AN EXPLORATION OF THE TAXABILITY OF INCOME DERIVED FROM ILLEGAL ACTIVITIES IN SOUTH AFRICA

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DECLARATION

I, **Andisiwe Sibulele Madubedube**, declare that the work on which this dissertation is original, (unless where acknowledgments indicate otherwise) and that no part of it has been, is being, or will be submitted for another degree at any other University or Institution. It is hereby presented in partial completion of the requirements for the award of the Master of Accounting in Taxation degree.

Andisiwe S Madubedube (21959479)

Signature

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ABSTRACT

This study aimed to explore the taxability of income derived from illegal activities in South Africa. The issue of whether or not income earned by a taxpayer as a consequence of illegal activity should be deemed income received by the taxpayer has caused controversy in South Africa and elsewhere in the world. According to the definition of "gross income", it has been found in a number of studies that a person can be subject to taxation based on either their receipts or their accruals. Gross income is what is required by South African Revenue Services from every taxpayer to declare all of his income in his tax return, including money from unlawful activities such as proceeds from the fraud. The rationale of this study was to tighten the present law on unlawful income taxation by determining and comprehending the appropriate technique for the courts to use in evaluating whether a taxpayer has 'received' illicit money for gross income purposes. This study was a qualitative, non-empirical investigation of the taxability of income earned through unlawful activities. In order to construct a hypothesis, the study used an inductive research approach to produce meaning from the data set acquired by identifying patterns and linkages. The inductive approach, on the other hand, allows the researcher to formulate the problem under review research using an existing theory, as was the case in this study. The study identified tools that allow tax authorities the power to have access to all taxpayers' financial information that could help in identifying their income for taxation purposes. The findings of the study include that, in all jurisdictions, income is regarded as taxable income if it falls within the definitions of taxable income, regardless of the nature of its legality. The significance of the study suggested enacting a legislative measure to ensure a more united, uniform, and effective strategy to tax unlawful money. And it is also critical in tightening the present legislation on illegal income taxation in identifying and analyzing the suitable methods for assessing whether the taxpayer has 'received' illegal income for gross income purposes. . The rules controlling taxation must be viewed in the context of other legal concepts, particularly the Constitution of the Republic of South Africa (the Constitution) is the country's supreme law.

Keywords: gross income; illegal income; received by or accrued to.

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CHAPTER ONE

ORIENTATION AND BACKGROUND OF THE STUDY

1.0 Introduction

The debate over whether income received by a taxpayer while engaging in illegal activity should be considered income for the purposes of calculating that person's gross income has occurred both in South Africa and abroad (Franklin, 1907:69). Various jurisdictions have reached varying conclusions about the aforementioned topic (Muller, 2007:166). The definition of "gross income" makes no reference to the legality or illegality of "receipts" or "accruals", since the law does not specify how unlawful income should be taxed, it is necessary to look into how the courts have handled tax disputes involving theft in order to understand how illegal revenue derived from theft should be taxed. This chapter discusses the research's background and problem statement, as well as the study's aim, objectives, significance, and structure.

1.1 Background to the study

Gross income as defined by Haupt (2021:16) refers to: *"any year or period of assessment*:

(i) *in the case of any resident, the total amount, in cash or otherwise, received by or accrued or in favor of such resident; or*

(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 favor of such a person a source within the Republic, during such year or period of assessment, excluding capital receipts or accruals*."

The issue of subjecting "*income received by and accrued to"* a taxpayer through illegal activities to income taxation has remained debatable globally and locally over several years (Warchol and Harrington, 2016:27). The "*CIR v Delagoa Bay Cigarette Co. Ltd (1918) TPD 319*" the taxpayer was a business that sold cigarette packages. One batch of these packets had a hefty price increase. A numbered voucher that entered the purchaser into a drawing for a monthly reward was included in each packet in the batch. The question was whether the taxpayer's allocation of two-thirds of the inflated price for prize distribution would be considered part of its gross income given that the money had been collected in violation of a

law governing lotteries. According to the ruling, the exchange between the taxpayer and the buyers of the cigarettes amounted to a sale, and the company's prize giveaways were not price refunds. This was because some purchasers received no prizes, while those who did, received more than they had paid for the cigarettes. There was therefore a receipt that was taxable, and its taxability was not affected by its illegality. While evaluating whether an amount is considered income or not, it is not taken into account whether the conduct was illegal, immoral, or supra vires. Additionally, section 23(o), which prohibits the tax benefit for costs made in the payment of civil penalties or in the investigation of corrupt actions, is a good example of how this prohibition is put into practice (SARS, 2017:1). The deductibility of the expense will lead to under-taxation and perpetuate the avoidance of tax-paying by the tax avoiders. Hence, this study aims to contribute to the ongoing discourse on the efforts to strengthen the country's tax revenue collection system by exploring the taxability of illegally generated income in South Africa.

The Income Tax Act, 58 of 1962 guides tax authorities in assessing a taxpayer's taxable income. The computation of income and expenditure is the beginning point for determining tax liability. According to the concept of "gross income," a person may be subject to taxation on either their receipts or their accruals. This is the situation due to the fact that the Act includes a definition of "gross income" as an integral component. As was said before, the Income Tax Act does not contain any particular provisions that provide for the taxation of profits made through illegal activities. As a consequence of this, the courts were tasked with determining whether or not the definition of "gross income" in section 1 of the Act applies to the funds at issue in each specific instance. However, the number of examples that have dealt with this issue is limited says Goldswain (2008:144). Both New Zealand and Australia have regulations that regulate how taxes should be applied to stolen items (Nyakanyanga, 2017:7). Before these legal developments, the concept of constructive trust that was in place in New Zealand and Australia made it impossible to tax money that had been stolen. The courts in New Zealand and Australia applied the constructive trust concept, which provides that if a taxpayer has a clear agreement to return or hand over a quantity of money to another person, then that money does not belong to the taxpayer and is instead the property of the other person (Olivier, 2008:817). In South African law, there is still some ambiguity regarding the basis on whether proceeds from stealing, as opposed to proceeds from other criminal activities such as fraud, may be subject to taxation. This is in contrast to other criminal crimes, such as fraud.

However, it is still disputed whether revenue obtained from unlawful activities should be included in gross income or not, and the subject is currently debated internationally. In the United States, the Constitution's Sixteenth Amendment grants the Congress of the United States of America the authority to levy and collect taxes (Sixth Amendment to the United States of America Constitution). In a number of judgments going back to the 1920s, American courts have debated whether revenue from illegal activity qualifies as taxable income and the courts have determined that money earned through illegal activities constitutes as gross income that can be taxed. (Bittker, 1974:135). There are currently provisions in the Australian Income Tax Assessment Act of 1997 and the New Zealand Income Tax Act of 2007 that deal specifically with the tax repercussions of the loss suffered by theft victims and how the proceeds of theft in the hands of thieves should be treated for tax purposes. However, the concept generally permits the Commissioner to disregard any constructive trust difficulties or any responsibility on the part of the criminal to restore the stolen money to its rightful owner and to treat the money as taxable income in the thief's hands (Gupta, 2008:110).

In South Africa, the income tax is levied under the Income Tax Act 58 of 1962, which was enacted in 1962 (the Act hereafter) and is divided into 112 sections and 11 schedules (SARS, 2018:1). The Act, introduced in 1914 has gone through numerous amendments and consolidations (Haupt, 2019: 5). Section 1 of the Act defines 'income' as, "*the amount remaining of the gross income after deducting any amounts exempt from normal tax under Part I of Chapter II"* (Republic of South Africa, 1962:26). These amounts include accrued to and 'received by' (Khumalo, 2015:14). Nevertheless, the Income Tax Act does not provide definitions for these terms, and countries that have a similar tax system as South Africa has been subjected to judicial law for definition.

"Accrued to" means "*the person must have become entitled to the amount in question for it to form part of the gross income*" (SAICA, 2019:17). After years of debates and deliberations about the meaning of the word 'accrual', that is, as to whether it meant 'entitled to', or 'due and payable'. In *CIR v People's Stores (Walvis Bay) (Pty) Ltd 41990 (2) SA 353 (A), 52 SATC 9,* the taxpayer was a clothes retailer in People's Stores, a division of the Edgars group of businesses. The taxpayer operated a business that involved the sale of products using a "six-month revolving credit plan." In accordance with the plan, the client was required to make six equal payments to the taxpayer. The amount of unpaid installments in the taxpayer's records as of the last day of the assessment year in question was R341 281. This sum was due in the

assessment year after that. This sum was added by the Commissioner to the taxpayer's gross income for the assessment year. It was decided that an amount accrued to the taxpayer when he becomes (unconditionally) entitled to it, but that something must be deducted from the face value of an accrual that is receivable in a future year of assessment.

In essence, even though a contingent right has a monetary worth at the moment it is acquired, the ruling, in this case, confirmed that it is not a vested right and cannot be considered an amount ''received by" or "accrued to" for the definition of "gross income". But it is important to distinguish between a delayed right and a dependent right. A delayed or postponed right that is vested in the legal sense of the word and does not depend on the happening of an uncertain future event is not dependent. For instance, as a nice gesture, a business agrees to double an employee's salary on December 24, 2021, without any restrictions. The employee's right does not depend on anything. As a result, it is a vested right whose enjoyment is put off or postponed until a future time. If a *spes* has accrued to the taxpayer, it must be valued in order to establish the amount to be included in gross income, according to *Mooi v. SIR 1972 (1) SA675 (A), 34 SATC 1*, where the Palabora Mining Co Ltd, the employer of the appellant who at the time held the position of Mine Secretary, offered him the option to subscribe for 500 ordinary shares of the business at a price of R1,25 per share on July 25, 1963, subject to certain restrictions. An employee received an option from the company to purchase shares at a set price, but this option could only be exercised later after meeting a set of requirements. The grantee must still be working on the company's project or be an employee of the company on the day that the benefit from the option grant begins to accrue, fixed by the condition of option exercise. Cost of the benefit to be the difference between the price payable for the shares and the market price on the date the benefit accrued; the causal relationship between the benefit and the services provided to the company; and the fact that the taxpayer was employed at the time the benefit accrued, which established the basis upon which the option could be exercised. Established by the fact that the taxpayer was employed on the accrual date. There cannot be an amount to be included in the taxpayer's gross income if the right has no value or cannot be valued. Unfortunately, none of the Act's provisions can be used to support these arguments, but they might succeed in court.

The current definition of "gross income" in its present form is inadequate. It is unlikely that it will be changed very soon to reflect the reality of the commercial environment as public infrastructure and government services are seen as crucial to economic growth as the money

will be included in the basket to render service to its citizens. In many developing nations, a lack of public services hinders economic progress and living standards (Akinyosoye, 2010:49). Income tax revenue is considered one of the contributors to the public infrastructure. The unprecedented health and economic crisis that developing countries are currently experiencing will cause additional development challenges in tax collection from illegal income. The government must begin to respond by utilising all available means to discover such revenue.

Significantly, in recent years, intellectual and political discussions on increasing finances and aid have highlighted concerns that tax fraud and avoidance may threaten developing countries' ability to fund their public sectors (Gurtner, 2010:189). Gurtner further reports that a developing country has a low economic output compared to other countries. However, the phrase 'low economic output' has no commonly acknowledged definition.

The legislative mission of the National Treasury is based on Section 216 (1) of the Republic of South Africa's Constitution of 1996, which supports the establishment of a national treasury to promote transparency, accountability, and sound financial controls in the administration of the country's public finances, as well as the detection of illegal income.

1.2 Statement of the problem

The South African tax revenue collection system has been losing an enormous amount of revenue due to its inability to capture the full income generated by the taxpayers, specifically, income generated through illegal activities as they seem to be neither easily detected nor voluntarily declared. Furthermore, the Income Tax Act 58 of 1962 (as amended) ('the Act'), does not provide a clear guideline on the taxation of income from illegal activities, and because of this, clarity on this phenomenon was, and can only be decided by courts. As such, there is a need to assess the effectiveness of the available tools used by tax authorities to proactively detect illegal income-generating activities. Despite various efforts by the country's tax revenue collection authorities to improve the efficiency of the system, there seems to be a challenge to capture the totality of the gross income including the illegally gained. According to the provisions of Section 1 of the Income Tax Act, a non-resident is required to pay tax on income received from a source in South Africa or from sources other than capital receipts and accruals if the income is considered to be gross income (Haupt, 2019:17). While South African residents must pay tax on income derived from a South African source or considered sources other than receipts or accruals of a capital nature in their tax assessment, an individual should include all

receipts or accruals of income for that particular period, to calculate his tax liability (Haupt, 2019:105) if South African taxpayers do not do likewise, that would be considered as tax evasion.

As shown in figure 1.1. below, tax evasion can be described as involving the use of deceit and fraud to reduce tax liability through activities such as the exaggeration of expenditures claimed as deductions and the non-disclosure of income. (Finer and Ylonen, 2017:70). On the other hand tax avoidance is prima facie lawful and can be achieved through postponement, reduction, or avoidance of a taxpayer's liability for tax through a variety of means that are considered to be lawful and also within the rules of the law in the South African context (Maina and Paranta, 2017:114).

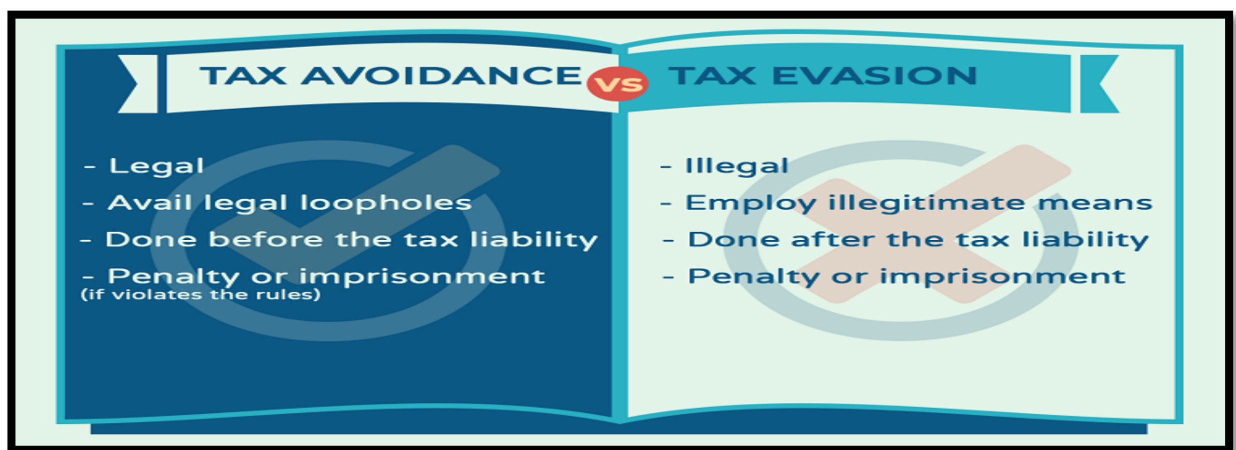

Figure 1-1: Tax avoidance and tax evasion

Source: Bbcincorp (2021:2)

It has long been accepted by the courts in many countries, including South Africa that tax avoidance is a legitimate activity that a taxpayer is entitled to pursue including illegal income. As such, this study aims to explore the taxability of income illegally gained in South Africa. In doing so, it seeks to contribute to the phenomenon relating to the income received by any taxpayer to strengthen the country's tax revenue collection system by exploring the taxability of illegally generated income in South Africa. The research gap can be combated by employing using the necessary tools to detect illegal income. Additionally, if they can be made accessible, cost-effective technological solutions that stop and detect this kind of tax evasion and tax fraud should be made available to tax authorities.

1.3 The research aim

The aim of this study is to explore the taxability of illegally generated income in South Africa.

1.4 The research objectives

1. To assess the effectiveness of the available preventive measure used by tax authorities to proactively detect illegal income-generating activities.
2. To explore the factors that contribute to the non-collection of tax revenues from illegal activities in South Africa.
3. To analyse accruals gained through illegal activities.
4. To compare how the two international countries, namely the United States, and Australia, with South Africa in the collection of income from illegal income.

1.5 The research questions

- Are the available tools used by tax authorities to detect illegal income-generating activities effective?
- What are the factors that contribute to the non-collection of tax revenue in South Africa?
- What are the illegal accruals that are gained through illegal activities?
- How do the two international countries, namely the United States and Australia, compare with South Africa in the collection of income from illegal income?

1.6 Significance of the research

This research is critical in tightening the present legislation on illegal income taxation in identifying and analyzing the suitable methods for assessing whether the taxpayer has 'received' illicit money for gross income purposes. The vertical application argument, which is based on the state's responsibility to defend people's fundamental rights against violations, is one way that this work contributes to the discussion about how the Constitution affects tax law. The objective is to formulate some suggestions on how taxpayers can use their rights under the Bill of Rights to avoid implicating themselves in unlawful activity. The objective is to additionally provide other suggestions, including potential legislative immunity, that will successfully end the existing circumstance.

The tax revenue collection system has generally been losing enormous revenue due to its inability to capture the full income generated by the taxpayers, more specifically, income generated through illegal activities which seems not to be existing within the scope of taxable income.

1.7 Research methodology

This study will be a qualitative, non-empirical investigation of the taxability of income earned through unlawful activities. According to Benzo, Mohsen, and Fourali (2017:70), qualitative research is an interpretive and naturalistic technique, in which qualitative researchers explore items in their natural environments with the goal of making sense of or interpreting occurrences in order to understand the meaning attributed to them. The qualitative research design is suitable for this study because it enables the researcher to get a more detailed understanding of the phenomena of interest, and also to understand unusual situations that could not be explained through large-scale quantitative methods (Houser, 2019: 64).

This study will make use of secondary data; such as legislation, scholarly and or journal articles, regulations, case laws, books, and credible internet sources, on the topic to conclude, and contribute a broader comparison to what is already available in the literature. Secondary data is data collected by other researchers for another purpose which is useful in indicating deficiencies and gaps in the existing literature and is cost-effective (Hair *et al.,* 2015: 119). The inductive approach is considered relevant for this study as it allows the researcher to construct a theory from his/ her findings. In this study, exploratory research was considered because of its characteristics that allow the researcher to learn more about a topic that has received little attention in the literature, and allowing participants in the study will help the advancement of new information in that subject (Hunter *et al.,* 2018:1). As a result, it is a preliminary research tool that provides a theoretical or hypothetical understanding of the research problem.

1.8 Limitations of the study

There are insufficient available materials, especially textbooks on this subject, therefore case law will be the main source of literature for this study. The available sources will be accessible easily through the online databases of the university

1.9 Structure of thesis

The research is divided into the following chapters:

1.9.1 Chapter one – Introduction

The introduction of the research captures the research context, the research problem, and aim, a brief literature review, research methods, limitations of the study, and lastly, the overview of the thesis.

1.9.2 Chapter two – The taxability of income from illegal activities.

This chapter will focus on the taxability of income from illegal activities. Theories and cases will be included.

1.9.3 Chapter three – A comparison of taxability of illegally obtained income between International countries and South Africa.

The study will examine South African judicial cases and expert views on the taxability of illegally gained income, juxtaposing them with some international court cases.

1.9.4 Chapter four – Research Methodology

This chapter concentrated on providing a background of the study. The methodology that will be used, the selection of cases, and sources used.

1.9.5 Chapter five - The tools to detect activities that generate illegal income.

This chapter will identify and make recommendations on the tools the tax authorities can use to proactively detect illegal income-generating activities.

1.9.6 Chapter six – Conclusion of the study

Chapter six will summarise and conclude the research, and suggest further areas of research.

CHAPTER TWO

THE TAXABILITY OF INCOME FROM ILLEGAL ACTIVITIES

2.0 Chapter overview

The preceding chapter concentrated on providing a background of the study. The problem that is being addressed and the aim of the study, the methodology that will be used, and the discussion of the theories which relate to evading tax.

2.1 The theoretical perspective

Theories are collections of key assumptions that are used to explain and grasp occurrences, as well as to check and validate present knowledge (Khlif and Achek, 2015:490). To understand the taxability of income derived from illegal activities phenomena, the theoretical positions are explored from the lenses of the formal rational theory. Before the study provides a detailed explanation of each theory reviewed, the diagram below provides a summary of the theories around the taxability of income derived from illegal activities and the anchor theory to this study is the Rationality theory as it encompasses all the factors mentioned on the other three theories.

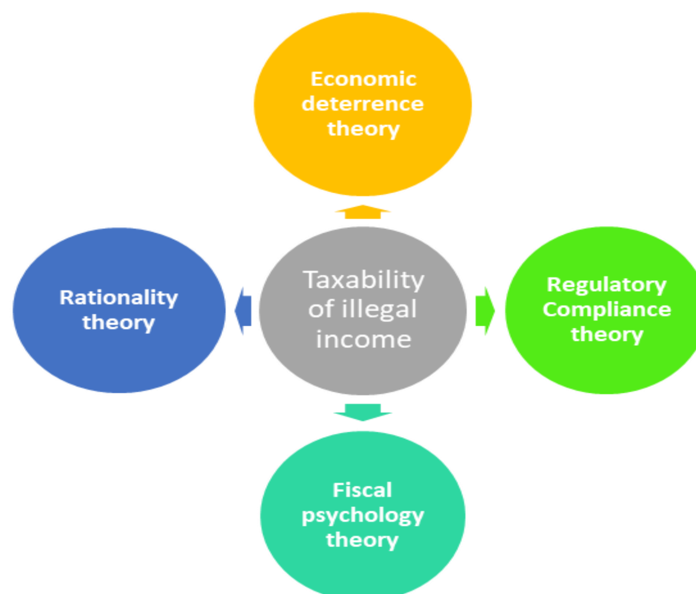

Figure 2-1: Theories of taxability of income derived from illegal activities.

Source: Redesigned by the researcher

2.1.1 Economic deterrence theory

The development of economic deterrence theory began with a brief intellectual history, focusing on the work of two Enlightenment philosophers, Cesare Beccaria and Jeremy Bentham (Wright, 2010:1), who set the conceptual groundwork for later deterrence and rational choice theories in the 18th century as both an explanation of crime and a method for reducing it. Additionally, classical criminologists argued that crime was not only an attack on an individual but society as well and also proposed that criminals would choose to breach the law only after weighing the dangers and benefits of their activities (Wright, 2010:1). The economic deterrence theory appears to function on these three crucial elements in progressive increments: severity, certainty, and quickness. First, there will be a deterrence effect by ensuring, or at least giving the public the idea, that their crimes will not go unpunished.

The economic deterrence theory's underlying premise is that factors such as honoring tax commitments, and the possibility of detection and corresponding penalties for evasion impact a taxpayer's conduct (Allingman and Sandmo, 1972: 324). The theory is still relevant in certain circumstances and it emphasizes that the amount of difference between the social and private value of consumption of illegal activities influences optimal public spending on arrest and conviction of illegal suppliers. When demand is inelastic, enforcing any prohibition does not make sense until the societal value is negative, not just lower than the private value so the elasticity of demand for these goods is also important (Hall, 2022:1).

As a result of enforced punishment, only a small proportion of a tax-paying population will be willing to break their commitments if detection is possible and penalties are high. It is important to keep in mind that the anticipated incidence of voluntary tax evasion will be fairly high if tax audit prospects are limited and imposed fines are ineffective, contrary to popular beliefs when the economic deterrence theory is used.

The Economic deterrence theory, in particular, predicts a high level of violation of tax laws. Even though this concept has been criticised for excessively advocating for coercive compliance motive rather than the conventional norm of consensus. There is sufficient data to demonstrate the importance of deterrent measures as a remedy for low compliance levels (Rupp, 2008:67). For example, the fear of being arrested or of being discovered has been shown in some cases to be effective way of motivating people to tell the truth.

Furthermore, this theory is based on the idea that if an individual recognizes that the net penalty of committing a crime outweighs the associated positive gain of the crime, deterrence from freely engaging in the wrong would be increased (Durrant, 2013:288). This assumption is predicated on the idea that each taxpayer is well-versed in the distinctions between right and wrong, as well as the consequences of wrong or criminal activity. According to the developers, Cesare Beccaria and Jeremy Bentham of the economic deterrence model, people choose whether to follow or break the laws depending on the expected benefits and costs of their actions.

While prisons are successful at incarcerating people and getting criminals off the streets, they are unable to dissuade future criminal activity, especially when harsh terms are imposed (Nagin, 2013:2). As a result, this hypothesis would be less applicable to this research. Prisons, on the other hand, may have the opposite effect: jailed persons learn more successful criminal tactics from one another, and time spent in prison may desensitize many people to the danger of additional incarceration, as exemplified by the case of a guy who was sentenced to life in prison (Durrant, 2013:288). This argument is irrelevant to this research since laws and regulations intended at preventing crime by increasing the severity of penalty have been found to be ineffective, in part because criminals are uninformed of the punishments for specific violations.

2.1.2 Regulatory compliance theory

Gary Becker and Georges Stigler developed the regulatory theory with the view that inspections and other actions are used to assess compliance. When the regulated community fails to comply or remediation is required, enforcement actions are taken (Fiene, 2016:7). The major elements determining compliance, according to social learning theory, are peers' opinions and the amount of social influence an individual has encountered. There are two fundamental perspectives on compliance in the sociology literature: instrumental and normative (Tyler, 1990: 45). Over the last 40 years since the 1970s, the Theory of Regulatory Compliance has evolved. It is more important now because the necessity for greater or less control has become politically contentious. What distinguishes the theory is its emphasis on selecting the correct rules rather than having more or fewer rules, as well as the nature of these rules as being highly predictive of positive outcomes when followed. Regulatory compliance theory is goal-oriented. Answers are seen as approximate signals of satisfaction for genuine response processes by defenders in an attempt to agree with the Weberian approach to characterising behavior. At the end of the nineteenth century, Max Weber, a German sociologist and author of The Protestant

Ethic and the Spirit of Capitalism (1905), was the first to use and explain the word bureaucracy. The Max Weber hypothesis, or bureaucratic management theory, is another name for it. He felt that bureaucracy was the most efficient way to build up an organization, administration, and organizations. Bureaucracy, according to Max Weber, is preferable to conventional organizations. In a bureaucratic organization, everyone is treated equally, and each worker's division of labor is firmly demonstrated (William, 2020:2). Several intuitive analyses have been conducted on this assumption by Max Weber. Important problems about whether the approach works and treats everyone equally have remained unaddressed to this point, which has had a constraining effect on the compliance model's further growth (Valeria, 2004: 150). Furthermore, Erick (2007: 25) believes that people who understand advanced compliance theories see compliance as a "planned" rather than an "automatic" response as stated by the above two authors Valeria and Erick call for attention.

The compliance theory takes into account the several individuals, institutions, and connections that affect compliance (Orozco, 2020:244). Furthermore, Craigie, Snijman, and Fourie (2009a:41) emphasise the importance of compliance by South African Revenue Services as it makes government and legislation to be meaningless. This applies equally to environmental non-compliance which includes unlawful harvesting of protected species, illegal dumping, non-compliance with permission, or failure to meet authorisation conditions are all examples of illegal activities (Kidd, 2011; Craigie et al., 2009b:22). Empirical evidence supports the notion that a combination of physical, psychological, and normative targets may influence compliance and noncompliance behaviors. Karingi et al., (2005:7) provided an example of a regulator that could be concentrating on increasing his profits, protecting himself from any potential losses, enjoying himself, and responding to compliance appropriately all at the same time. Like non-compliance behaviors are seen as an example of money laundering that is a significant risk. Non-compliance behavior is another use of illegal techniques to avoid paying taxes that must be paid legally. On contrary, Machogu and Amayi (2013:14) suggest that the stated goals of compliance may not necessarily convert into a universally agreed utility criterion. These pressures have an effect on each unit and can be used to explain compliance-related behavior at all levels of the system. The regulatory compliance effort aims to help Member Nations to improve the effectiveness and efficiency of public policies implemented through regulation and other policy tools. Additionally, Erick (2007:33), compliance is seen as a "planned" rather than an "automatic" response by those who have advanced compliance theories.

For a compliance theory to be useful, it has to justify the empirically documented conduct of tax controllers in enacting many, disparate targets at the same time (Jayapalan, 2003:152). The compliance will help in combating the illegal activities that will lead to no taxability of income.

There have been numerous theories presented as solutions to this fundamental challenge, but the majority of them have been shown to be inadequate. The recommendation is to combine various formulations of response, as indicated in figure 2.1 below. As can be seen, the proponents of compliance theories have made a popular and substantial contribution.

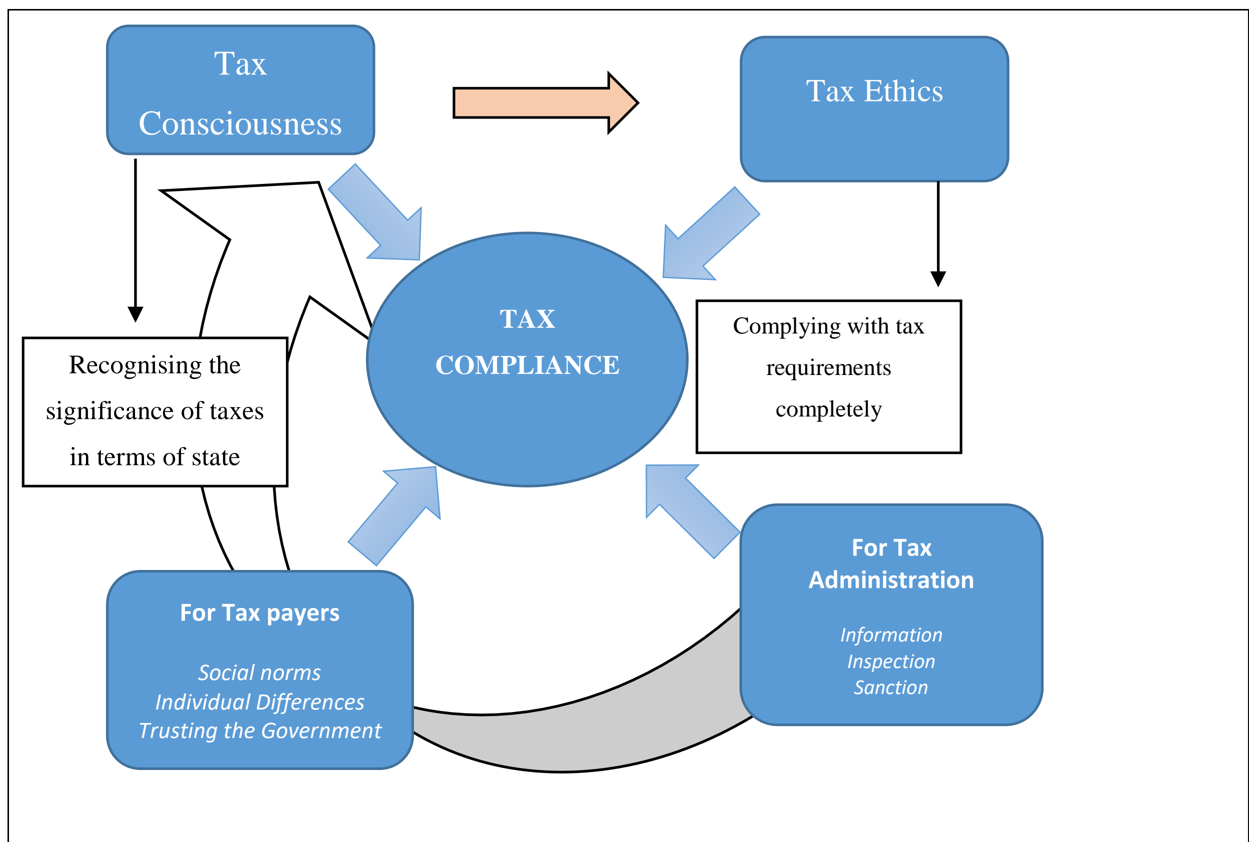

Figure 2-2: Forward-reverse connections of tax compliance.

Source: Saracoglu (2017:4)

As illustrated above, each theory has its position but is linked to the compliance theory somehow. When taken as a whole, assuming that the people that comply and non-comply help the regulatory function of the government entails directing firms to follow a set of regulations in order to regulate various business and economic activities when it comes to taxation of illegal income.

Machogu and Amayi (2013:33) made a comparison of the two statements which are the most well-known examples. It combines two different concepts which are compliance and non-compliance: the emphasis is on the concept of rational choice theory (game theory) in mutual transactions, the opportunistic appeal of failing to comply is likely to be outweighed with norm internalisation. The reflection of the various advances in the regulatory literature is regarded as a compromise stance between the logic of consequences and the logic of appropriateness. Taxpayers need to understand the regulatory policies so that they cannot compromise the system and end up engaging in illegal activities. Furthermore, Fiene (2016) states that despite the fact that the research comes from the human services field, this theory has implications for all rules, regulatory, and standard formulation across the human service and economic domains (Fiene, 2016:7).

2.1.3 Fiscal psychology theory

Simanjuntak and Mukhlis (2012:35) claim that the tax compliance theory is where the taxpayers concentrate on psychological aspects such as moral and ethical considerations. The Theory of Planned Behaviour, created by Ajzen (2011:12) in the 1970s, is one of these ideas. This theory aims to explain why people behave the way they do.

According to the literature, the theory was developed by Fishbein and Ajzen (2005:33). The founders of this theory’s main emphasis were on individual behaviors within society, which begin with certain objectives that need to be met. The motivation for appropriate behavior determines an individual’s ability to engage in behaviors (behavioral intention). Attitudes toward the activity, subjective norms, and perceived behavioral control significantly influence behavioral intention. These three components are influenced by behavioral beliefs, normative views, and control beliefs. As a result, the taxpayer's morality and ethics lie at the core of this concept. According to the theory, a taxpayer may comply even if the possibilities of being detected are slim. Rather than relying on increasing inspections and penalties as a remedy to compliance problems, psychological theories emphasize modifying individual attitudes towards tax systems. As long as the compliance tax law system is operating for everyone and supporting programs and services that improve people’s lives, taxpayers are likely to comply. Keeping the regulations clear and basic, is one technique to encourage compliance. Tax regimes that are overly complicated seem to be linked to a high rate of tax evasion.

2.2.4 Rational theory

The Formal rationality theory by Max Weber (1922:1) is employed as the central theory for the current study. Weber used the idea that is defined by (Sager and Rosser, 2009:4) which is a concept of formal rationality that was derived out of his desire to find a solution to the question of how the formal world operates. The rational theory for this study will be deployed as some form of inquiry focusing on the behavior of a taxpayer. Individuals have choices to choose from such a lifestyle that they want to adopt or feel relevant for their capabilities to execute (Kreiss, Finn and Turner, 2010:2). The Rational choice theory proposes that people will always make sensible, prudent, and logical judgments. A taxpayer choosing to buy a stock over another because they believe it will provide a better return knowing that it is illegal and will lead to tax avoidance is an example of a rational decision.

Scholars have argued that rationality should be considered as a process of manipulating rules to get the best possible outcomes (Guzman, 2014:80). To begin, there ought to be formal logic for the outcome, which adheres to a certain path and line of thinking, in which the consequences can be inconsequential or for the better or for the worse (McGehee, 2009:112). As a result, rationality need to be regarded as a notion that may take on a variety of forms since an individual possesses the capacity to choose between what is good and what is wrong. As a consequence of this, the criteria for making a reasonable choice are established by the decision-making process of the taxpayer as well as the revenue authorities. One way to explain how to make a reasonable decision is to think of it as the process of figuring out what choices are on the table and then picking the one that is most appealing. The assumption behind the Rational theory is that an individual always seeks to take those decisions which give them an advantage. In order to improve administrative effectiveness, Weber (1978:2) emphasised the importance of taxpayers choosing to comply with tax laws that will not lead to income not being taxed because the activity is illegal.

Weber (2015:37) provides different rationalities such as: (1) Practical rationality entails systematically identifying the best strategy for achieving the desired result given the available resources. (2) Formal rationality appears to consist of making decisions based on general rules, regulations, and the society's higher social structure. The rationality theory is applied to an investigation of taxpayer behavior as well as possible responses by tax authorities to counteract taxpayer avoidance inclinations (McCoon, 2010: 6). Rationality theory allows participants to make a decision from more than one option. The behavior of firms such as Multinational

enterprises is an example of aggregated behaviors of individuals within the organisation and has not been examined in some of the rationality theory research. According to Myers Attorneys (2018:1) an individual or legal entity with legal rights and obligations as defined by law. Furthermore, legal entities that are recognized as persons under the law include corporations and partnerships. It is important that the organisations be investigated by the rationality theory in depth to allow tax laws to detect illegal income received by corporations and partnerships that is why this theory is the anchor for this study.

In a similar vein, Alder (2012:247) stresses that rational conduct is the result of the interaction of the following three factors: The capacity to firstly employ; secondly, the appropriate resources to accomplish a certain objective; thirdly, the ability to allocate limited resources in ways that maximize utility; and finally, the capability of the agent to be self-regarding are the four components of this skill. Self-interestedness refers to the practice of placing one's own interests ahead of those of others, which is an essential quality shared by rational actors.

Individual behaviour, as well as society's behavior, may be better understood when utilising rational choice theory because it explains the reasons for making specific decisions based on the cost and advantages of living in social groups. This is supported by Lewin (2020:3) who stated that, "*It shapes their perceptions of others, their general perspective, and their ethics*." What appears to be "irrational" conduct can also be explained using the rational choice theory. The rational theory is more relevant for this study because of its application which covers a wide range of disciplines. Its prevalence and robustness to previous studies which focus on tax-related behaviors such as tax evasion. In this conception, illegal income is to enrich himself without disclosing to tax authorities the source. It also follows a logical course and makes sound assumptions.

2.2 Taxation of illegal income in the international context

2.2.1 Background

The United States Constitution's Sixteenth Amendment, enacted in 1909, permits the levying and collection of taxes on all sources of income. According to the Sixteenth Amendment and the Internal Revenue Code (IRC), gross income is defined as the whole amount of income earned from any source. There are certain exceptions to this definition (Rul, 2007:19). Consequently, the American tax law definition clearly states that the IRC sets the limit in terms

of what must be included or regarded as gross income. Because of this description, it follows that so long as the IRC does not include an exception for excluding the profits of unlawful acts from gross income, such proceeds are regarded to be a part of gross income and, as a result, will be subject to taxation..

The Supreme Court of the United Kingdom also recognizes that certain Acts of Parliament have distinctive constitutional provisions and are thus integrated into the constitution(Pigney, et al,. 2016: 4). The United Kingdom is a constitutional monarchy, which indicates that such a monarch is the head of state but is legally bound by the constitution. Because there is no single core constitutional instrument, the kingdom operates under an uncodified, or de facto, constitution, according to King George VI (2007:3). The United Kingdom's constitution is made up of the laws and values that govern the country.

2.2.2 Income derived from unlawful activities

It has been argued by Hingun and Nafiu (2015:391) that taxing criminal activity income is in some ways incompatible with outlawing the illegal acts, and that "*it would be regarded demeaning by taxing an illegal company's earnings, the government becomes a silent partner*" in it. Despite this reasoning, American courts have consistently determined that Congress did not intend to preserve illegally acquired wealth. In the case of *Sullivan, United States v. 332 U.S. 689 (1948)*, the court took this into account where the defendant Sullivan, a pharmacist who failed to remove a dozen sulfathiazole tablets from a properly labeled bulk container transported interstate commerce after ordering them from a supplier in the same state (who received them via interstate transportation) and place them in a pillbox branded "sulfathiazole" but without the statutorily needed directions for use or hazard warnings, and sell them locally to a retail buyer. According to the complaint, the defendant misbranded a medicine by removing tablets from a properly labeled and branded bottle, placing them in pillboxes that were not properly labeled, and selling them to customers.

The court came to a conclusion as a result of the respondent's activities. "*Altering, mutilating, destroying, obliterating, or removing the whole or any part of the labeling of, or doing any other act with respect to, a food, drug, device, or cosmetic, if such act is done while such article is held for sale after shipment in interstate commerce and results in such article being misbranded*," is prohibited. The complainant sent an appeal, then the Court in this case (*Sullivan, United States v. 332 U.S. 689 (1948*) approved the petition but later overturned it,

finding that the defendant's acts were a breach of the legislation in its plain meaning by selling drugs illegally and avoiding to pay tax as selling of authorized drugs were tax-free. The court also stated that taxing people who run legitimate businesses while allowing those who profit from breaking the law to get away with it satisfies no one's sense of fairness. It does not appear that America intended for an individual to start a business in order to avoid paying taxes, so raising the costs of those who are employed properly. Can it be stated that Congress intended to tax the law-abiding while allowing the criminal to walk free in all of these cases?

Furthermore, in the case of *Sullivan, United States v. 332 U.S. 689 (1948),* they found that income that is derived from illegal activities is in fact taxable despite the element of the illegality of such activities. However, the court did not find any reason to accuse the business. It is imperative to remember that, initially, the American courts were not acquainted with tax income from embezzlement or burglary until after 1961 (Finestone, 2015:715). Further discussion will be presented in Chapter 3 sections 3.1, 3.2, and 3.3.

2.3 Taxation of illegal income in the South African context

2.3.1 Background

The concerns surrounding the taxability of revenue earned from criminal acts or illegal income emerge from the beliefs of individuals, most notably Alphonse Gabriel "Al" Capone (Al Capone), who was born in 1899 to Italian immigrants in New York City (Kaaljak, 2015:50). He joined the Five Points Gang as a teenager and worked as a bouncer in organized criminal establishments like brothels. From 1925 through 1931, he was an Italian-American gangster who also led a Prohibition-era crime syndicate. Capone was found guilty of 22 counts of tax evasion by federal authorities, who were desperate to put him behind bars. In 1931, he was convicted guilty of five counts. Capone, acknowledging his guilt, attempted to pay the government taxes he owed, but he failed. This was a highly publicized case. He eventually admitted his income, and unpaid taxes were entered as evidence. He was judged to be responsible for the crime, and the court sentenced him to 11 years in a federal prison. Following his conviction, he replaced his defense team with tax law specialists and his grounds for appeal were enhanced by a Supreme Court judgment; nonetheless, his appeal was ultimately unsuccessful. He changed his defense team after his conviction. According to Al Capone, governments have no right to profit from the proceeds of crime since they forbid their citizens from engaging in illegal conduct (Kaaljak, 2015:50). Tax evasion is done on purpose by

taxpayers to avoid and hide evidence that may be used as proof by tax collectors (Aumeerun et al., 2016:3). The Act does not address the question of revenue derived from illegal transactions.

There are two cases that were similar in nature and the court made the same decision upon them, namely case 1 *CIR v Delagoa Bay Cigarette Company, 1918 TPD 391, 32 SATC 47 and* case 2 *ITC 1624, 59 SATC (T) 373, 377-8*. In the case of CIR v Delagoa Bay Cigarette Company the corporation ran an illegal lottery, it set aside a percentage of its tobacco sales revenue to give out rewards to persons who had winning numbers obtained from cigarette package coupons. Because the money was obtained in contravention of a legislation governing lotteries, the two-thirds of the inflated price that the taxpayer had put aside for prize distribution should be included in the taxpayer's gross income rather than being distributed as prizes. In the other case, *Income Tax Case 1624 (1997) 59SATC 373*, the company owned by a businesswoman who specialises in customs clearance and freight transportation claimed the wharfage costs. In these cases, Delagoa Bay and ITC 1624 before the court decided that if a taxpayer obtains money through fraudulent claims or negligent misrepresentation to clients when conducting business, the money is received and intended to be included in business income. The sum was taxed since it was included in gross income. The court in both cases ruled out that the legality or illegality of the enterprise that generated the money was irrelevant to the matter of the income tax liability.

Case 3, Income Tax Case 1545 (1992) 54 SATC 464, in which the taxpayer profits by selling dried milk cultures, which is milk evaporated to around 5% moisture content, commonly known as powdered milk. The court considered the taxpayer's viewpoint while making money from an unlawful lottery and selling 'dried milk cultures' to the public. Despite the fact that the transaction was invalid from the start, the taxpayer was eligible to the sum in dispute as gross income. In these three circumstances, a receipt was taxed regardless of its illegality. To emphasize that "illegality does not preclude an amount from being included as gross income," as the judge stated; nonetheless, where an amount is received by a taxpayer on his own behalf and for his own advantage, it must be included as gross income. Although the literature argues that some money should be in the gross income, it is still part of a void transaction.

Scholars (Roche, 2012-2013; Yoong et al., 2018: 35) and other tax authorities agree that the proceeds of crime and other illicit operations should be taxed similarly to legitimate activity or firm revenue. Those who challenge the morality of taxing prostitute profits (D'Arcy, 2009:90; Yoong et al., 2018:79) believe that such earnings qualify as gross income under section 1 of the

Income Tax Act. This view is further broadened by the opinion that if income from prostitution is good enough for fiscus to tax, then this should mean that the prostitute should also be given a platform where she can go about conducting her business without being hindered by the law.

Case law 4. *The MP Finance Group CC (In Liquidation) v C: SARS (2007(5) SA 521 (SCA),* A businesswoman ran a pyramid scam, which is a type of illicit investment plan. She solicited 'investors' who would pay her money in the hopes of receiving a substantial return on their investment. Individuals paid a significant portion of the deposits. The perpetrators were well aware that the plan was insolvent and fraudulent, and that they would not be able to pay all of the investors the amounts promised at the time they collected the deposits. She managed to repay to few for a short time, the depositors received so-called 'returns on their investments.' Her strategy was carried out through a slew of different businesses, some of which were incorporated and others were not. Eventually, they all failed. To facilitate administration, the many corporations were merged into one, MP Finance Group CC ('the company'). The SARS Commissioner evaluated the corporation for income tax for the years of assessment 2000, 2001, and 2002.

The liquidators argued that the funds paid to the pyramid scheme were not "*received*" as defined in the Income Tax Act. The Commissioner did not uphold the objection that was made. The corporation attempted to appeal the ruling to the Durban Tax Court, but it was dismissed. The corporation filed an appeal with the Supreme Court of Appeal after first obtaining permission to do so from the Court a quo. The court decided that the profits from a pyramid scheme should be subject to taxation. The taxpayer's motive was the basis for the Court's reasoning. The taxpayer's goal was to profit from the gains she made by stealing investors' money, and she did profit from those earnings. The conclusion of the MP Finance case is that it has shed light on the fact that a taxpayer who operates an unlawful business is subject to taxation on whatever earnings he makes from commerce beginning with the day the firm is established. For an amount to be treated as being a portion of the gross income of a taxpayer, the money must be received by the taxpayer for his benefit or on his behalf (Olivier, 2008:815). Notably, other scholars hold the view that the subjective intention associated with the recipient is not decisive. Muller (2007:28) argues that by using the subjective approach to determine the taxpayer's intention, "*all income derived from illegal activities will fall into the tax net if the taxpayer intends to benefit from proceeds, except where the taxpayer received the income as an agent (in the broad sense) on behalf of another*".

Hansie Cronje, the former captain of the South African national cricket team, was involved in match-fixing. It was argued in this case that Cronje should "*be allowed to continue his illegal dealings on the condition that he declare his ill-gotten gains for tax purposes*", (Donaldson 2000:2). A year later the same topic was covered by Pugsley (2001:17) who agreed with the view held by Donaldson where he stated that the 'cricket match-fixing scandal should be viewed as a chance to boost the state's finances' by assessing Hansie for taxable income relating to the income derived from match-fixing.

However, the judge Classen (2007, 19(4) SA Merc L J 54) "*views the phrase accrued in favour of a person as it appears in the Income Tax Act definition of gross income can be relied on for the purpose of levying tax on income that is illegally produced"*. Classen further points out that the reasons for income that is illegally produced not to be taxed cannot be related to the view that it is not taxable but rather to the lack of knowledge by revenue authorities (MP Finance case). This lack of knowledge can be attributed to the fact that income is often excluded from tax returns. It is only when those who are the perpetrators of such crimes have been apprehended as a result of the decision to tax their earnings.

2.3.2 Income derived from unlawful activities

It makes no difference whether the money came from a moral or unlawful action for assessing whether it is taxable. It is directly from such a viewpoint that Williams (2005:35) gives the opinion that if the activities of the taxpayer constitute trading, any income that can be associated with such trading is considered to be assessable for the purpose of income taxation, regardless of legality. The English decision of *Commissioners of Inland Revenue v Aken (1990) BTC 352*, in which the court found that if the activity is a trade, legality is immaterial for taxing reasons, was referenced to support this. Furthermore, the court determined that the word "trade" does not always imply illegality; there might be legal and illegal trade.

As an outcome, it is deduced that the element of legality cannot be regarded as a necessary characteristic of trade (Williams 2005:35). Furthermore, there is no provision in the definition of gross income for the inclusion of a receipt collected as part of a legal action. Consequently, it has been decided that the courts will deal with this issue.It is important to realise that illegitimate economic operations and agreements are not stripped of all legal consequences simply because they are recognized as a void between the parties. Regardless of the nature of the transactions' illegality or the inter-party implications, the money received by the taxpayer is

regarded receipts within the definition of gross income. Another issue to remember is that income obtained illegally is not necessarily considered "received" by the taxpayer legally speaking. Income must be received for the benefit of that specific taxpayer in order to be taxed (Williams 2005:36).

In the case of *Commissioner Of Taxes v G, 1981(4) SA 167 (ZA), 43 SATC 159*, the taxpayer was a government employee for a period of four years. He held a senior position and as such, he was entrusted with government monies for clandestine operations. He abuse the power from his position of trust to get more money from the government than was legally required from time to time. The taxpayer misappropriated the additional funds for his own profit. The money was either deposited in his bank account or spent on personal purchases. He was found guilty and sentenced to prison, with a portion of his term conditionally suspended, should the debt be paid in full. The money was fully reimbursed by the taxpayer. The Commissioner included the fraudulently received funds in the taxpayer's total income, making them taxable. The Commissioner went even further imposing penalties under the Act's section 35.

The Commissioner argued that gross income, as defined by section 8(1) of the Act, was "*every amount received by, accrued to, or in favor of a taxpayer in a year of assessment*". The taxpayer used the same 'gross income' definition He contended that the money he stole never became his, despite his intent to do so, and that he never "*received it in the meaning of the term used in the definition of gross income*". The court appeared to imply that proceeds of unlawful activity may be taxed, but it decided that "*the term 'received' should be given its ordinary meaning and that no rational reading would take it to mean a unilateral taking like theft*".

In the said case, Fieldsend (the judge), in his judgment said that the receipt does not "*cover a unilateral taking such as theft, which in any event confers no right upon the taker to the things taken. Stolen money does not appear to become the property of the thief, just as borrowed money does not appear to become the borrower's property",* because of the co-equivalent responsibility to repay it that exists from the time it enters his hands. It could be deduced from the discussion above that the courts do consider the money received illegally as taxable.

Another case that illustrates this concept is *Geldenhuys v. Commissioner of Inland Revenue 1947 (3) SA 256 (C)*. In this case, the taxpayer had to determine whether a certain amount of money was received by him or accrued to him as a result of the sale of a flock of sheep. The taxpayer was a farmer who had recently lost his wife. He and his wife had married within a

community of property and had written a joint will to distribute their inheritance.The will stated that the surviving spouse would be entitled to the estate's fruits and income for the rest of his or her life if either of them died. The heirs of the combined estate would be the children. The taxpayer's spouse died. Unfortunately, a lot of sheep died as a result of the extreme drought and they never recover to their initial size.

The farm was deemed overcrowded at the time. The taxpayer gave up farming in 1943. Her kids agreed that the sheep flock and the money were given to the taxpayer. The difference in value between the time when the taxpayer obtained the right to income and the time when the flock of sheep was purchased has been included in the taxpayer's gross income. The taxpayer had the right to income at the time when the value was lower (*Geldenhuys v. Commissioner of Inland Revenue, 1947 (3) SA 256 (C).*

The taxpayer argued that the flock of sheep did not belong to her and instead belonged to her children. The taxpayer was a usufructuary of the flock of sheep, and the court upheld the appeal on the grounds that she had no right to the flock of sheep at the time of realisation, and her heirs received the entirety of her earnings, which were not included in her gross income (*Geldenhuys v. Commissioner of Inland Revenue, 1947 (3) SA 256 (C).*

It is trite to say that it is relevant whether an amount was earned for the benefit of the taxpayer the legality of the matter must be the fact that who received it and that person should bear its income tax liability (Williams, 1995:181). Therefore, the decision in the case of Geldenhuys v CIR it was held that "received by" meant "*received by the taxpayer on his behalf, and for his own benefit*";

The taker's purpose alone cannot result in him getting the object in his own right. Only if the giver also seeks that consequence may he accept the object in his own right. The decision in Geldenhuys's case, however, relates to the theft of cash. Both 'income' and 'taxable income' are linked to the definition of 'gross income,' and it seems evident that the words 'received by' would be included in the definition of gross income. The receiver must be legally entitled to the money and have no responsibility to give it away. This means that the money must be received for one's own advantage. In the aforementioned technique, this court ruling is an objective interpretation method. It has been stated that the objective manner of interpreting taxability of money earned from illicit activities is restricted and has been utilized by taxpayers to avoid paying taxes.

2.4 Conclusion

This chapter provided a discussion on the available literature that addresses the concepts related to the taxability of revenue earned from unlawful activities. As a result of this, the chapter addressed some of the most important areas, including illicit activities and revenue. The fact that the receipt was obtained through dishonest or fraudulent means does not alter its status as capital; it continues to be income. Because the money has been obtained in the most literal meaning of the word, it will be subject to taxation on account of the fact that it has been obtained. As a consequence of this, it is believed that the main argument is that illicit commercial activities and agreements are not exempt from all potential legal repercussions only due to the fact that they are null and invalid between the parties involved. According to the definition of gross income, the money that were received by the taxpayer are considered to be receipts, regardless of the unlawful nature of the transactions or the consequences that were achieved between the parties. It is important to keep in mind, then, that income earned through illegal conduct is not necessarily considered to be "received" by the taxpayer in the true sense that the term is used in genuine legal proceedings. In order for an individual taxpayer to be subject to income tax, the income in question must have been received for the individual's own personal gain.

The next chapter presents a comparison of taxability of illegally obtained income between international countries and South Africa.

CHAPTER THREE

A COMPARISON OF TAXABILITY OF ILLEGALLY OBTAINED INCOME BETWEEN INTERNATIONAL COUNTRIES AND SOUTH AFRICA

3.0 Introduction

The goal of this chapter is to look into the principles underlying the taxability of illegally obtained income in South Africa and juxtapose them with international principles. The comparison will be carried out between South Africa and two international jurisdictions, namely, the United States of America (USA) and Australia. The choice of these countries in this study is because the USA, Australia, and South Africa have strong educational and interpersonal relationships with Africa, as well as significant economic and political interests and mutual development goals. Furthermore, the USA is looking for ways to strengthen US-South African collaboration on regional and international challenges. One of the challenges is to get tools on how to tax illegal income. The findings will be summarised in the concluding chapter of this research from case law in all countries and determine whether principles laid out in the USA and Australian laws are applicable in South African law.

3.1 The USA

This section explores how the taxability of illegally obtained revenue is taxed in the USA. The justification for considering the USA is that it is one of the countries that South Africa has entered into a tax agreement. In addition, the United States Constitution's Sixteenth Amendment requires Congress to levy and collect taxes on all income, regardless of where it comes from. Just as the South African court refutes the suggestion that taxation of illegally obtained income is in a way condoning illegal acts, the Americans hold the same view. This is seen in the case of *Sullivan v United States 274 U.S. 259 (1927).* The defendant, the plaintiff in error, was found guilty in the District Court of the Eastern District of South Carolina on the third count of an indictment charging him with violating section 253 of the Revenue Act of 1921 (42 Stat. 227, 268 [Comp. St. 6336 1/8v]). In 1921, he earned a net income of $10,000 from an automotive agency and a beverage business, and he refused to pay the tax on March 15, 1922.

The court held that:

"*Moreover, it cannot be said that the dictates of morality or propriety are all one way. It does not satisfy one's sense of justice to tax persons in legitimate enterprises and allow those who thrive by violation of the law to escape. It does not seem likely that Congress intended to allow an individual to set up his own wrong in order to avoid taxation, and thereby increase the burdens of others lawfully employed*."

Prior to the amendment of the Constitution of the USA, the legality of a person's income mattered in determining whether it was taxable. This was eventually changed in Section 61 of the 1986 Internal Revenue Code, where gross income was redefined as:

"*Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Annuities; (9) Income from life insurance and endowment contracts; (10) Pensions; (11) Income from discharge of indebtedness; (12) Distributive share of partnership gross income;(13) Income in respect of a decedent; and (14) Income from an interest in an estate or trust*."

However, the Supreme Court has held that earnings from illicit actions are included in the income of the criminal even if the code makes no mention of revenue acquired from illegal activity (Manolakas, 2016:58). On the other hand, in 1927 the Supreme Court of the United States issued a ruling that supported the imposition of income tax on unlawfully obtained money (Glass, 2013:1). In addition, the case of United States v. Briscoe, which was decided by the 65th Circuit Court of Appeals (1995). Tommy Briscoe, a former president of the AFL-CIO, was accused of a variety of crimes, including mail fraud, wire fraud, theft and misappropriation of union funds, causing the lending of an unauthorised union loan, destroying financial records that were required to be kept by a labor union, income tax evasion, failing to register a federal tax return, and filing a false federal income tax return. He was also charged with failing to file a federal income tax return and filing. Mr. Briscoe received a 46-month prison sentence and three years of supervised release on four counts, with the remaining ten offenses receiving a concurrent twelve-month prison sentence and one year of supervised release. The court held

that illegally obtained income is regarded as income to the recipient in the year in which the funds were obtained, irrespective of what happens to the funds afterward.

The USA treats both legal and illegal income in terms of taxability when the taxpayer has control of the income as he/she derives readily realizable economic value from it (*Rutkin v United States, 343 U.S. 130 (1952).* Rutkin, the petitioner, was charged with deliberately seeking to evade and defeat a considerable portion of his 1943 income and victory taxes under 26 U.S.C. 145(b), 26 U.S.C.A. 145(b). He was accused of filing a false and fraudulent tax return, claiming $18,966.64 in net income when he knew it was $268,622.04. That disparity, which would raise his tax burden from $6,843.93 to $222,408.32, was partly due to his failure to report a cash payment of $250,000 from Joseph Reinfeld on his original form.

In 1952, the Supreme Court of the United States held a case where the question was whether funds violently extorted from a victim with his consent should be taxed (Rutkin v United States). In this case, the court held that:

"*An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realisable economic value from it… that occurs when cash, as here, is delivered by its owner to the taxpayer in a manner that allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it. Such gains are taxable in the yearly period during which they are realized. This statutory policy is invoked in the interest of orderly administration.*"

It must also be noted on the other hand, in the case of *United States v Sullivan 332 US 689 (1948)*, it was decided that illegal businesses should not be required to pay the taxes that legal businesses would.

In *James v. United States (366 U.S. 213 (1961)*, a union official swindled more than $738,000 from his employer union and an insurance company between 1951 and 1954. The petitioner omitted to disclose these sums in his gross income in those years, violating 145 (b) of the Internal Revenue Code of 1939 and 7201 of the Internal Revenue Code of 1954. He was convicted of wilfully trying to cheat federal income tax for 1951 through 1954. He received three years in jail. The court ruled that embezzled monies constituted taxable income and must be included in the embezzler's gross income. Therefore, the embezzler should be taxed on such gains. However, the Supreme Court also mentioned that in a case where the embezzler

reimburses the victim, resulting in a decrease in his/her income, the embezzler can deduct any repayment in the year it's made.

3.1.1 Case laws

This section highlights tax cases involving unlawful income in the US. Illegally acquired income in the US wasn't always taxed. In *Commissioner v. Wilcox, 327 U.S. 404 (1946)*, the petitioner stole millions from 1951 to 1954. He was convicted of "wilfully" attempting to escape the federal income tax owed for each of the years 1951 through 1954 because he neglected to record those sums as gross income on his tax forms for those years.

Where the issue before the court was whether funds acquired from embezzlement should constitute taxable income to the embezzler or not, the court noted that for a gain to be taxable, there must be:

i) a right to claim the alleged gain,

ii) no obligation to repay or return such gain. It was therefore held that the taxpayer in the case of embezzlement does not "have *the right to claim the gains and had no obligation to repay. Thus, the court ruled that the taxpayer was not liable to an income tax for the gains from the embezzlement"*.

The court saw an embezzler as a borrower, ruling that the money could not be taxed as it must be returned. Taxable income does not result from "*simply receiving property or money that must be returned to the legitimate owner, as in a loan or credit*." Moral deviancy doesn't affect taxation. If the taxpayer had a statutory gain, profit, or benefit. The taxation legislation doesn't care if the taxpayer's purpose was immoral or the receipt was illegal.

In *James v. United States 366 U.S. 213 (1961)*, Eugene James, the defendant, was a labor union official who embezzled money from union coffers and failed to record these sums on his tax return. He went on trial for tax evasion and argued in his defense that the money he had embezzled wasn't considered income. He argued that just as the borrower's receipt of loan proceeds is not taxable (due to the borrower's corresponding obligation to repay the loan), neither should the person who embezzles money be considered to have received income because the embezzler is required by law to return the stolen funds to their rightful owner. The Supreme Court held that even though the wrongdoer had a duty to return the stolen money to its rightful owner, section 22(a) of the Internal Revenue Code of 1939 and section 61(a) of the

Internal Revenue Code of 1954[3] required that the receipt of stolen money be included in the wrongdoer's gross income and subject to taxation. The court overturned the *Commissioner v. Wilcox 327 U.S. 404 (1946)* in this case the Commissioner of Internal Revenue found that the respondent had to declare some money that he had embezzled as income and levied an income tax debt against him. The Commissioner was upheld by the Tax Court.

held that embezzled funds are not taxable:

"Taxable income [does not] accrue from 'the mere receipt of property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit. .... . . Moral turpitude is not a touchstone of taxability. The question, rather, is whether the taxpayer in fact received a statutory gain, profit or benefit. That the taxpayer's motive may have been reprehensible or the mode of receipt illegal has no bearing on the application of the taxing statute".

This was the verdict because the source of gross income is immaterial in section 61 (a) of the Internal Revenue Code of 1954. The court ruled that embezzled monies constituted taxable gross income in the year of misappropriation.

In a more recent case of embezzlement, the taxpayer used the embezzled funds for his personal use and failed to disclose these funds on the income tax returns *(Wood v Commissioner of Police [2011] QCA 327).* Mr. and Mrs. Wood (the Woods) received a notice of deficiency on April 30, 2009, for the taxable years 2001, 2002, and 2003, determining income tax shortfalls of $68,029, $78,941, and $6,661, respectively. The deficiency notice additionally established accuracy-related penalties of $13,605.80, $15,788.20, and $1,332.20 for the years in question under section 6662(a). The Woods were seeking a reversal of the respondent's decisions, claiming that they were only responsible for a portion of the defects and penalties. They upheld the respondent's judgments of the deficiencies and accuracy-related fines. They argued that the taxpayer had used the funds on his own accord and derived benefit from the funds, basically realising and accepting ownership of the funds. Before the court, the embezzled funds constituted the taxpayer's taxable income and were therefore taxable.

In summary, as mandated by the Sixteenth Amendment of the USA Constitution, Congress has the power to levy income from taxpayers, whether the income is legal or not. Courts have ruled that income from embezzlement and any other illegal activities is subject to tax in the year in which it was received.

However, this was not always the case where the court ruled that a taxpayer was not liable to income tax if he had no right of claim over the income or if there was an obligation to repay. The courts' judgments changed when the definition of gross income was amended to include all income regardless of legality in Section 61 of The Internal Revenue Code of 1986. Following this, US Tax Courts held that illegally obtained income is taxable as long as falls within the amended definition of gross income.

3.2 Australia

The next jurisdiction to review is Australian law. This section discusses the taxability of illegally obtained income in this jurisdiction. The Commissioner of Taxation has the administrative authority over the levying and taxation of income in Australia (Australian Income Tax Assessment Act of 1997). Gupta (2008:24) says the taxability of illegal income depends on the application of the ordinary concepts of income to illegal activity.

In the Australian legislation, taxable income is referred to as 'assessable income' and is defined in section 6.5 of the Australian Income Tax Assessment Act of 1997 as follows:

"(1) it includes income according to ordinary concepts, which is called ordinary income.

(2) For an Australian resident, includes the ordinary income driven directly or indirectly from all sources, whether in or out of Australia, during the income year.

(3) For a foreign resident, includes:

> *(a) the ordinary income 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".*

In addition, the Act states that in order to derive taxable income, the money in question must first be "*applied or employed in any way on the taxpayer's behalf or as the taxpayer has ordered*," before it may be considered "*received*" for the purposes of the Act (Australian Income Tax Assessment Act of 1997). In the same way as South Africa's Money Tax Act 58 of 1992 and the United States' Internal Revenue Code of 1986 do not differentiate between legitimately

and illegally obtained income in their definitions, neither does the Australian Income Tax Assessment Act of 1997.

The Commissioner of Taxation collects taxes on any income within its authority and definition, regardless of a taxpayer's citizenship or the legality of the money. Australian resident taxpayers are taxed on assessable income from all around the world, whereas non-resident taxpayers are taxed exclusively on Australian income (Gupta 2008:24). Regardless, calculating a taxpayer's taxable income for a particular year differs in Australia, South Africa, and the US. In Australia, taxable income is computed by subtracting assessable income from deductions for the income year. This is done for each tax year. Unlike South Africa and the USA, where income is taxed on gross profit, Australia taxes net profit.

3.2.1 Case laws

This section discusses the taxability of unlawful income in Australia.

According to *MacFarlane v Federal Commissioner of Taxation 1(3 FCR 356) (1986),* the taxpayer failed to disclose certain amounts of money appropriated by him from the company he controlled and whether money appropriated "deemed dividend" for purposes of Section108 of Income Tax Assessment Act 1936 whether "dividend" part of his assessable income pursuant to Section 44(1) of the Act also whether legal title determinative. The taxpayer also failed to disclose certain money appropriated by him from the company he controlled - whether money appropriated "deemed dividend" for purposes of s.108 of Income Tax Assessment (Machogu & Amayi, 2013:2277).

The argument in favour of the taxability of illegally derived income is largely justified in a court of law. The court mentions that an opposing argument would benefit the delinquent over honest persons. In MacFarlane v Federal Commissioner of Taxation (1986), it was held that in a case where a victim can recover their property or gains of its disposal, from the wrongdoer, the taxability of such gains as received by the wrongdoer remains. The court held that "*though the law-breaker may receive his desserts elsewhere, which may include an order for restitution, he has also had his reward, and it was a profit*" ((Machogu & Amayi, 2013:2277). Therefore, monies from theft are taxable in the hands of the thief, regardless of whether they will be recovered by the victim.

It was also decided that the taxpayer received a reward for successfully completing a course and obtaining a formal qualification. The reward was not for any services rendered but an inducement payment that motivated the taxpayer to complete his qualification. The reward did not have attributes of an income as the payments were not made regularly. The issue at hand was to determine whether the payments fall within Section 26 (e) of the Income Tax Assessment Act 1936, which states that:

"*The assessable income of a taxpayer shall include the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses, and premiums allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him, whether so allowed, given or granted in money, goods, land, meals, sustenance, the use of premises or quarters or otherwise*..."

The court argued that the amounts received by the taxpayer do not meet the definition of income under Australian law.

In the case of *Montgomery v FC of T 98 ATC 4120 (1999),* the taxpayer received a share from an inducement payment made by the landlord of a city building to the firm (where the taxpayer was a partner) on its relocation to the city building. In this case, the court had to rule on whether this amount can be regarded as taxable income. The court held that the amounts paid to the taxpayer were indeed taxable. Here, the taxpayer agreed to the inducement agreement was not in the ordinary course of the business of the firm. However, this does not suggest that the amounts received do not constitute the firm's income as gains were obtained and the agreement was entered upon with an intention of making it again.

More recently, the court dealt with the finances of a convicted drug dealer, wherein the drug dealer lost money due to theft and wanted the money to be included as deductible income as per the definition of 'income' in the Income Tax Assessment Act 1936. In this case, the court had to then determine whether 'deductions' in the Act include the loss of money intended to be used by a drug dealer for the wholesale purchase of drugs *FC of T v La Rosa, FCA (2003).*

In the above-mentioned case of FC of T v La Rosa (2003), the loss was due to theft and the cash at the point of loss was earmarked for acquiring drugs as trading stock. Therefore, it was lawfully regarded as circulating capital and a revenue asset as it was held for the purpose of deriving income. Such an amount is thus regarded as a deduction when calculating assessable

income. The court also mentioned that the source of the income does not affect the taxation of the income.

To surmise, the Australian residents taxable income is calculated on all ordinary income received from all sources while for non-Australian residents it is calculated only from Australian sources. In addition, assessable income is calculated by subtracting deductions from the gross income of a taxpayer in the year of assessment. The reviewed cases provide evidence that illegally gained income is taxed if it is within the definition of assessable income in the Act. When the gain is in a form of a reward that is not received as a result of service rendered, the amount is not regarded as income as it does not exhibit traits of an income in line with the Income Tax Assessment Act 1936.

In addition, it can be concluded that amounts received from fraud, for example in the form of bribery, are also taxable in the Australian jurisdiction. Lastly, it can also be concluded that losses by a criminal during the course of conducting his business are regarded as deductions and are therefore considered when calculating the net taxable income of the criminal.

3.3 South Africa

In South Africa, it is still arguable that the taxability of illegally obtained income remains unanswered, this study seeks to contribute towards answering one of many questions. The obligation under the Constitution of the Republic of South Africa is to collect all taxes owed and to ensure optimal tax compliance, according to the South African Revenue Services (SARS) Interpretation Note (2020:15).

3.3.1 South Africa's tax perspective

With regard to a tax dispute in which (MP Finance Group CC) argued that payments paid to the pyramid scheme were not'received' under the Income Tax Act's definition of gross income. The court had to determine whether the sums paid by the various investors were taxable income. The conclusion was reached that all revenue, even if tainted with illegality or generated from criminal acts, is subject to taxes. The Court dismissed her claim that the unlawful nature of the transactions and the pressing need to return the investors robbed her of any profit, and the sums taken in her gross income were permitted to be included (MP Finance Group CC).

In *Commissioner for Inland Revenue v. Insolvent Estate JP Botha t/a Trio Culture (30/89) (AD)* - from late July to early October 1984 - J P Botha (the insolvent) operated from offices in Brits, Transvaal, and across the Witwatersrand-Vereeniging district of Pretoria. The firm made almost $30 million in this short time. The insolvent's estate was finally sequestrated on January 15, 1985. The company had to divert its activities by running a milk-culture scheme which was not its initial business. The new business name "Trio Kulture" drew a written agreement. This written agreement was called the "kweekkontrak". The "kweekkontrak" was written down on paper and signed by both parties. The Trio Kulture program constituted a lottery, as defined by section 1 of the Gambling Act, 51 of 1965 ("the Gambling Act"), and the public's milk culture purchases were void from the start. The Supreme Court of Appeal ruled that funds obtained by illegal and fraudulent pyramid schemes are "received" under the Act's definition of "gross income" because the scheme operator's goal is not to have contracts with investors but to take their money to carry out the scam (*Commissioner for Inland Revenue v Insolvent Estate JP Botha t/a Trio Culture*).

Also, the court cannot disregard the conclusion nor deny the existence of an agreement between the Revenue services and the complainant Insolvent Estate J P Botha due to its illegality. Ignoring the fact that they are immediately repayable under the law, they constituted receipts within the meaning of the Act. Therefore, any income received is taxable, regardless of the legalities in which it was received. Taking into account the facts that have been agreed upon.

It is important to realise that a conclusion related to the Trio Kulture case the emphasis was that any country would appreciate collecting more tax for their country's commitment. Imposing a tax on illegal income can be seen as a way of making the criminals pay and increase an already strained fiscus. While on the other hand, it can be seen as condoning these criminal activities, with the government's indifference to the consequences of these activities on the society in favour of acquiring more income (*Commissioner for Inland Revenue v Insolvent Estate JP Botha t/a Trio Culture*).

Another example of illegal activities is the case of *Mann v Nash (Inspector Of Taxes) (1932) 1 K.B. 752*, the Appellant, in the course of his business of providing automated machines for public use, dealt in and made arrangements to exploit certain automatic devices whose use had been ruled illegal. The devices were placed in public places for public use, and the proceeds were split between the Appellant and the occupier of the property. The Special Commissioners held that the provision of the machines as part of the Appellant's ordinary business and that he

was not entitled to claim that the portion of his profits derived from them was exempt from taxation because it was earned by illegal means in an appeal against assessments to Income Tax made to include profits so arising. They just discover profit from what appears to be a trade, with revenue restrictions requiring that trade earnings be taxed. As a result, the appeal was unsuccessful.

For income to be taxable, it must meet the gross income definition requirements provided in Section I of the South African Income Tax Act (58 of 1962), which is as follows:

"Gross income, in relation to any year or period 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 such resident; or

(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 or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely- (a) any amount received or accrued by way of annuity, including any amount contemplated ... (b) any amount payable to the taxpayer by his spouse or former spouse, ... (c) any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount…"

According to *Ochberg v Commissioner for Inland Revenue (1931) AD 215*, in this case, A taxpayer owned 100 percent of a company's stock. The corporation issued more shares to the shareholder in exchange for services performed by the company. Because he still owned 100% of the company's stock, the shareholder was in no better position. The Special Judge determined that the shares were income and that the appellant's profits in the transactions were derived from business activity involving profit-making schemes. Income Tax Act is underlined by the principle that the state deducts a percentage of the tax money back accrued to the taxpayer during the assessment year. That is, the taxpayer is taxed on their incomes, not capital. The definition of gross income and its components will be briefly discussed in this section, namely, received by, accrued to, and in favour of. Since the focus of this study is on the taxability of illegally gained income, therefore in defining these terms, the purpose is to find the relationship between the terms and illegally gained income in the South African Income Tax system.

The preceding definition of gross income does not distinguish between income received lawfully and income obtained illegally. Thus, discussing the highlighted components of gross income definition concerning illegally gained income, by referring to the previous case, (*Ochberg v Commissioner for Inland Revenue*), is important. These are discussed below.

3.3.2 The total amount, in cash or otherwise

The term 'gross income' encompasses both cash and non-monetary income. This means that after the monetary value of non-monetary income has been determined, it must be included in gross income. Every consideration received in the context of the concept of 'gross income' must be valued, as it cannot be included in gross income if it is unvalued. In one of the oldest income tax cases in South Africa, (*WH Lategan v Commissioner for Inland Revenue, (1926) CPD 203)* where the appellant, a wine farmer, entered into an arrangement in May 1920 under which he sold the wine he had produced during the assessment year that concluded on June 30, 1920, for the sum of £5,924. In relation to this amount, £3,500 was due and, subject to the deductions listed below, was paid before the 30th. It was suggested that the word 'amount' in the 'gross income' definition be broadly defined to include not only money but the value of every form of earnings by the taxpayer, whether corporeal or incorporeal, which had a money value in this case of (WH Lategan v Commissioner for Inland Revenue), where the court was called to decide the date of accrual of the proceeds from the sale of wine by the farmer. In terms of the contract, the purchase price was payable partly in the year it took place and partly in subsequent years. The taxpayer's contention was that the amounts payable in future years had not accrued to him in the year of the sale. So the decision against the taxpayer clearly states that 'accrued to' means 'become entitled to' and that once delivery had taken place the seller became entitled to the full sale price.

The Commission of Enquiry into Fiscal and Monetary Policy in South Africa found that the outcome in the Lategan case accurately reflected the law by Margo Commission van Zyl (2015:105). It was concluded that no legislative solution to the problem of the meaning of the term "accrued" was required.

A more recent and eminent case that dealt with the total amount, in cash or otherwise, in the case of *The Commissioner for the South African Revenue Service v Brummeria Renaissance (PTY) LTD and Others 69 SATC 205 (2007) SCA 99 (RSA).* The taxpayer has companies that develop retirement villages and sell life rights in the dwelling units in those villages to retired

persons. They were confined to the residential unit for the rest of their lives. In return for acquiring the life right, they were to make an interest-free loan to the company. The taxpayer's issue was that there was no money involved in the situation, so nothing had to be included in gross income in the light of the principles enunciated by the court in Brummeria. As such, the appeal was turned down.

The court held that:

"*… the question of whether a receipt or accrual in a form other than money has a money value is the primary question and the question of whether such receipt or accrual can be turned into money is but one of the ways in which it can be determined whether or not this is the case; in other words, it does not follow that if a receipt or accrual cannot be turned into money, it has no money value. The test is objective, not subjective… The question cannot be whether an individual taxpayer is in a position to turn a receipt or accrual into money*."

In an Interpretation Note 58 published by SARS, It is stated that gross income received in accordance with paragraph (c) of the Income Tax Act's definition of gross income is taxable (South African Revenue Services, 2014: 23). It specifies that if a person obtains benefits other than money, he or she must report it, for example, a gift, in terms of the aforementioned paragraph, then the monetary value of that gift should be taxed.

3.3.3 Received by, accrued to, and in favour of

The fact that the terms "*received by*", "*accrued to*", and "*in favour of*" are not defined in the gross income definition in the Income Tax Act, has left these terms for judicial interpretation (Haupt, 2021:15). It is important to first understand what these terms mean in accordance with tax law and thereafter determine whether illegally gained income satisfies these definitions. This section reviews past case laws to learn how these courts have held judgments pertaining to these terms.

i) 'Received by'

A case law that has mostly been used as a reference when dealing with the term 'received by' is the case of *Geldenhuys v Commissioner for Inland Revenue (1947 CPD)*, where in the Karoo, a widow ran a farming operation.

She agreed to a usufruct interest created by their joint will when her husband passed away, which stated that their children would be the only beneficiaries of the estate and that she would only be allowed to enjoy the assets while she was alive. A flock of sheep that was part of the joint estate and hence subject to the usufruct interest was later sold by the widow due to a drought in the region where it was necessary to determine whether a quantity of money was "received by or accrued to" the taxpayer as a result of the sale of a flock of sheep and a taxpayer with a usufructuary interest together with a bare dominium holder needed to be sorted out in knowing who must be taxed on the proceeds. In this scenario, the giver's intent was clear: the government never intended for the thief to keep the money and spend it as he pleased, therefore the thief could not be said to have received it at all. The precedent was set in Geldenhuys v CIR where the court held that:

"*The words 'received by' in the setting of the definition of 'gross income' in the Income Tax Act have been construed to be limited to amounts received by the taxpayer 'on his own behalf for his own benefit' or 'received by him in such circumstances that he becomes entitled to it."*

In other words, if a taxpayer receives money, it must be received in such a way that the taxpayer becomes entitled to it. The conclusion drawn by the court in the case of Geldenhuys v CIR is the same as the (MP Finance Group CC and The Commissioner for The South African Revenue Services), in which the court emphasised the nature of receipt in determining whether it formed part of gross income or not. This would be determined by whether the taxpayer would benefit from the receipt as well as the intent of the recipient. Income earned from criminal actions has been determined to be taxable, even if the taxpayer did not receive the monies for his or her own advantage.

In the same vein, in the case of *A Company v The Commissioner for the South African Revenue Service. 2019. TC Case No. IT 24510. (SATC).* The shop sells gift cards that can be redeemed at any store for merchandise as part of the services it provides to its consumers. In their case, the fundamental question was whether the money received by the taxpayer from its clients for issuing gift cards was 'received by' within the meaning of this phrase in the gross income definition when the transaction was completed, or only when the card was redeemed or expired. The court further held that: "… *the question practically in issue between the parties is one of timing; it is ultimately a matter of determining at what stage, rather than whether the revenue in question falls to be included in the taxpayer's gross income*." In addition, the correct application of the current law regarding illegal income is that when the taxpayer is not entitled

to the income but intends to benefit from it, then the income will be ‘received by’ the taxpayer as stated in the gross income definition (Muller, 2007:170).

In conclusion, income acquired through illegal actions is presumed to be under the definition of ‘received by’ as long as the criminals or persons receiving it do so on their own behalf, for their own profit, or with the purpose to benefit. In Geldenhuys v Commissioner for Inland Revenue (1947 CPD), the court also held that in the case where an individual receives money on behalf of someone else, the money is not taxed on the person who receives it, but on the person, it is being received on behalf of.

In the previously stated case*, WH Lategan v Commissioner for Inland Revenue (1926) CPD 203*, the terms ’accrued to’ or ‘in favour of’ in the Income Tax Act’s definition of gross income simply translate to “to which he has become entitled”. In other words, these terms simply mean ‘entitled to’ in agreement statement of facts formulated under the case of WH Lategan v Commissioner for Inland Revenue the court concludes that it might be difficult to hold that the cash amount of the debt had accrued to the taxpayer in the year of assessment if the debt was payable in the future and not in the year of assessment. He had not gained the right to claim payment of the obligation in the year of assessment, but he had gained the right to do so in the future. This right had vested in him, had accumulated to him in the assessment year, and it was a valuable right that he might cash in if he so desired.

In general, the court’s interpretation of, ’accrued to’ or ‘in favour of’ means that if a taxpayer is entitled to receive an amount, this amount qualifies as gross income in accordance with the Income Tax Act’s definition of the term. In addition, it means that the taxpayer will be taxed on such an amount in the year in which he or she became entitled, regardless of whether that amount has been received or not. It’s understandable for the taxpayer to believe that the accrual began when the event occurred, even before contacting and gaining consent from the insurer. This suggests that the definition of “accrued to” in the statute should be reconsidered, or the courts will be inundated with claims regarding gross income and accrual. If no accrual exists, the taxpayer can contend that no amount should be included in gross income and hence taxed.

In support of WH Lategan v Commissioner for Inland Revenue that is mentioned above, the court in the case of *Commissioner for Inland Revenue v People’s Stores (Walvis Bay)(Pty)Ltd)(1990)(2) SA353 (A),* in which the taxpayer was a clothing retailer that was part of the Edgars network of companies. The taxpayer’s business used a six-month revolving credit

program to sell items. Under the terms of the agreement, the customer was supposed to pay the taxpayer in six equal installments. On the last day of the assessment year, the taxpayer's books show late payments. The money was due the next evaluation year. The Commissioner included the amount in the taxpayer's gross income for that assessment year. The taxpayer appealed the Commissioner's decision, stating that the past-due payments were neither due nor paid within the current assessment year. And also contended that the Commissioner was required to include the unpaid installments, he should only include the amounts with their current value, not at face value. The key question, in this case, was whether the amount accrued to the taxpayer when it was due or when it was payable. Amounts are credited to the taxpayer in the year in which they become due. The correctness of the finding that the expressions 'accrued to' or 'in favor of' simply imply that the individual in question has become entitled to the sum in question sparked debate where the Appellate Division upheld the accrual premise that, because the taxpayer had the right to receive these installments in the future, the outstanding installments were correctly included in the taxpayer's gross income.

When it comes to taxability of income and the gross income definition in the Income Tax Act, it is immaterial whether the amount has been actually received by the taxpayer. Since it has already been established in this study that income from illegal activities falls within the definition of gross income in accordance with the Act, then such income will be taxable if it falls within the definition of gross income and its concepts.

The under-declaration of income by taxpayers is an ongoing challenge that deprives the national revenue which is the base of resources that are being used to meet the direct needs of the citizens. This undermines the concerted global efforts enshrined in Goal 16. 4 of the Sustainable Development Goals aim to dramatically curb illegal financial and arms flows, improve asset recovery and return, and combat all kinds of organized crime by 2030 (Khan and Akbar, 2016:277). Figure one below depicts the plight of the challenge. The top ten countries account for roughly 62.3 percent of global illicit financial outflows, as per the World Bank, and South Africa is ranked number seven after China, Russia, Mexico, India, Malaysia, and Brazil (Kar and Spanjers, 2015:8). Thus, the necessity to increase the national tax administration system's efficiency continues to be a priority so that the government can achieve its socio-economic goal through the tax system (Savic, et al., 2015:1147).

Table 3-1: Illicit Financial Outflows from The Top Ten Source Economies, 2004-2013 (in millions of nominal U.S. dollars on in percent)

Rank	Country	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Cumulative	Average
1	China, Mainland	81,517	82,537	88,381	107,435	104,980	138,864	172,367	133,788	223,767	258,640	1,392,276	139,228
2	Russian Federation	46,064	53,322	66,333	81,237	107,756	125,062	136,622	183,501	129,545	120,331	1,049,772	104,977
3	Mexico	34,239	35,352	40,421	46,443	51,505	38,438	67,450	63,299	73,709	77,583	528,439	52,844
4	India	19,447	20,253	27,791	34,513	47,221	29,247	70,337	85,584	92,879	83,014	510,286	51,029
5	Malaysia	26,591	35,255	36,554	36,525	40,779	34,416	62,154	50,211	47,804	48,251	418,542	41,854
6	Brazil	15,741	17,171	10,599	16,430	21,926	22,061	30,770	31,057	32,727	28,185	226,667	22,667
7	South Africa	12,137	13,599	12,864	27,292	22,539	29,589	24,613	23,028	26,138	17,421	209,219	20,922
8	Thailand	7,113	11,920	11,429	10,348	20,486	14,687	24,100	27,442	31,271	32,971	191,768	19,177
9	Indonesia	18,466	13,290	15,995	18,354	27,237	20,547	14,646	18,292	19,248	14,633	180,710	18,071
10	Nigeria	1,680	17,867	19,160	19,335	24,192	26,377	19,376	18,321	4,998	26,735	178,040	17,804
Total of Top 10		262,994	300,565	329,526	397,912	468,623	479,289	622,435	634,524	682,086	707,765	4,885,718	488,572
Top 10 as Percent of Total		56.5%	57.3%	60.6%	56.9%	56.6%	64.2%	68.7%	63.0%	65.8%	64.9%	62.3%	.
Developing World Total		465,269	524,588	543,524	699,145	827,959	747,026	906,631	1,007,744	1,035,904	1,090,130	7,847,921	784,792

Table3;1 Source: Kar and Spanjers (2015: 8)

3.3.4 Case laws

According to Božič (2015:177), case law underpins the judicial decision-making process adopted by courts in a particular jurisdiction; and it is based on rulings held in earlier cases. In other words, case law informs the laws and principles adopted within a discipline, for instance, tax law in this study. In addition, tax case law, together with statutes and regulations, contributes to the interpretation of aspects of tax that may be blurred when the court is hearing a particular case (Mitchell, 2016:1). However, as aforementioned in chapter one, there is limited available literature on this topic, tax court cases will therefore be the main source of literature to support discussions in this section.

The Income Tax Act's definition of gross income makes no distinction between legal and illegitimate income in terms of taxability. As a result, courts have had to objectively decide whether revenue received falls under the Act's gross income criterion. In making these determinations, courts have referred to previous cases that have ruled on similar cases, dating from centuries back. This section will discuss a more recent illegally obtained income case- the case of MP Finance Group CC (In Liquidation) v Commissioner of South African Revenue Service as discussed above.

In the case of *Geldenhuys v Commissioner for Inland Revenue (1947) (3) SA 256 (C)* and other comparable instances that were discussed, the ruling was consistent with the meaning of the terms. In interpreting the income tax treatment of stolen money, The South African Revenue Services Interpretation Note 80 (2014:15) maintained that income from illegal activities constitutes gross income and is therefore taxable. SARS noted the following, in reference to the case of MP Finance Group CC (in liquidation) v Commissioner for South African Revenue Service (2007).

As noted by Skalak, S.L., Lau, R. and Clarke, S. (2011:20), "*While the MP Finance case dealt with money fraudulently received under an illegal contract, its principles are considered to apply equally to the theft of money through robbery, burglary, or other criminal means. The key issue is whether the thief intended to benefit from the stolen funds. If so, the requisite ingredients for a receipt have been met… The issue is not whether the victim intended to part with the money but rather whether the thief intended to benefit from it*."

In the context of South African Income Tax law, this section has dealt with the meaning of gross income and its notions, such as 'received by', 'accrued to,' and 'in favour.' The Income Tax Act 58 of 1962 defines gross income and does not distinguish between legal and illegal income nor does it provide definitions for the aforementioned concepts. In order to comprehend the treatment of illegally obtained money under South African income tax law, case laws and other secondary sources were helpful in defining these ideas.

Fundamentally, the whole amount received by or accrued to or in favor of the taxpayer, in cash or otherwise, is referred to as gross income (Commissioner for Inland Revenue v People's Stores, 1990). From the discussion in this sector, it is clear that, while evaluating whether any payment received by the taxpayer is taxable, it has to be established whether that amount falls within the above-mentioned definition of gross income under the Income Tax Act. It has been proved by a number of cases, such as the case of Geldenhuys v Commissioner for Inland Revenue (1947) that the manner in which the amount was earned, is irrelevant when the amount satisfies this definition.

The case of MP Finance Group CC (in liquidation) v Commissioner for South African Revenue Service (2007) is a more recent income tax case and is one that can be used as a basis for holding court judgments pertaining to the taxability of income gained from illegal activities. According to Classen (2007:15), this case is the leading authority when dealing with such cases. The author

further mentions that in principle, the judgment passed by the court was accurate and the judge justified the means required to pass it.

The main premise of this case was whether the invested amounts in the definition of gross income definition under the Income Tax Act made the payments taxable. This was the case as the taxpayer received the monies on her behalf with the intention to benefit from it. For the purpose of this case, it did not matter that the taxpayer have a right to the funds- as by law she was supposed to immediately return the money to the investors. The fact that there was an intention to benefit, then the illegally obtained income was duly taxable and fell within the definition of 'gross income' as per the requirements of the Income Tax Act. To sum up this discussion, the evidence provided from previous cases revealed that illegally gained income is taxable in South Africa.

3.4 Comparison between the USA, Australia and South Africa

The aforementioned sections discussed the taxability of illegally obtained income in South Africa, the USA, and Australia, with the aim of drawing some similarities and differences between these tax regimes. In each of these countries, there is a specific state organ that is mandated to levy and collect taxes from taxpayers. In South Africa it is South African Revenue Services, in the USA it is the Congress, and in Australia, it is the Commissioner of Taxation.

The South African and American legislation tax all gross income of the taxpayer, subject to it being within the definition of gross income as provided in the South African Income Tax Act and the Internal Revenue Code of 1986, respectively. On the other hand, according to the definition of assessable income in the Australian Income Tax Act, the Australian legislation imposes income tax on a 'net' basis (Copland, 1924:78). However, many of these definitions do not differentiate between income from legitimate and illegal activities. Therefore, it has been left to the courts to decide on the treatment of illegally obtained income. For the most part, the courts have been consistent in the treatment of illegally obtained income for taxation purposes. In addition, courts in all three jurisdictions have ruled that the source and legality of the income are irrelevant when determining the taxability of the income. What matters is whether the income is within the definition of the respective legal prescripts. In other words, the definitions of what constitutes taxable income form the cornerstone of tax cases in the courts as stated by Copland (1924:78).

In the case of MP Finance Group CC (in liquidation) v Commissioner for South African Revenue Service (2007), the court held that amounts from the investments were part of the taxpayer's gross income as the taxpayer received these amounts on their own behalf and with the intention of gains. The court disregarded the possibility of the taxpayer reimbursing the victims and stated that the tax court was only interested in the taxability of the income. A similar decision was reached in the USA in the case of Rutkin v United States (1052), where the court held that funds received from criminal acts such as violence and threats are regarded as gross income because the taxpayer has control over them.

Although there have been similarities in the treatment of illegally obtained income in South Africa and the USA, there have been inconsistencies in the allowances made in tax courts. For example, the American legislation allows for the taxation of gains received from embezzlement and the South African legislation allows for the taxation of income received by pyramid schemes. However, the difference between these judgments is that in the case of James v United States (1961), the court allowed for deductions to be made in an event where the embezzler reimburses the victim.

Regarding gifts or rewards, income tax is calculated on the monetary value of the gift or reward, provided that this was received in recognition of services rendered by the taxpayer. The SARS Interpretation Note 76 provides an example where a barman received rugby tickets from a guest in recognition of his excellent hospitality, the barman's taxable income included the monetary value of the tickets. Therefore, the monetary value of anything received for a service rendered is taxable under the South African tax laws.

While in Australia, in the case of Federal Commissioner of Taxation v Smith (1986), the taxpayer received a reward for successful completion of a course and not for any services rendered. As a result, the amount of the reward was not considered income in terms of taxation law. The reward was not in the general conception of what constitutes income or by virtue of the definition of "income from personal exertion" in Section 6 of the Act. The payments, therefore, do not fall within that definition.

3.5 Conclusion

The purpose of this chapter was to determine the taxability of income derived from illegal activities in the different jurisdictions that were reviewed. It can therefore be concluded that

any income falling under the purview of taxable income in the respective jurisdiction is taxable, regardless of its legality. Even though it is tainted with illegality, taxing revenue from unlawful operations is a long-standing tax policy in as indicated in the dispute above, both South Africa and the United States of America are involved. It has been demonstrated that income is taxed in both jurisdictions regardless of the legality of the source of that revenue.

It is claimed that, despite their illegality, receipts are now unquestionably taxable. Gross income refers to all income received, regardless of source, for tax purposes in the United States. The US employs the "*economic advantages technique*", which determines whether a taxpayer "*has such control over ill-gotten gains that he derives readily realisable economic value from it in practice"* Classen (2007:15). As a result, in order for an amount to be taxed, it must provide an economic benefit to the taxpayer. South Africa, on the other hand, employs the 'beneficial receipt' technique, which asserts that there is no tax burden if there is no 'receipt'. "Received by" in this circumstance refers to "received by the taxpayer on his own account for his own use".

The next chapter highlight the research methodology used in the study.

CHAPTER FOUR

RESEARCH METHODOLOGY

4.0 Introduction

This chapter focused on laying the groundwork for the research. Selecting cases and data sources for the study's research methodology, case study selection, and data analysis. When it came to determining the taxability of illegally earned income, this dissertation used qualitative analysis. Qualitative research involves collecting and analysing non-numerical data (e.g., text, video, or audio) to understand concepts, opinions, or experiences. It can be used to generate new ideas for research or to gather in-depth insights into a problem (Bhandari, 2020:15). To gather information, the researcher combed through previously published articles and journal articles related to the topic at hand, as well as relevant tax legislation and the various principles applied by courts over the years (case law). The University's online databases would provide easy access to all of the aforementioned sources.

4.1 Method used

The taxability of income derived from illegal activities was examined qualitatively rather than empirically in this study. Interpretive and naturalistic techniques were used in qualitative research, which aims to make sense of or interpret occurrences in order to understand the meaning attributed to them (Benzo, Mohsen, and Fourali, 2017:70).

The study extracted data from a literature review from the South African Republic, Australia, and the United State of America. Examining different judgments rendered by courts. A review of pertinent Practice and Interpretation Notes and the Income Tax Act.

This dissertation referred to previously decided cases that dealt with the question of whether income derived from illegal activities should be subject to income tax. The cases were discussed in order to provide a clear understanding of how our courts have applied the law, to understand the principles applied by the court in determining whether illegal income should be taxed, and also to set the background for determining future cases to be correctly decided.

4.2 Criteria used to select cases

In order to comply with the objectives, descriptive criteria for case selection were used. These criteria provided the most information possible about the distinctive features, qualities, and characteristics of a given social phenomenon, as well as the data that is available regarding that phenomenon (Gerring, 2009:1). The criteria provided some direction by classifying a number of different case selection methods that were most comparable to and most similar to previous judicial decisions regarding the regularity of revenue received.

4.2.1 Period of cases

Table 4-1 Chronological order of the selected cases

Case year	Case name	Case reference
1918	CIR v Delagoa Bay Cigarette Company.	TPD 391, 32 SATC 47.
1926	Sullivan v United States,	15 F.2d 809 (4th CIR.)
1926	WH Lategan v Commissioner for Inland Revenue.	CPD 203. (SATC).
1927	United States v Sullivan.	274 U.S. 259. (USSC).
1931	Ochberg V Commissioner for Inland Revenue AD.	215 (SATC).
1946	Commissioner v Wilcox,	327 US 404.
1947	Geldenhuys v Commissioner for Inland Revenue (3)	SA 256 (C).
1952	Rutkin v United States.	343 U.S.130. (USSC).
1961	James v United States	366 US 213
1972	Mooi v. SIR (1) SA675 (A),	34 SATC 1.

1981	Commissioner of Taxes v G (4)	SA 167 (ZA) 168C-169H.
1981	COT v G, (4)	SA 167 (ZA), 43 SATC 159.
1986	Federal Commissioner of Taxation v Smith.	(FCA)
1986	MacFarlane v Federal Commissioner of Taxation 1	(3 FCR 356)
1990	CIR v People's Stores (Walvis Bay) (Pty) Ltd, (2)	SA 353 (A), 52 SATC 9.
1990	Commissioners of Inland Revenue v Aken	BTC 352. 1 W.L.R. 1374.
1990	Commissioner for Inland Revenue v Insolvent Estate Botha (2)	SA 548 (A).
1995	Unites States v Briscoe.	No. 94-1414. (USCA).
1999	FC of T v Montgomery.	(HCA)
1999	Montgomery v FC of T 98	ATC 4120
2003	FC of T v La Rosa.	(FCA).
2005.	A v The Commissioner for the South African Revenue Service.	TC Case No. IT 11282. (SATC).
2005.	A Group CC v The Commissioner for The South African Revenue Services.	TC Case NO. TC 11247. (SATC).
2007	MP Finance Group CC (In Liquidation) v	SA 521 (SCA).

	Commissioner, South African Revenue Service (5)	
2011	The Commissioner for the South African Revenue Service v. Werner Van Kets.	ZAWCHC 435.
2011	Wood v Commissioner.	No. 17822-09. (USTC).
2019.	A Company v The Commissioner for the South African Revenue Service.	TC Case No. IT 24510. (SATC).

Source: Redesigned by the researcher

4.3 Sources used in cases and literature

An authoritative body's proclamation of legal rules served as sources of case law and literature for this investigation. Legislation served a variety of purposes, including regulation, authorization, facilitation, prescription, provision of funds, sanction, grant, declaration, and restriction.

The 'key words', gross income; illegal income; "received by" or "accrued to" were used in the following sources:

- Google Scholar
- Internet
- Journal Articles
- Lexis Nexis
- Google
- Use of key-words
- Theses
- Books
- Documents

4.4 Conclusion

Gathering data from selected sources was the focus of this chapter. Other laws, court rulings, and regulations should adhere to it when it comes to taxing illegal income. It is important to remember that each state has its own constitution that must be followed. Because they provide the researcher with the most relevant data for the period or subject at hand, therefore, sources were critical. Using qualitative methods allows researchers to gain a more in-depth understanding of their subject matter, as well as gain insight into situations that cannot be explained using large-scale quantitative methods.

CHAPTER FIVE

THE POSSIBLE TOOLS TO DETECT ACTIVITIES THAT GENERATE ILLEGAL INCOME

5.0 Chapter Overview

The preceding chapter focused on a comparison of the taxability of illegally obtained income between two international countries and South Africa. This chapter will identify tools that tax authorities can use to proactively detect activities that generate illegal income. Consistent with the discussion on the treatment of illegal income, this chapter will review tools used by some international countries as well as South African authorities. Moreover, this chapter will provide recommendations on how the South African tax authorities can improve the tax system to be more effective in the treatment of illegal incomes.

It is important to note that there is limited literature related to tools that can be utilized to detect illegal income-generating activities and income resulting from those activities. In addition, the available literature is mostly limited to tax evasion and money laundering. The previous chapter looked at several cases that revealed that both national and international courts have ruled that all income is subject to tax, regardless of its legality. The South African legislation has made it mandatory to register for income tax when one is liable. According to South African Revenue Services (2014:13), all income that falls under the definition of ‘gross income’ should be declared by taxpayers in their annual tax returns.

Tax authorities are mandated to levy, collect tax, and easily track the legally obtained income for income tax purposes using the information provided by the taxpayer. However, it may be difficult for tax authorities to collect taxes from revenue obtained through illegal transactions if the income is difficult to detect (Joint Committee on Taxation, 2021:10). In addition, taxpayers who make gains from illegal activities avoid all law authorities, including tax authorities as declaring their illegally obtained income would result in criminal prosecution. Moreso tax authorities are usually unaware of the day-to-day business of illegal activities and the income they generate, therefore, they are only able to consider the taxability of the income generated once the wrongdoers have been caught (Ntwana, 2011:19).

According to the World Bank (2017:5), illicit financial flows refer to revenue that is illegally made, transferred, or used across borders, and they emphasize the importance of making such flows public. However, illicit financial flows are not easy to measure due to their illegal nature and their underlying activities (The World Bank, 2016:1). Money and activities that are clearly linked to illegality, such as illegal natural resources extraction, smuggling and trafficking, money laundering, tax evasion, and international trade fraud, are included in illicit financial flows (The World Bank, 2016:2). The success of income-generating crimes depends on the ability to conceal the income's financial trail (Schlenther, 2013:130). It is therefore important that tax authorities identify such income for taxation purposes.

The Organisation for Economic Cooperation and Development (OECD, 2012:30) claims that tax authorities have several approaches at their disposal to detect risks of tax crimes. These include intelligence gathering, random audit program risk profiling, and accounting and computer forensics. These approaches depend on the available skill set, technology advancement, and experience in their application in the respective country to work. According to the Institute for Security Study (2021:15), forensic skills are gravely lacking in South Africa. The Hawks – which is a South African Directorate of Priority Crime Investigation that investigates commercial crimes since 2009, is said to lack advanced skills.

The following section will look at some tools used by the governments of Australia and the United States of America to identify illegal activities that generate taxable income to eliminate tax crimes and build a strong tax system.

5.1 Australia

The Australian Transaction Reports and Analysis Centre (AUSTRAC) is an Australian government agency tasked with detecting, deterring, and interrupting financial system abuse in order to protect the public from serious and organised crime. According to the Organisation for Economic Co-operation and Development (2006:15), the ATO and AUSTRAC investigate tax crimes, either individually or in collaboration with the Australian Federal Police and the Australian Crime Commission, which are its partner law enforcement agency. The Australian government also makes use of double taxation agreements as means of preventing tax crimes by implementing their own tax regulations between Australia and other international tax authorities. The Australian Taxation Office (2019:15) defines double taxation treaties as official bilateral agreements between two countries. The basic goal of the double tax treaty is to share

taxation rights between contracting countries, avoid inequalities, maintain equal rights and security for taxpayers, and prevent tax evasion. More than 40 countries have signed such agreements with Australia (Australian Taxation Office, 2019:20).

Australia's tax treaties are in place to avert avoidance and evasion of taxes on a variety of income streams between treaty partners by: "*…preserving the application of domestic law rules that are designed to address transfer pricing and other international avoidance practices providing for exchanges of information between the respective taxation authorities..*." (Australian Taxation Office, 2019:22).

The Australian Taxation Office (2020:10) reported that the Australian tax authority receives data from financial institutions and other government organizations and compares it to their own to discover missing income. This is referred to as data matching and is consistent with the information sharing system adopted in South Africa in terms of the 2012 government Gazette. Similar to SARS, ATO collects, holds, uses, and discloses personal information concerning their functions in line with relevant legislation (Australian Taxation Office, 2021a:35).

The ATO has put together a fraud and corruption plan which aims to ensure a strong tax system in the country by preventing, detecting, and responding to these crimes which are based on the following activities, among others (Australian Taxation Office, 2021b:37):

- *Internal and external audits, as well as specialized reporting procedures for receiving confidential fraud tipoffs from both internal and external sources.*
- *The Public Interest Disclosure Act (PIDA) and the Tax Whistleblower Act (TWA).*
- *data modeling and intelligence analysis to spot probable fraud and corruption, identity crime models to stop systemic attacks, and trends, patterns, and irregularities.*
- *intelligence exchange with law enforcement and integrity authorities, as well as overseas jurisdictions, and collaboration between them.*

According to the Australian Taxation Office (2013:13), tax crimes undermine community confidence in the tax system, which results in taxpayers being discouraged from willingly paying their taxes. Therefore, it is important that tax crimes are detected and punished by law to maintain community confidence for a robust tax system and economy.

5.2 The USA

The Internal Revenue Services (IRS) Criminal Investigation Division is the only USA agency allowed to conduct criminal tax investigations according to the Organisation for Economic Cooperation and Development (2006:15). It also works with other law enforcement agencies with jurisdiction over the predicate crime. This division, (IRS) employs several investigative methods, namely, the source and application of funds method, the bank account analysis, and the net worth method (Hochman, 2014:24). These methods are used to identify any gaps between a taxpayer's income and expenses; they are also used to identify the actual tax liability during a taxable year. Moreover, Capgemini Consulting (2016:5) states that to effectively tackle this threat, tax authorities must move towards involving people, processes, and technology. As mentioned during the review of literature on South Africa and Australia, community involvement plays a big role in identifying individuals with suspicious expenditures and lavish lifestyles and this has been achieved through strong whistle-blower systems.

The USA also utilized information sharing with other jurisdictions, as mentioned above, the USA signed an income tax convention with South Africa in 1997. This convention is mostly centered around the USA tax model treaty and provides for the sharing of information in order to avoid tax evasion, as well as common criteria for limiting the benefits of the convention to people who are not treaty shoppers (Internal Revenue Service, 1998:1). According to the agreement, the taxes covered are as follows:

"The existing taxes to which the Convention shall apply are, in particular: a) in the United States: the Federal income taxes imposed by the Internal Revenue Code of 1986 (but excluding social security taxes) and the Federal excise taxes imposed with respect to private foundations; (hereinafter referred to as "United States tax"); b) in South Africa: i) the normal tax; ii) the secondary tax on companies; (hereinafter referred to as "South African tax (hereinafter referred to as "South African tax")"

"In addition to, or in place of, existing taxes, this Convention shall apply to any identical or substantially similar taxes imposed after the date of signature of the Convention" (Internal Revenue Service, 1998:7).

In 1982, the USA and Australia signed a double taxation agreement to avoid double taxation and prevent fiscal evasion in the area of income taxes. The agreement is largely based on the

US Department of the Treasury's draft income tax model convention announced in June 1981 and the OECD model published in January 1977, as well as modifications in the two nations' income tax legislation and tax treaty policies (Internal Revenue Service, 1983:3). Both agreements also indicate that contracting governments must notify each other of any substantial changes that alter their respective agreements' obligations.

5.3 South Africa

To ensure integrity, trust, and ability to carry out its mandate effectively, SARS has developed a system based on the Program of Voluntary Disclosure (VDP). The VDP aims to persuade taxpayers to come forward voluntarily to assist SARS in resolving their tax difficulties and avoiding understatement penalties and other administrative penalties (Strategic plan SARS, 2020:5). One of its objectives is to trace and punish taxpayers who do not comply with tax legislation. The benefit of this program is to provide taxpayers and traders with clarity and certainty about their obligations and also make it simple for taxpayers and traders to meet their responsibilities (Strategic plan SARS, 2020:9). Together with the Department of Trade, Industry, and Competition, SARS also focuses on non-compliance is identified and investigated through trade and unlawful financial movements. The following section discusses the tools used in South Africa to identify income that has been illegally obtained.

5.3.1 Lifestyle audit

Conducting a lifestyle audit is one of the most successful methods for locating hidden assets and income sources. This is done by scrutinising mismatches in a person's lifestyle, this process involves determining and analysing an individual's income, expenses, and equity (Meaden and Moore, 2019:2). Thompson (2020:3) states that lifestyle audits aim to determine whether an individual is illegally living above their means. According to Powell (2011:10), this is legitimate fraud prevention and detection mechanism that typically includes an audit of a taxpayer's properties, motor vehicles, company registrar information, and credit history. The South African government and SARS have used lifestyle audits across the public sector to reduce fraud and corruption. The lifestyle audits done on the economic interests of eleven members of the Western Cape cabinet and their spouses and/or life partners are an example (Parliamentary Monitoring Group, 2020:15). All members of the cabinet and or life partners appeared to be living within their means, according to the audits, and no transactions raised any suspicions.

According to Thompson (2020:3), SARS identifies candidates for lifestyle audits through whistle-blowers, internal monitoring mechanisms, as well as reporting entities such as banks, the deeds office, and automobile registration authorities. SARS uses "the lifestyle questionnaire" to get information regarding an individual's assets, income, investments, and expenses. If the individual fails to provide evidence for their source of income, such income is classified as undisclosed income – which is a criminal offense in South Africa. A taxpayer who evades tax is investigated by SARS and once the investigation is finalised, the National Prosecuting Authority (NPA) decides whether to institute a criminal prosecution (SARS, 2021:20). The use of the whistle-blower system is consistent with the Irish government intervention, where they encourage ordinary citizens to bring forth any information that might be useful in fighting tax crimes (Revenue, 2018:17).

Meaden and Moore (2019:2) add that people who want to avoid tax usually receive their income in cash. Therefore, various forensic accounting methodologies are available to identify this cash and estimate its value as described below (Meaden and Moore, 2019:5):

The first one is the bank deposits method, where the expert reconstructs a person's income using bank deposits, checks, cash payments from undeposited receipts, gifts, loans, inheritances, and insurance proceeds. What follows is that to calculate the total cash from unknown sources, the expert deducts funds from known sources' total receipts. Secondly, there is the expenditure method, where a taxpayer's sources of income and cash used during a specific period are analysed. If the taxpayer's expenses are more than the income, the excess possibly represents undisclosed income. Thirdly, SARS also employs the asset technique, which assumes that any unfounded growth in a person's net worth is due to unreported income. In this situation, to determine the taxpayer's net worth, the expert consults bank and brokerage statements, real estate records, loan and credit card applications, and other documents. The rise in the taxpayer's net worth during the relevant period is then calculated, followed by the deduction of stated income and expenditures. The excess represents income from unknown sources.

Powell (2011:11) cautions that results obtained from lifestyle audits are only indicators of mismatches in a taxpayer's income, expenditures, and assets, and should not be regarded as conclusive proof of illicit activity without further evidence. It is therefore important to question whether lifestyle audits are reliable in detecting illegal income-generating activities and income resulting from those activities. Powell (2011:11) raises one limitation that may impact the

reliability of lifestyle audits as the classified information of the taxpayer can never be used in the lifestyle audit. Niven (2021:35) also adds to the limitations mentioned above stating that a successful income and asset disclosure system includes a number of techniques, including lifestyle audits. However, they are insufficient for making definitive judgments. They can be used to discover red flags that need to be investigated as part of a bigger monitoring program. The South African Revenue Service (SARS), which has been conducting lifestyle audits for the past two years in an attempt to reclaim unpaid taxes, has declared that it will continue to do so, perhaps to close the gap. In 2019, KPMG, a worldwide auditing firm, began conducting lifestyle audits for its employees in order to promote integrity and uncover potential abuses of internal systems and client contracts. In 2018, the country's current president, Cyril Ramaphosa, called for lifestyle audits of those in positions of power. Some state personnel have already been subjected to lifestyle audits, including members of the Western Cape cabinet and South Africa's national power utility Eskom; this can also help because the president is driving the initiative.

Munyao (2019:42) adds that lifestyle audits can be expensive to conduct as individuals involved in financial crimes can hide their assets in foreign jurisdictions. In addition, lifestyle audits are best suited for cases involving large quantities of money because they rarely reveal modest currency transactions such as consumable purchases or one-time medical costs (Munyao, 2019:43).

5.3.2 Information sharing

There are different ways in which tax authorities can use information sharing to detect illegal activities and the income derived therefrom. This could be information sharing by domestic institutions with the relevant tax authorities or information shared between different jurisdictions. Pertaining to the sharing of domestic institutions to SARS, the South African government gazetted that "reporting institutions must furnish returns of sums of money invested with, loaned to and deposited with the reporting institution and of interest received by or accrued to or in favour of any person from the reporting institution or any business carried on by the reporting institution in the Republic…" (South African Revenue Services, 2012:10).

Different jurisdictions can share information by entering into double taxation agreements – which is defined in Article 2 of the Vienna Convention on the Law of Treaties (1986) as "*an international agreement governed by international law and conclude in written form: (i) between one or more States and one or more international organizations; or (ii) between*

international organizations, whether that agreement is embodied in a single instrument or in two or more related instruments and whatever its particular designation."

South Africa has entered into several double taxation agreements, these include agreements between South Africa and Australia and the United States of America. Double taxation agreements may improve some of the limits on information exchange by allowing countries to share tax information collected within their jurisdictions and received from other jurisdictions outside the agreement (Schlenther, 2013:135). In addition, these agreements could enable governments to work together in tax investigations. In 2014, South Africa entered into a double taxation agreement with the USA to improve international tax compliance and promote transparency between the two countries on tax matters. According to U.S. Embassy and Consulates in South Africa (2014:35), the agreement will ensure that South African financial institutions report information about USA account holders to SARS and SARS will, in turn, relay the information to the Internal Revenue Service (IRS). Equally, the IRS will provide similar information about South African account holders in the USA to SARS. Each country will thus have access to their respective account holders' information residing in their contracting partner.

Furthermore, South Africa and Australia entered into a double taxation agreement and according to South African Revenue Service (2008:4) the taxes covered in the agreement are as follows:

"a) the income tax imposed under Australian federal law, including the resource rent tax in respect of offshore projects relating to the exploration for or exploitation of petroleum resources;

b) the normal tax; (ii) the secondary tax on companies; and (iii) the withholding tax on royalties in the case of South Africa.

c) to any equal or substantially similar taxes, including dividend taxes, imposed by the Federal Government of Australia or the Government of the Republic of South Africa under domestic law after the date of signature of the Agreement, in addition to or in substitution of existing taxes".

Commissioner for the South African Revenue Service v Werner Van Kets (2011:35), SARS sought orders declaring that sections 74A and 74B of the Income Tax Act 58 of 1962 may be

used to obtain information from any person in South Africa in order to comply with SARS's obligations under a double taxation agreement that has been concluded and includes a provision for the exchange of information. The Australian Tax Office (ATO) requested that SARS share information in accordance with article 25 of the double tax treaty between South Africa and Australia. The main question before the court was whether the words “any taxpayer” used in sections 74A and 74B of the Act can be interpreted to include a person who is not a taxpayer as defined in section 1, but who has been identified as the person who can provide the information under the request, which in this case was initiated by the ATO, under the terms of the agreement.

In its ruling, the court made the following declarations:

1. Declaring that the SARS may use sections 74A and 74B to request information from anyone in the Republic of South Africa in order to comply with its duties under any double taxation agreement that has been concluded for the exchange of information.

2. The term ‘taxpayer’ as used in sections 74A and 74B must be interpreted in light of South Africa's obligations under any double tax treaties that require information to be provided.

3. Residents of South Africa are bound by the provisions of the agreement between South Africa and Australia (for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income between South Africa and Australia), as amended by the protocol, and must respond to any request made under the agreement.

In summary, Odeku (2019:4) advocates for the use of lifestyle audits as a proactive tool in anti-corruption operations and fraud within the South African government. However, it must be noted that lifestyle audits can prove to be economically inefficient for cases of small amounts of money, thus limiting the authorities' ability to use them as means of detecting illegally obtained income in such cases. Also, the fact that these do not provide conclusive results that a crime has been committed for generating income is another limitation to the extent to which lifestyle audits can be relied upon.

Another tool identified is information sharing, this could be an agreement between reporting institutions and SARS. The government Gazette (2012:29) gives SARS the power to access all taxpayer’s bank transactions, in terms of section 69 of the Income Tax Act. On the other hand, there are double taxation agreements, which allow for information sharing between countries,

usually two, in order to avoid double taxes and tax avoidance. The court concluded in the *Commissioner for the South African Revenue Service v Werner Van Kets (2011)* case that Article 25 of the South African-Australian agreement can be used to broaden the definition of "taxpayer" in South Africa's Income Tax Act.

5.4 Conclusion

The identified tools allow tax authorities the power to have access to all taxpayers' financial information which could help in identifying their income for taxation purposes. However, there is still a limitation in terms of accessing a taxpayer's income that is derived from illegal activities, especially when such income is received in cash. In addition, banks and other financial institutions do not access an individual's cash transactions. As stated in the 2021 Financial Action Task Force Report (2021), it was pointed out that authorities from various countries have not yet come up with identifying the financial activities related to unlawful mining, illegal logging, or waste trafficking that requires applicable red flags, training, typologies, or analysis techniques. In addition, there is not enough experience from tax crime investigators to process information received from financial institutions.

The Australian Taxation Office acknowledges that threats related to tax crimes may not be completely removed, it is however crucial that tax authorities should take all necessary steps to minimize them. As the world is moving towards a digital era. South Africa, for example, is still lagging behind in terms of technological growth. Thus, authorities must adopt innovative technology tools to detect undisclosed income and illegal activities. SARS should move from traditional methods like lifestyle audits and information sharing and adopt tools that have been proven to work. This can be done through extensive research and investigating tools that have worked, which are mainly new technology innovations. To succeed in tax crime investigations and gain greater access to all taxpayers' information, the South African government should focus on improving the skill set of investigators and adopting current technologies by investing in accounting and computer forensics.

CHAPTER SIX

CONCLUSION OF THE STUDY

6.0 Chapter overview

The taxability of illegally obtained income is gaining interest in the tax research field. South African, American, and Australian tax courts have adopted similar principles regarding the taxability of illegal income, although there are some differences (to a lesser extent). Some people, such as Alphonse Gabriel "Al" Capone (Al Capone), an Italian-American gangster who ran a Prohibition-era crime organization from 1925 to 1931, believe that income derived from unlawful operations or illegal income is taxable.

Firstly, the facts presented in the study will be summarised in this chapter. Secondly, the chapter will draw the conclusion from the literature reviewed and case law discussion. Finally, the study's shortcomings will be discussed, as well as areas where additional research could be conducted.

6.1 Discussion

The tax revenue collection system has lost substantial amounts from its inability to entirely capture income generated through illegal activities. In all three jurisdictions investigated in this study, illegal income has not been explicitly mentioned in the definitions of taxable income. As a result, in dissecting these definitions, the courts have unanimously concluded that illegal income should be taxable under respective taxation laws.

This study investigated the taxability of illegally generated income in South Africa, the USA, and Australia with the aim of contributing to strengthening the South African tax revenue collection system. A qualitative approach was adopted together with the use of secondary data from the literature review. In addition, the theoretical sampling method employed was limited to case laws that have taken place between 2000 and 2015, and data were analyzed using the grounded theory. The Income Tax Act, 58 of 1962, governs income tax in South Africa, and assessing a taxpayer's taxable income and, ultimately, tax liabilities begins with determining the taxpayer's gross income. A person's income might be taxed based on receipts or accruals, according to the definition of "gross income." South African tax legislation, case law,

textbooks, and journal articles are among the study's secondary data sources. This study compared and discussed the taxability of illegally obtained income in Australia, New Zealand, and the United States. The country selection was based on similarities in the treatment of illegal income in these jurisdictions, as well as the fact that South Africa has tax treaties with the aforementioned countries. This study aimed to make a vital contribution to the limited, but growing literature for a more comprehensive understanding of how courts determine taxable income and the treatment of illegally obtained income. To achieve its aim and objectives, the study followed a qualitative research design, and inductive and exploratory research approaches to aid in generating interpretations derived from the data collection in order to detect patterns and linkages in order to construct a theory.

The central theoretical foundation of this study is the formal rationality theory by Max Weber (1922:48) which used ideal types to answer the research question related to how formal organisations work. Uebel (2018:37) says a mental construct that helps the understanding of salient and conspicuous elements of the real world is defined as an ideal type. The reason for deploying the rational theory for the current study is because, to an extent, the study focuses on the behaviour of the taxpayer. The criteria for making a logical choice are established by the decision-making process of the taxpayer as well as the authorities responsible for collecting money. One way to explain what it means to make a reasonable decision is to think of it as the process of analyzing all of the possibilities and then choose the one that is most appealing..

6.1.1 Taxability of illegal income in South Africa

The Constitution of the Republic of South Africa mandates SARS to collect all taxes owed and maintain optimal tax compliance. To be taxable, income must meet the criteria of gross income set forth in Section I of the South African Income Tax Act 58 of 1962 with the entire amount received by or accrued to or in favour of a resident, in cash or otherwise, is one of the primary components. There is no distinction, however, between legal and illegal income.

Money, the monetary worth of all forms of earnings, and rewards obtained for a service done by a taxpayer are all included in total taxable income. In addition, the government can only tax income taxable received by the taxpayer on his own behalf with the intention to benefit from it or when he becomes entitled to it for his own benefit. Furthermore, the element of entitlement means that the taxpayer will be taxed on the income in the year in which he or she became entitled, regardless of whether that amount has been actually received.

This study discussed the more recent illegally obtained income case which has been important in addressing the question around the taxability of illegally obtained income – the case of MP Finance Group CC (in liquidation) v Commissioner for South African Revenue Service 2007 (5) SA 521 (SCA). A pyramid scheme failed to pay out millions of dollars to investors in this instance. The court found that the money was given to the scheme operator with the goal of profiting from it, and hence the income was taxable under South African law. Although the case was regarded as fraud, the principle of considering the receipt of the income and the intention by the taxpayer to benefit equally applies to cases of other criminal activities (South African Revenue Services, 2014:45).

6.1.2 Taxability of illegal income in the USA

The study reviewed the taxability of illegally obtained income in the USA, where the Sixteenth Amendment of the United States Constitution requires Congress to tax taxpayers' income. Prior to 1986, illegally obtained income was not taxable under US tax law. This changed with the amendment of tax laws when gross income is defined in Section 61 of The Internal Revenue Code of 1986 to include all income from whatever source it is derived. The code also does not distinguish between legal illegally gained income and the American case law has established that, for taxation purposes, there is no distinction between the two incomes. What matters is whether the definition of gross income is satisfied. However, in the case where for example taxpayer 'A' extracted monies from taxpayer 'B' illegally and later reimburse 'B', such monies may be deducted in the year in which the income was received.

In addition, the case law also established that income is taxable when the individual has control over it, derived readily realisable economic value from the income, and used the funds that are used in the taxpayer's accord to benefit from it. This includes, but is not limited to, illegally obtained income through extortion, embezzlement, and fraud.

6.1.3 Taxability of illegal income in Australia

The next jurisdiction to be reviewed was Australia where the Commissioner of Taxation has the administrative authority over the levying and taxation of income in Australia. Taxable income is defined in section 6.5 of the Australian Income Tax Assessment Act of 1997 as '*assessable income*.' Taxable income is computed for Australian residents using all regular income from all sources, while it is calculated for non-Australian citizens using only Australian

sources. Furthermore, assessable income is calculated by deducting deductions from a taxpayer’s gross income in the year of assessment.

Furthermore, assessable income is considered to be ‘received’ once the taxpayer uses it on their behalf or it is used as he or she has instructed. Similar to the above tax laws, Australian law also makes no distinction between legally and illegally obtained income in their definition. However, the difference is that taxable income in Australia is determined by subtracting deductions for the income year from assessable income for the same year. The Australian case law has established that as long as the perpetrator has profited from the income, such income is regardless of whether the victim(s) have been compensated, income is taxed (MacFarlane v Federal Commissioner of Taxation, 1986). In addition, for a reward to be taxable, it must have been received for a service rendered and have attributes of an income as the payments were not made regularly (Federal Commissioner of Taxation v Smith, 1986).

It can be concluded that income from various sources, such as fraud, theft, and bribery are taxable under Australian law. A self-assessment program is used in the tax system. As a result, everyone is responsible for filing their own tax returns with the ATO each year.

6.1.4 The possible tools to detect illegal income-generating activities

Tax authorities may find it difficult to trace illegally obtained income when collecting taxes because they may be unaware of the day-to-day operations of illegal businesses and criminals do not declare their incomes. One of the reasons is to avoid criminal prosecution. The study identified tools that tax authorities can use to proactively detect illegal income-generating activities and income resulting from those activities.

The first tool used in South Africa is the lifestyle audit, where a person’s life is analysed to identify mismatches in their income and expenses. Lifestyle audits can be expensive to carry out, and they do not provide conclusive proof of illicit activity on their own, they need to be supplemented by further evidence. On the other hand, there are various forensic accounting methods that can be used to identify income received in cash and estimate its value, namely, the bank deposits, expenditure, and asset methods. In addition, South Africa uses information sharing within the country and other international jurisdictions as a way of detecting illegal activities. Financial institutions in the country provide tax-related information to SARS and double taxation agreements enable information sharing between countries.

Both the USA and Australia have entered into double taxation agreements with South Africa and among themselves, where each country has an obligation to share tax-related information as stipulated in the agreements. The agreements can also be used to curb tax avoidance and evasion. Similar to information sharing adopted within the South African tax system, Australia has data matching which allows the tax authority to receive data from various institutions to match it against their own to identify undisclosed income which seems to be successful. On the other hand, the USA uses mismatches to discover income and expenditure, the source and application of money technique, bank account analysis, and net worth approach. Another strategy to fight the problem of discovering illegitimate money is to use technology that can be solved in one of two ways. The first approach would be to introduce “some form of statutory immunity” into the system. Surveys are conducted on a regular basis in an attempt to determine the true scope and cost of fraud to businesses and society. The second step would be for the judiciary to issue definitive legal rulings establishing immunity in the South African income tax regulation framework, allowing a taxpayer to exercise his constitutional right against self-incrimination when filing tax returns.

6.2 Conclusion

In all jurisdictions, income is regarded as taxable income if it falls within the definitions of taxable income, regardless of the nature of its legality. Taxable illegal income may include different criminal activities. The study also identified tools that may be used to identify illegally obtained income and the main recommendation for South Africa is the adoption of modern technological innovations. This can be achieved through improving the skill set of investigators by investing in research and development and accounting and computer forensics. Implementing these proposals will almost certainly necessitate some compromise on one or more principles. If a balance must be made between the requirement to declare funds received from criminal acts and the constitutional right against self-incrimination, such a compromise would be worth the benefit to all parties involved. Furthermore, both our legislative and our judiciary would benefit from remembering the objective of tax laws. This study has succeeded in determining the taxability of illegal income in South Africa and identifying preventive measures that might enable tax authorities to identify illegal income-generating activities. However, there is still a need to answer more questions about the treatment of illegally obtained income in South Africa. Specifically, the progress the tax authority has made in identifying and taxing such income. Therefore, an investigation into how South Africa has progressed in

identifying illegal income-generating activities for tax purposes is an area that the study recommends for future research.

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