is to evaluate the principles applied by the courts to determine whether an amount obtained in an illegal manner, is included in the gross income of a taxpayer. The meaning of the phrase ‘received by’ in the definition of gross income (see s 1 of the Income Tax Act 58 of 1961 (‘the Act’)), its judicial interpretation, and the latest decision of the Supreme Court of Appeal in MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service (2007 (5) SA 521 (SCA)) will be examined.

Is SARS entitled to levy income tax on stolen amounts ‘received by’ a taxpayer? It will be argued that this question may be answered by examining the phrase ‘received by, accrued to or in favour of a person’ and by applying it correctly. It is submitted that the phrase ‘accrued ... in favour of a person’ as
it appears in the definition of gross income, could be relied on to levy tax on illegally produced income.

2 The Definition of Gross Income


The starting point to calculate a person’s tax liability is thus to determine such a person’s gross income (see Huxham & Haupt op cit at 9; Meyerowitz op cit in par 6.1; Williams op cit at 26). This definition is central to the entire Income Tax Act (Silke op cit in par 2.0).

The meaning of the phrase ‘received by, accrued to or in favour of a person’, is not explained in the Act. The courts are therefore often required to interpret the meaning of terms based on the specific set of facts before them (see Huxham & Haupt op cit at 10).

The courts have held that an amount is considered to be received by a person only in cases where it is received for that specific taxpayer’s personal benefit (see idem at 11; Meyerowitz op cit in par 6.8; *Geldenhuys v Commissioner for Inland Revenue* 1947 (3) SA 256 (C) at 266; *Commissioner for Inland Revenue v Gem & Co (Pty) Ltd* 1955 (3) SA 293 (A) at 301F; *Secretary for Inland Revenue v Smant* 1973 (1) SA 754 (A) at 764B-D; *Commissioner of Taxes v G* 1981 (4) SA 167 (ZAD) at 168D-F).

For an amount to be received by a taxpayer, it must be received in such circumstances that she becomes entitled to the money (*Geldenhuys v CIR* supra at 269). In *CIR v Gem* (supra) it was held that an amount was not ‘received’ for purposes of gross income if there was a legal obligation upon such receipt to pay the amount to somebody else. The Court used the example of a farmer who borrowed a tractor from someone else. From the very moment that this tractor is delivered to the farmer, he is under an obligation to return it to the owner; the tractor is not received by the farmer for his own benefit to use it as he pleases. It is for this reason, that he will not be liable to pay income tax in respect of this receipt.

The phrase ‘accrued to, or in favour of’ has been found to mean ‘entitled to’ (see *Lategan v Commissioner for Inland Revenue* 1926 CPD 203 at 209; *Commissioner for Inland Revenue v Peoples Stores (Walvis Bay) Pty Ltd* 1990 (2) SA 353 (A) at 298E; Meyerowitz op cit in par 6.17). In *Lategan v CIR* (supra), the Court had to consider when the proceeds of the sale of wine had
accrued to a farmer. The contract of sale in this case stated that the purchase price was payable partly in one year and partly in the following year. The Court found that the entire purchase price had accrued to the farmer at the moment when delivery of the wine took place, as that had been the moment when the taxpayer had become ‘entitled to’ the money (see at 209). In Mooi v Secretary for Inland Revenue (1972 (1) SA 675 (A) at 684), the Court held that accrual occurred at the moment when an option had become exercisable. This has been interpreted to mean ‘unconditionally entitled to’ (see Huxham & Haupt op cit at 13; Williams op cit at 79). Since the decision in CIR v Peoples Stores (supra), it has been accepted that an amount will accrue to a taxpayer at the moment when she became entitled to it. In CIR v Peoples Stores (supra) this meaning was further interpreted to mean that an amount accrued to a taxpayer when she had an unconditional right to the funds.

The interpretation of the phrase ‘received by, or accrued to or in favour of’ as it has been applied by the courts to illegal transactions will be analysed later.

3 The Courts’ Interpretation of Illegal Transactions and Gross Income

The proceeds of illegal activities would usually not be declared in the tax returns of the perpetrators of crime. A part of the criminal activities in which they are involved could also be tax evasion, of which the Commissioner is usually unaware. It is only after they have been caught out, that the Commissioner will have to consider whether or not to levy tax on their income.

Amounts obtained in an illegal manner, have not always been considered as ‘received’ by the perpetrator of the crime in the true legal sense of the word. For an amount to be taxable, it must have been received for the taxpayer’s own benefit (see Meyerowitz op cit in par 6.8; Huxham & Haupt op cit at 12; COT v G supra at 168D-F; see also Silke op cit in par 2.5 for a discussion of COT v G; Williams op cit at 77).

There have also been decisions in which illegal funds have been found to be taxable, irrespective of the fact that the perpetrator did not receive the amounts for her own benefit (see Commissioner for Inland Revenue v Delogoa Bay Cigarette Co Ltd 1918 TPD 391 at 394; Income Tax Case 1545 (1992) 54 SATC 464 at 474; Income Tax Case 1789 (2005) 67 SATC 205 at 213A-B).

Examples of illegal activities that have come before the courts will now be considered to establish why the courts drew the distinction between the inclusion or exclusion of the proceeds of such activities.

3.1 Examples of Amounts that Have Been Excluded from Gross Income

3.1.1 Stolen Funds

Amounts obtained by a person due to theft have not always been included in the thief’s gross income. This was because a so-called ‘unilateral taking’
conferred no right on the thief (see Huxham & Haupt op cit at 12; Meyerowitz op cit in par 6.8; See also COT v G supra).

Dishonest taxpayers relied on the linguistic meaning of the phrase ‘received by’ as applied in Geldenhuys v CIR (supra) to escape tax liability by arguing that they were not ‘entitled to’ the amounts received for their own benefit (see COT v G supra at 168D-F).

One of the best examples of such an escape from tax liability by a taxpayer is found in COT v G, a decision based on Zimbabwean tax legislation that at the time had exactly the same wording as the South African Act. In this matter the taxpayer was employed by the Government of Zimbabwe and entrusted with funds destined for secret operations of the state. G stole an amount of $58 000, was convicted, and received a suspended sentence on condition that he repay all amounts taken. The question for decision was whether or not the amounts which he had stolen could be included in his gross income as amounts ‘received’ within the meaning of the definition of gross income. The Court followed a very technical and systematic approach. It analyzed the meaning of ‘receipt’ in terms of the *Shorter Oxford Dictionary*. There a receipt was described as something which is accepted by one person after being offered to her by another. It was held that a receipt required the action of taking delivery of something from another person and that it was not an unilateral act (see COT v G supra at 169E-G). The Court held that the plain meaning of the words used in this definition could only be modified in exceptional cases because the definition of gross income struck at the very core of the Act. It held the proceeds of theft not to be a receipt because a thief ‘takes’ money. The Court found that it could not have been the intention of the Legislature to allow such a drastic extension of the plain meaning of the phrase used (see at 170A). The decisions in CIR v Genn (supra) and Geldenhuys v CIR (supra), which confirmed that a receipt had to be obtained for the personal benefit of the taxpayer, were quoted with approval and applied.

3.1.2 Secret or Undisclosed Profits

In *Income Tax Case 1792* ((2005) 68 SATC 236) the Court, per Malan J, considered the question whether or not secret profits made by an agent were ‘received’ by him for purposes of gross income. The taxpayer had a mandate to buy and sell shares on behalf of a principal. The taxpayer joined a syndicate which bought shares at a low price and then sold them at a higher price to the very principal who had employed the stockbroker to buy the shares in the first place. A secret profit was made in this manner. The agent was convicted of fraud and sentenced to imprisonment. The intention of the syndicate to which the agent belonged was to obtain profit for itself. The Court held that this intention was not decisive when determining whether or not the amounts had been received for purposes of gross income. It did not mean that there had ‘legally’ been a ‘receipt’ of the shares (see at 239H-240A). The Court quoted
Geldenhuys v CIR (supra) with approval and stated that an amount must be received in such circumstances that a person becomes ‘entitled to’ it.

The Court further found that the original acquisition of the shares had not been by the syndicate, but by the agent for the benefit of his principal. It held that the law did not recognize the subjective intention of the agent to steal the shares or profit, but deemed the shares to have been received by the principal (see at 240H). Any actions that had been taken during the execution of his mandate had been on behalf of the principal. The agent had a duty not to advance his own interests as a relationship of trust existed with the principal (see at 241A). For these reasons the Court came to the conclusion that the secret profits that were realised, did not belong to the syndicate or the stockbroker. The amounts had not been ‘received’ within the meaning of the definition of gross income for the personal benefit and advantage of the taxpayer in his own right, but had accrued to the principal on whose behalf the agent was acting (see at 241C-D).

It is trite that a person does not receive an amount for his own benefit when acting as an agent for another (see RC Williams ‘Two Recent Cases Reconsider the Concept of “Beneficial” Receipt or Accrual for Income Tax Purposes’ (2000) 117 SALJ 40). The author agreed (at 42 and 46) with the dictum in Income Tax Case 1624 (1997) 59 SATC 373 at 380) where it was observed that ‘[i]f money is paid to an agent (in the broad sense) for the purpose of being paid by him to another for the payer’s benefit, so that the agent is in essence a conduit or trustee, the effect of the contract is that the money has not been received by the agent for his own benefit’.

The decision in ITC 1792 (supra) corresponded with this dictum in ITC 1624 (supra). The amounts that were earned as a secret profit in ITC 1792, had accrued to the principal from the start and not to the agent. In a certain sense ‘legality’, taken broadly or indirectly, was still required in ITC 1792 for the receipt to have been taxable. The mere physical receipt of the profits was not sufficient to render it taxable. Entitlement to it was still required in addition to the physical receipt of the amounts.

Factually, the stockbroker still had the use of the money and the resultant personal benefit of it. The principal, who was entitled to the funds, was initially not aware of that the agent was in possession of his funds. This principal would not have been able to disclose the receipt of the funds in his tax return, yet he would be liable for income tax if the decision in ITC 1792 is applied. In these circumstances, the principal would probably never obtain the secret profit that had been earned by the agent on his behalf, unless the dishonest agent’s secret conduct had been discovered. The agent could keep the profit and use it to his own benefit. The principal cannot, from a practical point of view, be taxed on amounts that he had not been aware of having in his possession. But in law this would be possible.

It is submitted that the fact that the agent had the personal use of the funds, must be relevant for practical and income-tax purposes. There had been a breach of trust by the agent and this had caused a change of intention. I will
argue that this intention of the agent to steal funds which had already accrued to the principal, is relevant and that a court should consider this intention in future, if the decision in *MP Finance Group v Commissioner, SARS* (supra) is to be applied to this situation.

### 3.1.3 The Position of the Investor in a Pyramid Scheme

In *Income Tax Case 1810* ([2006] 68 SATC 189) interest was owed to a taxpayer as a return on an investment in an illegal pyramid scheme. The Commissioner included the interest in the assessment of the taxpayer’s income and argued that the Income Tax Act did not distinguish between obtaining an amount derived from legal activities and from illegal activities. It was common cause between the parties that the taxpayer had not received any amounts in question. The taxpayer, an investor, argued that he had never unconditionally become entitled to the interest and could therefore not be taxed on amounts that had not accrued to him. The scheme was insolvent from the beginning. The money obtained from one ‘investor’, was used to pay a return to the next investor. The operator of the scheme also appropriated money from the funds invested. The Court, per Jansen J, held (at 192H) that ‘I can, however, not come to a conclusion that it could ever have been the intention of the legislature to have a person taxed on income that he never got, or, if he gets it, would lose it in terms of other legislation’.

The Court found the amount of interest not to have accrued to the taxpayer in this matter. This decision appears correct as the case dealt with the accrual of interest only, and with the phrase ‘accrued to’. The Court confined its enquiry to the word ‘accrued’ only, and referred (at 191E-G) to the decision in *Lategan v CIR* (supra) as authority for the fact that the word ‘accrued’ means ‘entitled to’. The investor had to be ‘entitled to’ the interest in the year of assessment concerned in order for it to accrue to him (see *Lategan v CIR* and *CIR v Peoples Stores* as discussed in par 2.1 supra).

Because of the illegal nature of the contract, the Court applied the ex turpi causa rule. According to this rule an illegal contract cannot be enforced (see RH Christie *The Law of Contract* 4 ed (2001) at 459 for further discussion). The interest had not accrued to the taxpayer because he had no legal right (or entitlement) to enforce the pyramid scheme to pay it. The Court applied the decision in *Fourie NO v Edeling NO & Others* ([2005] 4 All SA 393 (SCA) at 410A) in which it was held that an undertaking by the operators of a pyramid scheme to pay returns to investors, was a nullity because the investors obtained no unconditional legal right to enforce the payment of such returns.

The Court in *Income Tax Case 1810* did not consider the phrase ‘accrued . . . in favour of’. It would have been extremely difficult to assign a meaning to this phrase in the circumstances described above. The correctness of the dictum quoted above is questionable. It is not clear from the wording of the Act that it was in fact the intention of the Legislature not to tax a person on an amount which she obtained but would lose in terms of other legislation. It is
accepted that it could not have been the intention to levy tax on an amount that would never accrue to a person, if accrual is always considered to mean ‘an unconditional legal right’. If the second part of the phrase ‘accrued to or in favour of a person’, namely the ‘accrual . . . in favour of’, is given a meaning other than ‘an unconditional legal right’, the outcome might well be quite different.

3.2 Examples of Amounts Included in Gross Income

3.2.1 The Illegal Lottery

In CIR v Delogoa Bay Cigarette Co Ltd (1918 TPD 391), the company sold cigarettes that were worth sixpence at a price of ten shillings. Each pack of cigarettes sold contained a lucky number. An advertisement was placed in each pack which stated that two-thirds of the income earned from the sale of these cigarettes, would be set aside and deposited to a fund from which monthly prizes would be drawn. The company paid two distributions or prizes and was then prosecuted for the illegal running of a lottery. The question before the Court was whether or not the two distributions paid by the company, could be deducted as expenses incurred in the production of income.

The Court held that the legal or illegal nature of the source of income was not decisive in determining its taxability. Any expenses incurred in the production of illegal income would be allowable deductions if they would have been subtracted if the income had been legal (see at 394).

The Court considered the phrase ‘received by, or accrued to or in favour of a person’ because there had to be an income before it could be determined whether or not there could be a deduction in relation to such an income. It held that the Act did not differentiate between legal and illegal reasons for income and neither should a court (see at 395). The Court thus followed a simple approach without any technical or linguistic analysis of the phrases concerned.

3.2.2 The 'Fraudulent' Overcharging of Customers

The Special Tax Court in ITC J624 ((1996) 59 SATC 373) decided (at 380) that the amount by which a trader had fraudulently overcharged his customers, had been received by the trader as taxpayer due to the fact that there existed a contract between two parties and that the amount had been received due to the existence and execution of that agreement (see further also Huxham & Haupt op cit at 12). The amount by which the customers had been overcharged was therefore included in gross income.

The Court did not regard fraudulent overcharging as theft. This makes sense if one applies the basic principles of the law of contract: the buyer always had a choice whether or not to pay the higher price. If customers willingly pay the higher price, it could hardly be regarded as illegal. However,
it may be argued that in appropriate cases intentional overcharging may amount to fraudulent misrepresentation by the seller, which renders the contract voidable at the discretion of the buyer (see further Christie op cit at 313). This should be distinguished from a contract which is void ab initio due to its illegal nature and which is therefore unenforceable (see idem at 452-3; see also Fourie v Edeling supra).

3.2.3 The Operators of a Pyramid Scheme

In ITC 1545 (supra), the taxpayer was a dealer in stolen diamonds who ran a pyramid scheme involving the sale of so-called ‘dried-milk cultures’ that were actually worthless. The Commissioner had included the profits made in terms of these illegal schemes in the taxpayer’s gross income. The Cape Special Tax Court referred to the decisions in Geldenhuys v CIR (supra) and SIR v Smant (supra) with approval, but went even further in its analysis. It held that the use of the disjunctive ‘or’ in the phrase ‘received by or accrued to’, implied that situations may arise where an amount is received but has not yet accrued. It held that a person could receive a salary prior to earning it, but that money received on behalf of someone else could not be received for purposes of gross income.

The Court found that an amount received by a taxpayer for his own benefit and behalf in consequence of a transaction void due to its illegal nature, had been received within the ambit of the definition of ‘gross income’ in s 1 of the Act (see at 474). The Court did not consider the meaning of the word ‘received’ in detail. In my view, the separation of receipt and accrual in the sense of entitlement (meaning an unconditional legal right), was a step in the right direction.

In ITC 1789 ((2005) 67 SATC 205) illegal amounts taken by the operators of a pyramid scheme were considered as having been ‘received’ within the ambit of the definition of gross income. The Court’s reasoning was focused on the intention of the taxpayer. She had run a scheme of profitmaking with a proper business infrastructure. She intended to benefit, and did in fact benefit, from the profits she had created by stealing investors’ money. The Court held that the argument that the illegal nature of the transactions and the immediate obligation to repay the investors had deprived her of all benefit, did not prevent the inclusion of the amounts that had been taken in her gross income. As authority for this argument it placed reliance on ITC 1545 (supra) and the decisions referred to there (see at 212A-C). This was a practical approach and the meaning of receipt was not investigated in such detail as by the Court in COT v G (supra).

The taxpayer in ITC 1789 took the decision on appeal (see MP Finance Group v Commissioner, SARS supra which is discussed in par 5 infra).

4 The Linguistic Dilemma Created by the Courts

The courts have not always applied the meaning of the phrase ‘received by, or accrued to or in favour of a person’ consistently. In some cases there have
also been unwarranted extensions of the meaning of the phrase, which eventually lead to the exclusion of amounts from gross income which should have been included (see, eg, COT v G supra).

The courts employed the question whether a person is entitled to an amount as a test to determine the moment when the amount had ‘accrued to’ a person (see Lategan v CIR supra at 209; CIR v Peoples Stores supra at 363B-D and 367D; Mooi v SIR supra at 684; (see Commissioner for Inland Revenue v Witwatersrand Association of Racing Clubs 1960 (3) SA 291 (A) at 298E). The issues in many cases (at least in the three just referred to) related to the timing of an accrual, not its linguistic meaning or whether or not there had in fact been an accrual. Yet, the courts have applied this test to determine whether there had been an accrual, irrespective of the timing of such a possible accrual.

That renders the meaning of the phrase very narrow as it could in these circumstances only mean to obtain ‘a legal right’ (see CIR v Witwatersrand Association of Racing Clubs supra at 298E and 306B). This narrow meaning may be acceptable for the phrase ‘accrued to’. But in the process the meaning of the phrase ‘accrued . . . in favour of’ had simply been overlooked.

In Lategan v CIR (supra at 209) the Court said that ‘the words in the Act, “has accrued to or in favour of any person” merely mean “to which he has become entitled”’ (my italics). This dictum went much further than stating that an amount had ‘accrued to’ a person at the moment that she had become ‘entitled to’ it. The Court had also found the phrase ‘accrued . . . in favour of any person’ to have occurred when a person become ‘entitled to’. This might have been a mistake or oversight, but its impact had clearly not been considered. There had been no reason on the facts before the Court to include the phrase ‘accrued . . . in favour of’ in this part of the judgment. In short, the phrase ‘accrued in favour of’ should have a much wider meaning than ‘entitled to’ as is the effect of the dictum in Lategan v CIR.

This meaning of ‘accrued to’, which was held to mean ‘entitled to’, was later approved by the Supreme Court of Appeal in CIR v Peoples Stores (supra at 367D; see also CIR v Witwatersrand Association of Racing Clubs supra at 298E).

However, the phrase ‘accrued . . . in favour of’ should not have the same meaning as the phrase ‘accrued to’ in the sense of obtaining a legal right. There is a disjunctive ‘or’ present in this part of the definition, which in my view, implies that the Legislature contemplated two separate types of accrual. There could be an accrual ‘to’ a person in the sense of legally earned income, and/or an accrual ‘in favour of’ a person in a wider sense, which could include income obtained in an illegal manner.

The courts have not only found ‘accrued . . . in favour of’ to mean ‘entitled to’, but have gone even further and applied the test of entitlement to the question whether or not an amount had been ‘received by’ a person (see Geldenhuys v CIR supra at 269; COT v G supra at 168D-F and, indirectly, also CIR v Witwatersrand Association of Racing Clubs supra at 298E; see further the discussion in par 2.1 supra).
If ‘received by’ had been found to mean ‘entitled to’, ‘accrued to or in favour of’ had been found to mean ‘entitled to’, and ‘entitled to’ had been held to mean the obtaining of ‘a legal right’, there would be absolutely no leeway for a court, following these precedents, to find that illegally obtained money could ever form part of a person’s gross income.

It is submitted that an amount may also be received in circumstances where a taxpayer does not have a right to that amount and that this type of receipt should be taxable too. There is nothing in the Income Tax Act which prevents this interpretation of the phrase ‘received by’. The meaning of the phrase should not be restricted to amounts that are received in circumstances where a taxpayer is also entitled to the amounts.

Similarly, the phrase ‘accrued . . . in favour of’ should be given a wider meaning to include amounts that a taxpayer is not legally ‘entitled to’. The courts have not in the past consciously analysed the possible different meanings of the phrases in any detail and that may be why there have been conflicting judgments on the question whether or not illegally obtained funds are subject to income tax.

It should hopefully be clear from this discussion that the time for legal certainty had arrived. The perfect opportunity to clarify the issue at the highest level came in MP Finance Group v Commissioner, SARS (supra).

5 MP Finance Group v Commissioner, SARS

5.1 The Facts

A busineswoman operated an illegal investment business commonly known as a pyramid scheme. She canvassed ‘investors’ who would pay amounts to her in the belief that their investments would yield large returns. For a while she also managed to repay large amounts to the depositors, as so-called returns on their ‘investments’. Her particular scheme operated through a vast array of entities, some incorporated, others not. Eventually all the entities were insolvent. In order to facilitate the administration of the various entities, they were consolidated into one, namely MP Finance Group CC (‘the corporation’) by an order of court. The Pretoria High Court also ordered that all actions that had been taken against the previous entities were to be regarded as having been taken against the corporation. All claims that had been proved against the original entities during the insolvency procedures at the offices of the Master of the High Court, were to be treated as claims against the new, consolidated corporation. As a result of this order, the Commissioner of SARS assessed the corporation for income tax originally due by the respective entities during the 2000, 2001 and 2002 years of assessment. The liquidators objected to these assessments on the basis that the amounts paid to the pyramid scheme had not been ‘received’ within the meaning of the definition of gross income in the Income Tax Act. The Commissioner disallowed the objection. The corporation appealed to the Tax
Court in Durban where the appeal was dismissed (see *ITC 1789* supra). The corporation then appealed to the Supreme Court of Appeal with the necessary leave from the Court a quo (see *MP Finance Group v Commissioner, SARS* at 521H-522F).

5.2 The Legal Question and the Taxpayer’s Arguments

The question before the Court was whether or not the deposits that had been obtained by the corporation could be regarded as having been ‘received by’ it in terms of the definition of gross income, notwithstanding the fact that the taxpayer had operated an illegal pyramid scheme and the deposits were received in the course of the running of such a scheme.

The main argument on behalf of the corporation was that the deposits that had been received, were loans to it by the investors. In law they were repayable at the moment they were granted. The corporation argued that the deposits had never been ‘received’ in terms of the Act. As authority for this argument, it relied on *Fourie v Edeling* ((2005) 4 All SA 393 (SCA)). The Court there found that there could be no relaxation of the in pari delictum potior est conditio defendentis rule if there was no equal guilt or participation in the illegal scheme by the investors. It held that the only option for an aggrieved investor in a pyramid scheme would be to claim a refund by means of an enrichment action, the condictio ob iniustam causam.

The corporation argued that as in *Fourie v Edeling*, it had not become entitled to the deposits because the amounts had not been ‘received by’ it, nor had the amounts accrued to it. It argued that the scheme had no entitlement to the investors’ money because the operation of the scheme and the consequent investments had been illegal, and that the Court could not enforce the illegal contracts. It argued further that the relationship between the parties would be exactly the same as in *Fourie v Edeling*, that the investors would have a claim in terms of the relevant condictio, and that the scheme would be liable to repay them immediately at the very moment of receipt of the deposits. It was for this reason, so the argument ran, that the deposits concerned had not been received by the corporation and could therefore not be included in the gross income of the corporation (see *MP Finance Group v Commissioner, SARS* supra at 523A-E).

5.3 The Decision of the Court and the Ratio

The Court held that the corporation had received the amounts in question in accordance with the literal meaning of gross income as the term was defined in the Act. (see idem at 524E-F).

The Court assessed the modus operandi of the various incorporated and unincorporated entities prior to their consolidation. The scheme had been run in a very convincing manner with seemingly authentic ‘official’ documents in the nature of share certificates, acknowledgments of receipts, and share agreements. These documents had been issued to investors from time to time,
supposedly concerning their ‘investments’. The deposits made by the investors were mostly kept in cash by the operator of the scheme, assisted by her family, employees and the agents that were employed by the scheme to canvass for investors. This cash was used to effect payment to some investors. It was also from this pool of cash that the operators of the scheme had appropriated substantial amounts of money (see idem at 523F-G).

The Court held that it was important that the operators of the scheme had been aware of the fact that it was insolvent, fraudulent and that the scheme would not be able to repay its investors or provide them with the promised returns. From 1 March 1999, the various entities had earned their income by deceiving the public and stealing investors’ money. Because of this intention, the Court found that the deposits had been ‘received by’ the corporation in terms of the Income Tax Act (idem at 524A-B).

The perpetrators of the scheme had accepted the money with the intention of retaining it for their own benefit. This intention was crucial when deciding whether the amounts were in fact received by the corporation. Howie P stated in no uncertain terms (at 524E-F) that

‘it does not matter for present purposes that the scheme was not entitled to, as against the investors, to retain their money. What matters is that what they took in was income received and duly taxable’.

The Court further rejected the contentions based on Fourie v Edeling (supra). It held that the relationship between the operators of a scheme and the investors had been at issue in that case and not the relationship between the scheme and the fiscus. For that reason the case had to be distinguished. The Court found (at 524E) that an illegal contract was not always without consequences and that it could have fiscal consequences as was in fact held in Commissioner for Inland Revenue v Insolvent Estate Botha (1990 (2) SA 548 (A) at 556C-557B).

Therefore, the Supreme Court of Appeal found that when it came to illegal contracts, a separate set of rules applied to their income-tax consequences and their consequences as between the parties involved.

6 Comments

The decision in MP Finance Group v Commissioner, SARS that illegally obtained funds must be included in the gross income of a taxpayer is to be welcomed. However, a few comments may be made with regard to the manner in which the decision was reached.

6.1 The Absence of the Rule of Precedent

It is a pity that the Supreme Court of Appeal did not discuss any of the previous decisions by other courts in dealing with this issue. However, the Court a quo had referred to such decisions and the inference could perhaps be drawn that it regarded the decisions relied on a quo by the Commissioner as correct. Still, it may well have been useful for the parties to have relied on
these decisions in their arguments on appeal so that the Supreme Court of Appeal would have been able to indicate which of those decision had been correct.

6.2 The Intention of the Taxpayer as a Test for ‘receipt’

The Court in MP Finance Group v Commissioner, SARS found that the deposits had been received by the corporation because the operators had had the intention to deceive the public and steal their money (see at 524D-F). One could interpret this as an indication of their intention to keep the funds for their own benefit. The evaluation of the taxpayer’s intention is a very useful tool to determine taxability and the fact that that was the ratio of the Court’s decision is to be commended.

A few remarks may be raised about the manner in which the taxpayer’s intention may be determined in future.

6.2.1 Facts Should be Considered before Fiction

An enquiry to determine the taxpayer’s intention is a recognised test when deciding whether or not a receipt is of an income or a capital nature (see Huxham & Haupt op cit at 22-7; Meyerowitz op cit in pars 8.23-8.71).

It may be incredibly difficult to determine a natural person’s subjective state of mind. A person’s ipse dixit – what the taxpayer says her intention is – is usually balanced by taking objective factors into account when determining the intention (see Huxham & Haupt op cit at 23 and also at 26-7; Meyerowitz op cit in pars 8.23-8.71).

The enquiry to determine whether or not a taxpayer received an amount, should be more objective in cases where an element of illegality is present. The taxpayer’s ipse dixit should be treated with extreme caution in these cases. Where there are facts in conflict with the taxpayer’s evidence, reliance on the ipse dixit should be minimal (see Huxham & Haupt op cit at 23). The presence of a criminal element in the taxpayer’s mindset is an obstacle in establishing her subjective intention. The perpetrator who had fearlessly convinced investors to ‘invest’ in a pyramid scheme, could equally well produce just as many false oral statements or documents in court.

The enquiry to determine the taxpayer’s intention should focus firstly on who has the use of the money, and secondly on who derives the benefit of it. The use of the money for personal benefit is a factual enquiry. This is indeed what the Court did in MP Finance Group v Commissioner, SARS to determine what the taxpayer’s intention had been, and correctly so. On the facts of the case, the money was taken and used as a source of income. The taxpayer’s income-earning activity was to steal money. Its illegality should not influence the tax treatment of the amount received (see Delogoa Bay Cigarette Co v CIR supra at 394; ITC 1545 supra). It should be conceded that no objective enquiry can ever be perfectly objective. Due to the fact that fraud and dishonesty could influence the outcome of the enquiry, the subjective
intention and the ipse dixit of the taxpayer should be reduced to secondary factors which could be taken into account.

6.2.2 Possible Practical Problems

The use of taxpayer intention as a test for receipt could be problematic from a practical point of view. It is conceivable that the operator of the pyramid scheme in *MP Finance Group v Commissioner SARS* initially had the intention to repay all the investors in the naïve belief that her investment scheme had been legal. Would this mean that she had not received the amounts concerned or would it mean that she had received the amounts as an agent on behalf of the investors?

Another problem that could arise is the question which party’s intention must be taken into account? The pyramid scheme in *MP Finance Group v Commissioner, SARS* was run by individuals, incorporated and unincorporated bodies (see par 5.1 supra). The operator’s family members, employees and agents were also involved. The Court did not specify whose intention it considered. It examined the modus operandi of the various entities and concluded from an evaluation of the facts what the intention of these entities had been. It could be problematic to ascertain the (common) intention of the vast array of entities and individuals that were involved in the initial operation of the scheme; indeed, some of them could have been blissfully unaware of the fact that they were involved in the running of a pyramid scheme.

The intention of the individuals, partners, members of close corporations, directors and all others involved in a pyramid scheme or other criminal activity must be assessed. The dominant intention in this analysis should, it may be thought, be that the individuals and entities that had been in control of the group.

6.3 The Possession of Funds by Agents

A relationship of agency, almost similar to the relationship considered in *ITC 1792* (supra), had also been present between the investors and the operators of the scheme in *MP Finance Group v Commissioner, SARS* (supra at 523F-G). It is a pity that the liquidators did not use the argument that the scheme had only acted as an agent on behalf of the investors and could not therefore have received the amounts in question for its own benefit as the Court had held in *ITC 1792* (supra, as discussed in par 2.3.2 supra). This could have raised interesting issues for the Supreme Court of Appeal to consider, especially as far as the intention of the taxpayer was concerned.

The problems that could occur for a principal who was unaware of the amounts in his possession, were illustrated earlier (see par 2.3.2 supra). These problems could possibly be solved by taking into account the law of things, specifically the principles governing possession.

There is possession the moment when a person has the physical control (corpus) of a thing coupled with the intention to possess (animus) (see CG van
der Merwe *Sakereg* 2 ed (1989) at 90). The requirements of corpus and animus do not have to be exercised personally in order for a person to possess a thing. The animus may be exercised by a third party such as an agent (see idem at 112).

For the principal to possess, the agent must have a mandate to possess a thing (or funds, as the case may be) on behalf of the principal and must also have physical control over the thing with the intention to posses on behalf of her principal and not for herself. If these two requirements have been met, the principal will have possession of a thing through her agent even in cases where she is unaware of such possession (see idem at 113).

It is submitted that a principal cannot possess secret profits made by her agent, because the second requirement, namely that the agent should have the intention to possess on behalf of the principal, would be absent. In these circumstances, it is the agent who receives the funds and the profit on her own behalf and for her own benefit. The agent will have the possession of the money, because she has the physical control and use of funds (corpus) as well as the intention to keep it for herself (animus). The agent therefore receives the amount in question for her own benefit.

Any change of intention by the agent, namely from holding or investing funds on behalf of a principal to possessing it for her own benefit, is crucial. A change of intention on the part of an agent should be taken into account to determine the moment when the deprivation of funds or value took place. This should be the exact moment when an illegally obtained amount should become taxable. If the decision in *MP Finance Group v Commissioner, SARS* is applied, receipts should be taxable in the agent’s hands from the moment she changes her intention, from one of investing money on behalf of her principal to one of taking it for herself or earning a secret profit, as that is the moment when she would ‘receive’ the amount for her own benefit or alternatively the moment when it will ‘accrue . . . in favour of’ her.

6.4 The Tax Treatment of Agents and Secret Profits: An Example of Double Taxation?

The question could arise why it should be necessary to levy tax on the agent at all? The eventual tax liability would in any event shift to the principal due to the fact that the funds had ‘accrued to’ her at the moment that it was earned by the agent.

If the argument of the Gauteng Special Tax Court in *ITC 1792* (supra) is followed, the secret profits that had been earned by an agent are not taxable in her hands because it had not ‘accrued to’ her but to the principal. The principal has an unconditional legal right to claim payment of the profits. The principal is ‘entitled to’ the funds because it had been received for her benefit and not for the agent’s own benefit. In this sense the decision in *ITC 1792* cannot be faulted.

In *MP Finance Group v Commissioner, SARS* the Supreme Court of Appeal held that the intention to take an amount must be taken into consideration for
income-tax purposes. If this is applied to the agent that earned secret profit, an
agent will be subject to income tax because the secret profits were ‘received
by’ her with the intention to keep it for herself. The principal had not received
the funds nor is she aware of the fact that it had accrued to her.

This is precisely the problem. Both parties could now be liable to pay
income tax on exactly the same amount at exactly the same moment in time.
The agent and the principal would mostly both have the intention of obtaining
the funds for their own respective benefits. It is conceivable that the same
amount of money could be taxed twice if both these decisions are applied.
Firstly, the agent would pay tax because the amount was ‘received by’ her.
Secondly, the principal would pay tax on exactly the same amount or value
because it had accrued to her at the very moment that it was earned. It is also
conceivable that both parties could argue that they are not liable for income
tax. The agent could argue that although the amount had been ‘received by’
er, she is not liable for income tax because the amount had already accrued
to the principal. The principal could argue that although the amount had
accrued to her, she is not liable for income tax because that amount had been
received by the agent for the latter’s own benefit. The reason for all this: both
‘received by’ and ‘accrued to’ are part of the definition of gross income.

If this scenario is placed before two different courts in two different
provinces (other than Gauteng, of course), the use of decision in *MP Finance
Group v Commissioner, SARS* as authority would not be of much assistance to
any of the parties. The Court did not find that the levying of income tax on an
amount ‘received by’ a person who does not have a right to that amount (such
as a dishonest agent) would prevent the Commissioner from levying income
tax on the person who is entitled to the funds because it had accrued to her.
This may well be an unforeseen result of the finding in *MP Finance Group v
Commissioner, SARS*.

6.5 The Absence of a Lesson in Linguistics

A further disappointing feature of the decision in *MP Finance Group v
Commissioner, SARS* was that the parties did not raise and analyse the linguistic
meaning of the phrase ‘received by’ on appeal. The term ‘receive’ in *COT v G*
(supra at 169E-G) was held to require both the act of giving and receiving.
The unilateral ‘taking’ of an amount was not regarded as sufficient by the
Court. Yet, in *MP Finance Group v Commissioner, SARS* this is precisely what
the Court found to be taxable.

The reason for this linguistic leap is not clear from the judgment. It almost
leaves one with the impression that this amount was taxed for considerations
of equity or as a further punishment for the involvement in illegal activities.

It may be conceded that the depositors in *MP Finance Group v
Commissioner, SARS* ‘gave’ the deposits voluntarily with the intention that the
amounts would be invested by the scheme on their behalf. This would amount
to a relationship of agency as was discussed in *ITC 1792* (supra). The amounts
had not been given to the scheme in circumstances where it could ‘receive’ the money for its own benefit. The line of cases which had dealt with the question of beneficial receipt was also not analyzed. It is submitted that the causa for the ‘receipt’ or ‘taking’ was the act of theft and not the conclusion of the contract and deposits made in consequence of it. This would also explain why the Court focused on the intention of the taxpayer to motivate its decision. A proper investigation into the meaning of ‘receipt’ was required. Taxpayers and the Commissioner could have benefited immensely from the legal certainty such an analysis could have created.

In my view, the entire argument concerning legality should actually be focussed on one phrase, namely ‘received by, or accrued to or in favour of’. The Court did not deal satisfactorily with the question whether or not a unilateral taking constitutes a ‘receipt’ in terms of the Act. To state that the literal meaning must be adhered to (see MP Finance Group v Commissioner, SARS supra at 524E-F) and to apply a literal approach without analysis of what such a literal approach or literal meaning entails, does not provide guidance to future litigants.

Maybe the time has arrived for the Legislature to define ‘receipt’ in such a way that it is distinguished from accrual in the sense of a right to an amount. To equate receipt with accrual or entitlement, as the court did in Geldenhuys v CIR (see par 3 supra), is to undermine the very core of the definition that forms the basis of the entire system of income tax. Similarly, the decision in Lategan v CIR (supra) found ‘accrued . . . in favour of’ to mean ‘entitled to’. While the decision in MP Finance Group v Commissioner, SARS could indirectly be interpreted to have found that entitlement in the sense of a rightful claim is no longer required in order for an amount to have been received by a person, an express finding to that effect would have been preferable.

Alternatively, the phrase ‘accrued . . . in favour of ’ could be used as a basis to include illegally obtained amounts in the phrase ‘gross income’. It has already been mentioned that the courts have found both parts of the phrase ‘accrued to or in favour of’ to mean ‘entitled to’ (see par 5 supra). It is submitted that these terms should not all have the same narrow meaning of a rightful claim, as this would defeat the purpose of having alternative phrases, separated by the disjunctive ‘or’, in the definition of gross income. This narrow interpretation would also mean that no illegally obtained funds could ever be included in the gross income of the perpetrator of a crime.

This could not have been the intention of the Legislature. When interpreting legislation, each word should be given its own meaning and a court has a duty to give meaning to a defining section (see LM du Plessis Re-Interpretation of Statutes (2002) at 202 and 212). The court in MP Finance Group v Commissioner, SARS did not adhere to this duty; the definition of gross income was not given a meaning at all.

In the following paragraphs an attempt will be made to interpret the meaning of the phrase ‘received by, or accrued to or in favour of’.

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7 A Brief Linguistic Analysis

The question for determination is what meaning should be assigned to the phrase ‘received by, accrued to or in favour of’ as it appears in the definition of ‘gross income’ in the Income Tax Act. It is not the purpose of this analysis to investigate the linguistics or the origin of the terminology used in the Act in any detail. However, the nature of the problem discussed earlier does warrant a brief investigation into the meaning of four phrases, namely, ‘entitled to’, ‘received by’, ‘accrued to’, and ‘or accrued . . . in favour of’.

7.1 ‘Entitled to’

‘Entitled’ has been described as ‘having a rightful claim thereto’ (see RD Claassen Dictionary of Legal Words and Phrases 2 ed (2006) at E24; JL van Dorsten Revenue Words and Phrases Judicially Considered (1989) at 273-4). This was the meaning as it related to a trust inter vivos, and not specifically to the phrase gross income. The Oxford English Dictionary (see <http://www.dictionary.oed.com>, visited on 12 Jul 2007) describes the phrase as ‘to furnish (a person) with a “title” to an estate. Hence gen. to give (a person or thing) a rightful claim to a possession, privilege, designation, mode of treatment, etc.’.

7.2 ‘Received by’

‘Received by or accrued to’ has been described as having received in such a way that the person becomes entitled to the amount (see Claassen op cit at R-23 where Geldenhuys v CIR supra is referred to; see also Van Dorsten op cit at 728-33 who refers to further decisions on this meaning).

The Oxford English Dictionary (op cit ) describes receive as ‘to take or accept (a person) in some capacity . . . ; to take for, regard as . . . ; to make use of to have (a thing) given or handed to oneself; to get from another or others . . . ; to have (some quality, attribute, or property) given, bestowed, conferred or impressed . . . ; to take, accept, or get, in various senses; . . . an act of taking; a definite amount taken’.

The description of the verb in this dictionary included the act of taking, which indicates that the analysis in COT v G (supra), in terms of which it was held that a taxpayer had to be entitled to an amount in order to receive it, contained certain shortfalls. The Court was incorrect to find that the act of taking could not form part of the meaning of receipt (see idem at 170A) as is evident from the definition referred to.

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

7.3 ‘Accrued to’

The phrase ‘accrued to or in favour of’ has been found to mean ‘entitled to’ (see Claassen op cit at A-25; see also Van Dorsten op cit at 2-8 for a detailed discussion).
The phrase ‘accrued to’ is no longer problematic after the decision in CIR v Peoples Stores (supra) and has, save for the few comments below, not been investigated in detail.

It is submitted that the phrase ‘accrued . . . in favour of’ should never have been included in this analysis as the Court did in Lategan v CIR (see par 3 supra). The legal questions in the decisions discussed above which considered the question of accrual, dealt with the question when an amount could have been considered to have accrued (in other words, the timing of the accrual); they did not investigate the meaning of the entire phrase and did not decide whether or not there had in fact been an accrual.

‘Accrual’ should not be given too narrow a meaning in the sense that it is interpreted only to mean the obtaining of a rightful claim to an amount. That meaning should be limited to the phrase ‘accrued to’.

7.4 ‘Accrued . . . in favour of’

Van Dorsten (op cit at 402) usefully observed that

‘while the words “in favour of” would appear to allow a more extended application than the word “to” in the phrase “accrued to or in favour of”, “to” being more direct, nevertheless both “to” and “in favour of” depend upon there being an accrual’.

The Oxford English Dictionary (supra) describes the meaning of the verb ‘accrue’ to mean

‘to fall (to any one) as a natural growth or increment; to come by way of addition or increase, or as an accession or advantage . . .; to arise or spring as a natural growth or result . . .; to grow or arise as the produce of money invested . . .; to grow, grow up . . . gather up, collect . . .; to gain by increment, to accumulate’.

It describes the phrase ‘in favour of’ to mean

‘to the advantage of . . .; in consideration of, for the sake of . . .; to indulge (oneself, a feeling) . . .; to indulge with permission (to do something) . . .; to indulge or oblige (a person) with something . . .; to prove advantageous to (a person) . . .; to attended with advantage or convenience . . .; facilitating one’s purpose or wishes . . .; advantageous, helpful, suitable’.

It is certainly conceivable that the operator of the scheme and her accomplices in MP Finance Group v Commissioner, SARS (supra) ‘collected or gathered’ money to ‘facilitate their own purposes or wishes’. If the extended meaning of the phrase is employed (as suggested by Van Dorsten op cit at 402), the proceeds of illegal activities will definitely fall within the ambit of the definition of gross income. There is no indication in the meaning of the words that illegally obtained funds cannot ‘accrue . . . in favour of’ a person as a natural growth or natural result of an activity, even if illegal.

The phrase ‘accrued to or in favour of’ is separated into two parts by the disjunctive ‘or’. This should not be ignored. It could be inferred that the Legislature contemplated that an amount could accrue to a person or also accrue in favour of a person. The phrase ‘accrued . . . in favour of’ should be given a wide meaning so that amounts that were obtained as a natural result of illegal activities are included in the gross income of a taxpayer on this basis.
There would be a ‘growth’ in the estate of the perpetrator when possession of the proceeds of crime is taken. This growth should be subject to income tax.

8 Conclusion

The fact that amounts paid to an illegal pyramid scheme is considered to be ‘received’ for purposes of gross income, as decided in *MP Finance Group v Commissioner, SARS* (supra), must be welcomed. The Court has managed to separate the requirement of entitlement, or accrual in the sense of a rightful claim, from the ‘receipt’ of an amount.

It is submitted that the use of the phrase ‘accrued . . . in favour of a person’ provides a logical solution to be applied in the event of illegally obtained funds. The Commissioner should be entitled to levy income tax on amounts obtained by a person if she has gained use of those funds in her favour or received it for her own benefit. This should be a factual enquiry and each case should be considered on its own facts.

The intention of the taxpayer should be used to determine the moment when an illegal amount was beneficially received by, or had accrued in favour of, a taxpayer. The change of intention by an agent from holding funds on behalf of a principal to holding it for her own benefit will indicate the changed relationship within a pyramid scheme from one of agency to possession for the benefit of the scheme or the perpetrator personally.

The controversy raised by this decision will become apparent once its further implications are realised by SARS and by taxpayers. Is the decision authority for the statement that the proceeds of all types of illegal activities must be included in gross income, or should it apply only to the proceeds derived by means of illegal pyramid schemes? Are the deductions of salaries and other expenses incurred in the production of this illegal trade, allowable? How far will the authorities go to collect illegal income? Once the collection of such income has taken place, the ‘illegal’ amounts been confiscated from the perpetrators of the crime, and the initial owners repaid, will the amount that was so repaid be included in the gross income of the original owner for a second time, or not? And, if included, will it be regarded as a receipt of an income or of a capital nature? All this remains to be seen. Having to argue and determine these matters will certainly not be easy. One could well end up arguing in circles, and get caught up in linguistic contradictions which lead to unrealistic practical results. At present *MP Finance Group v Commissioner, SARS* is the leading authority on whether or not illegally obtained funds should be taxable. Unfortunately the reasons for and reasoning behind its decision could have been valuable tools for students, academics, practitioners and the Commissioner and could have been relied on in future cases based on the same or similar facts. Yet, although the Court in principle reached a correct result, it does seem that this was one decision where the end result did not necessarily justify the means required to reach it.

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*LEGALITY AND INCOME TAX*