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RESEARCH TOPIC:

**AN ASSESSMENT OF THE TAXATION OF INCOME DERIVED FROM ILLEGAL
ACTIVITIES IN ZIMBABWE.**

SUBMITTED

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DECLARATION

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DEDICATION

In the past few days someone told me that a grateful heart is a magnet for miracles. This is an opportunity for me to thank everyone who has somehow been involved in the build up to this project.

No words can express my gratitude to God, confident of this very thing, that He has started a good work in me and He will carry it to completion. My mother, there is no end for things in the heart. An unending love and constant desire to make you proud dwell indefinitely in my heart. To my sister, you know me best, you have watched me grow as I have watched you grow. I have got nothing but love for you.

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Except the Lord build the house, they labour in vain that build it: except the Lord keep the city, the watchmen waketh but in vain. Thank you, Lord, for manning the Fort.

ACRONYMS/ ABBREVIATIONS

CIR	Commissioner for Inland Revenue
COT	Commissioner of Taxes
ITC	Income Tax Court
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
SIR	Secretary for Inland Revenue
USA	United States of America

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CHAPTER ONE.

Some things you can't escape; death, taxes and a racist society.¹

1.1 Introduction.

In Zimbabwe, the question as to whether income derived by a taxpayer whilst pursuing illegal activities should be made subject to the Income Tax Act of Zimbabwe² (hereinafter the Act), is a relatively uncharted area of the law. Compared to other jurisdictions like South Africa and the United States of America (hereinafter USA), which have been developing this area of the law through case law and scholarly writings, the subject has been dormant in Zimbabwe. This research will draw comparisons between the taxation regime relating to the taxation of income derived from illegal activities as it stands in Zimbabwe and that of South Africa and the USA.

One is only taxed in terms of the gross income they have 'received' in any year of assessment, hence the problem arises, does one 'receive' income derived from illegal activities? In Zimbabwe, the prominent decision on whether or not income derived from illegal activities is to be taxed is *Commissioner of Taxes v G*³ (hereinafter *COT v G*). The crux of the Courts finding in this case was that, this form of income is not 'received' for purposes of the Act. The court pursued the objective approach to the taxation of income derived from illegal activities. The objective approach is when a court applies the literal rule of interpretation to the word 'receive'. According to this approach a taxpayer 'receives' an amount if they have legal entitlement over it. Legal entitlement over an amount is absent if, upon such seeming receipt, a legal obligation to pay the amount over to another person immediately arises.

¹Cole, JL 'Neighbors' 4 *your eyez only*, (2016) Dreamville Inc. Under Exclusive licence to Roc Nation Records, Distributed by Universal Music Distribution.

²Income Tax Act of Zimbabwe [Chapter 23:06].

³*Commissioner of Taxes v G* 1981 (4) SA 167 (ZA).

However, the position as it is in Zimbabwe relating to taxation of illegal income is now at odds with the position in South Africa.⁴ Though inconsistent in their decisions⁵, courts in South Africa are now leaning towards the subjective approach as opposed to the objective approach in ascertaining tax liability on income derived from illegal activities. In *MP Finance Group CC (In liquidation) v Commissioner for South African Revenue Service*⁶ (hereinafter *MP Finance*) the Supreme Court of Appeal of South Africa (hereinafter SCA) decided that the absence of legal entitlement over amounts that are derived from illegal activity does not exempt it from tax. The subjective approach looks at the intention or purpose of the taxpayer towards the amount which he has fraudulently received. If the taxpayer enjoys a benefit or potential benefit upon acquiring such funds, then the theoretical legal obligation upon him to repay the money should not exempt such income from tax.

Key to the discussion as well, is the observation that the phrase "income from illegal activity" is not self-defining.⁷ Income may be derived from a wide range of illegal activities. Illegal activities exist between two extremities. There are those that are not related to any legitimate enterprise such as murder-for-hire and those relating to legitimate enterprises but involving peripheral violations of the law, such as trading without the requisite license.⁸ The question thus arises as to whether amounts flowing from these two variants of illegal activity, should be treated differently or painted with the same brush of immoral turpitude.

1.2 Background.

The definition of gross income is provided for in section 8(1) of the Act. Gross income is the basis on which to determine a taxpayer's taxable income. Gross income means:

⁴ South African Revenue Service Interpretation Note No.80 *The Income Tax Treatment of Stolen Money* (2014) 13.

⁵ E Muller 'The taxation of illegal receipts. A pyramid of problems! A discussion on ITC 1789 (Income Tax Court – Natal)' (2007) *Obiter* 166.

⁶ *MP Finance Group CC (In liquidation) v Commissioner for South African Revenue Service* 2007 (5) SA 521 (SCA).

⁷ BI Bittker 'Taxing income from unlawful activities' (1974) Vol 25 *Case Western Reserve Law Review* 138.

⁸ Bittker (n7 above) 138.

...the total amount received by or accrued to or in favour of a person or deemed to have been received by or to have accrued to or in favour of a person in any year of assessment from a source within or deemed to be within Zimbabwe...⁹

It is thus apparent that the Act applies only to those amounts that are ‘received by’, ‘accrued to’ or ‘in favour of’ an individual.

This therefore means that, in order to establish whether or not income that has been derived from an illegal activity by a taxpayer is taxable, it must be shown that the taxpayer ‘received’ the amount in question. The meaning of the phrase ‘received by, accrued to or in favour of a person’, is not explained in the Act. The courts are therefore often required to interpret the meaning of the phrase based on the specific set of facts before them.¹⁰

In Zimbabwe, a reading of *COT v G* reveals that, when interpreting the phrase ‘received by’ in relation to illegal activities, one follows the reasoning in the South African case of *Geldenhuis v Commissioner for Inland Revenue (hereinafter CIR)*.¹¹ In *Geldenhuis supra*, it was established that the meaning of ‘receive’ in the taxing statute, means a taxpayer should receive the amount ‘on his own behalf and for his own benefit’.¹² The effect of this definition is that an amount is only received if one has legal entitlement to it. Receiving an amount through theft or embezzlement for instance, does not constitute a ‘receipt’ as the amount legally belongs to another.

The above approach is known as the *objective approach* to the taxation of illegal income. The flaw with the objective approach is that, the taxpayer will rely on the lack of legal entitlement to evade tax liability. The lack of legal entitlement over the amount in question means it does

⁹ Income Tax Act (n2 above) Section 8.

¹⁰ E Bonthuys and C Monteiro ‘Sex for sale: the prostitute as businesswoman’ (2007) Vol 121(3) *South Africa Law Journal* 664.

¹¹ *Geldenhuis v Commissioner for Inland Revenue* 1947 (3) SA 256 (C) quoted in, *COT* (n3 above) at 171A.

¹² *Geldenhuis* (n11 above) 260.

not fall into his gross income. The objective method of interpretation is thus inhibiting when it comes to the taxability of income from illegal activities.¹³

However, in the *MP Finance* case the Supreme Court of Appeal applied the *subjective approach*. This approach seeks to interpret the intention of the taxpayer towards the amount in question.¹⁴ This means that if a taxpayer receives income from illegal activities, which income he has no legal entitlement over, but has the intention of keeping such income for his own benefit, he will be taxed on such an amount in terms of gross income.

The reasoning behind the subjective approach is that, it is irrelevant in the determination of whether or not an amount is ‘income’, if it is derived from an activity that is illegal, immoral or *ultra vires*.¹⁵ It is submitted that, the only true test that exists is whether or not the income was generated in the furtherance of a trade as defined in section 2(1) of the Act.¹⁶ The understanding is that fiscal law should tax an amount if it meets the requirements of income regardless of legality or illegality of the source from whence it is derived.

1.3 Statement of the problem.

Revenue collected from tax finances the State. The United Nation has recognised a surge in the underworld and illegal economy.¹⁷ It thus becomes all the more important to answer: Should income from illegal activities be without fiscal consequences as per the objective approach, or should it be taxed as per the subjective approach?

By following the precedence set in *COT v G*, a lot of State revenue is lost from exempting income derived from illegal activities from income tax. Furthermore, it increases the would

¹³ SARS Interpretation Note (n4 above) 15.

¹⁴ NH Khumalo, *The taxability of income derived from illegal activities in terms of the Income Tax Act 58 of 1962* Unpublished LLM Thesis, University of KwaZulu-Natal, (2015) 3.

¹⁵ RC Williams *Income tax in South Africa: Cases and Material* (1995) 181.

¹⁶ “‘trade’ includes any profession, trade, business, activity, calling, occupation or venture, including the letting of any property, carried on, engaged in or followed for the purposes of producing income as defined in subsection (1) of section eight and anything done for the purpose of producing such income;’.

¹⁷ *‘Huge tax orgy in sex industry’* Sunday Times 12 February, 2006.

be, taxable income base the taxpayer makes without consequence of possible taxation. On the other hand, the subjective approach, opens Pandora's box. Other contentious ancillary issues relating to the taxation of illegal income arise. For instance, an anomaly arises of whether expenses incurred in generating that income would be deductible,¹⁸, in declaring illegal income does not one self-incriminate and lastly it generally does not appear to be good policy to have the State partake in the forbidden fruit.

1.4 Research Question.

With regard to taxing income derived from illegal activities, which approach should be taken in Zimbabwe. The objective approach or the subjective approach?

¹⁸ LB Mtshawulana *'Gains gained from illegal activities: An analysis of the taxation consequences'* Unpublished Masters in Commerce Thesis, Rhodes University, (2008) 7.

1.5 Research Objectives.

- i. To examine if the phrase '*received by*' should be interpreted in terms of the objective or the subjective intention of the tax payer.
- ii. To assess if it is wise to have the notion of public policy have a bearing in the determination of whether or not to tax income derived from illegal activities.
- iii. To consider what regard should be had to the constitutional protection against self-incrimination when the revenue authorities request a tax return from one engaged in an illegal scheme of profit making.
- iv. Seeing that in the furtherance of a trade, deductible expenditures occur, it is imperative to investigate if they apply when the trade is illegal.
- v. To establish whether it is good policy to have the government partner with the unlawful activity by requiring a part of the illegal proceeds.

1.6 Methodology.

For this research the desktop approach and a comparative analysis with primarily South Africa and USA, as well as other jurisdictions will be used. The desktop approach involves the use of all sources found in the library such as textbooks, internet sources, journal articles and case authorities. With comparative analysis, the methodology aims to make comparisons between Zimbabwe and South Africa and USA. This is owing to the similarity in our fiscal statutes in the former and the advanced stage of legal development in the latter.

Key to note is that the Zimbabwean Act was akin to South Africa's Income Tax Act¹⁹ until 2001 when South African amended its tax legislation.²⁰ However, the provisions relating to

¹⁹ South African Income Tax Act 58 of 1962.

the taxation of gross income relevant to this research remain unchanged save for few insertions.

1.7 Limitations of the research.

Zimbabwe's position is only reflected by the *COT v G* case which dealt with the question of whether income derived from illegal activities should be subject to income tax. As alluded to in the introduction, the subject has been dormant in Zimbabwe. The lack of judicial precedence makes this case the only landmark decision on the topic in the jurisdiction upon which the research will rely on to reflect the Zimbabwean position.

Though the study into the taxation of income derived from illegal activities is important, this comparative study of the taxation of income from illegal activities is restricted to primarily South Africa and the USA. This research is limited to the discussion of the phrase 'received by' rather than 'accrued to' because the notion of accruals has different jurisprudence not subject to this research.

1.8 Literature review.

There is anything but consensus on whether or not income which is received by a taxpayer in the course of carrying on illegal activities is received by such taxpayer for purposes of assessing such person's gross income.²¹ Various cases and jurist have tussled with the issue back and forth and there appears to be no outright consensus. However, what is apparent is that there are two schools of thought, those behind such taxation and those against it.

The meaning of the phrase 'received by, accrued to or in favour of a person', is not explained in the Act. The jury is out on whether one 'receives', within the meaning of the taxing statute, an amount he fraudulently acquires. Classen opines that the key to answering this debate is

²⁰ 'As was announced in the Budget Review, a "residence minus" system will be adopted with effect from years of assessment commencing from 1 January 2001.' Brief note on residence basis of taxation' South African Revenue Service, 15 September 2000 <https://sataxguide.wordpress.com> (Accessed 20 March 2018).

²¹ Muller (n5 above) at 166.

the definition of the phrase 'received by' in the computation of gross income.²² This is because income tax is charged, levied and collected on amounts that have been received by a taxpayer.²³

Bittker opines that perhaps the matter should not be allowed to forage that far. He posits that taxing an illegal activity seems inconsistent with prohibiting it. It might be thought degrading for the government to become a "silent partner" in an unlawful business by taxing its ill-gotten gains.²⁴ In the same vein, Maina and Paranta argue that receipt of proceeds of an illegal activity by the state constitutes aiding and abetting violation of the law by the state, as such contravening public policy.²⁵

However, in the United Kingdom that position is rejected as reflected in the case of *Mann v Nash*²⁶ wherein it was opined that;

*...It is said again: 'Is the State coming forward to take a share of unlawful gains?' It is mere rhetoric. The State is doing nothing of the kind; they are taxing the individual with reference to certain facts. They are not partners; they are not principals in the illegality, or sharers in the illegality...'*²⁷

Assuming the preceding argument prevails and the state may indulge itself in illegal income, the next topical issue is on the meaning of the term 'received by' in the gross income definition. In terms of legal receipts, there is consensus by the courts on the meaning of the phrase received by.²⁸ The receipt must be by the taxpayer on his own behalf or for his own

²² Classen, LG 'Legality and income tax - Is SARS 'entitled to' Levy income tax on illegal amounts 'received by' a Taxpayer?' (2007) Vol 19 *SA Merc LJ* 536.

²³ Income Tax Act (n2 above) section 6.

²⁴ Bittker (n7 above) at 131.

²⁵ E Maina and E Paranta, 'Taxing Income from Illegal Activity: The Kenyan Perspective' (2017) *Strathmore Law Review* 106.

²⁶ *Mann v Nash* (1932) 1 KB 752.

²⁷ *Mann* (n26 above) 530.

²⁸ Muller (n5 above) 170.

benefit.²⁹ Confusion reigns supreme on the definition of ‘received by’ in relation to illegal receipts.

Warneke & Warden posit that, owing to the immorality of the trade from whence income in question is derived, the taxpayer is always under obligation to repay that amount and thus never receives it.³⁰ This stance creates a quaint scenario. This reasoning means that taxing income implies a moral responsibility test by the government, of the activities from which it flows. As the government taxes income from legitimate enterprises which are tainted by illegality, it should therefore maintain the same stance with income from entirely unlawful activities. That would be the only way for it to remain above this debacle.³¹

In direct contrast to that, the United States Supreme Court in *Commissioner v Wilcox*³² rejected the morality argument, observing instead that;

*Moral turpitude is not a touchstone of tax liability. 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.*³³

The Court in the above case focused on the subjective intention of the taxpayer as the basis for his tax liability. Muller argues that in order to remedy this disconnect on whether or not to tax income derived from illegal activities, the subjective approach which ascertains the intention of the taxpayer for purposes of “beneficial receipt” should be adopted.³⁴ This means that if a taxpayer receives income from illegal activities with the intention of keeping the money for himself even though it is stolen money, he will then be taxed on such an amount in terms of gross income. This approach seeks to not concern itself with the moral turpitude of

²⁹ *SIR v Smant* 1973 (1) SA 754 (A) 764B-D; *Geldenhuis* (n11 above) 260.

³⁰ D Warneke & D Warden ‘Fraudulent Transactions, Are the Receipts Taxable?’ (2003) 17 *Tax Planning* 26.

³¹ Bittker (n7 above) 145.

³² *Commissioner v. Wilcox* 327 U.S. 404 (1946).

³³ *Wilcox* (n32 above) 408.

³⁴ Muller (n5 above) 166.

where the income is derived but rather on the fact that a dollar from illegal activity buys the same as a dollar from legal activity.³⁵

However, the blanket taxability of income derived from illegal activities created by the subjective test leaves a lot of ancillary issues unresolved.³⁶ The taxation of illegal income means that the taxpayer has to file a tax return declaring their illegal income. In the event of a tax evasion trial on their illegal activities, such a tax return can be relied on as evidence against them and leads to an infringement of the right against self-incrimination.³⁷ Bittker argues that the privilege against self-incrimination protects one against prosecution for failing to file a tax return requiring him to disclose his illegal activities.³⁸ This however creates an absurd situation where the government is expected to assess the tax liability one based on a vague tax return, which would not suffice for an honest taxpayer.

Another issue which appears to be a moving target pertains to the deductibility of expenses incurred in the generation of income from illegal activities. It is imperative to interrogate whether the deductions should apply to ill-gotten gains.

In *Joffe and Co (Pty) Ltd v CIR*³⁹ the Court made reference to expenses that are incurred in good faith for the purposes of trade. In the light of *Joffe supra*, expenditure should meet the requirements of ‘in the production of income’ for it to be deductible.⁴⁰ However, it has been argued that considerations of public policy may prevent the deduction of expenses relating to an illegal activity. The reason behind the denial of deductions is that the government does not

³⁵ M Stein ‘Tax on the fruits of fraud – A tale of two cases’ (1998) Vol 12 *Tax Planning* 116.

³⁶ SC Mntwana ‘*Taxation of Illegal Income: The Duty to Disclose Income Derived from Illegal Activity and the Constitutional Right against Self Incrimination*’ Unpublished LLM Thesis, University of South Africa (2011) 9.

³⁷ In Zimbabwe the right against self-incrimination is found in the Constitution of Zimbabwe Amendment Act No.20 2013, section 70(1)(i). ‘Any person accused of an offence has the following rights – to remain silent and not to testify or be compelled to give self-incriminating evidence;’.

³⁸ Bittker (n7 above) 132.

³⁹ *Joffe and Co (Pty) Ltd v CIR* 13 SATC 354.

⁴⁰ Mtshawulana (n18 above) 78.

want to allow taxpayers to benefit from their illegal activities through the tax law.⁴¹ The overarching public policy consideration that permeates this research is to the effect that; it is not desirable in society for one to enjoy benefits from his own intentional wrong.⁴²

However, as per *Hancock v General Reversionary and Investment Company*,⁴³ in order to establish the deductibility of expenses one must ascertain if they were incurred to meet an expense concomitant to the running of the business or once and for all.⁴⁴ In the former, it should be treated as an ordinary business expense in which case it will be deductible, while in the latter the expense should be treated as a capital expense which is non-deductible. Thus, it would appear as if, illegality of the business should not affect the deduction formula, since even the Act does not make such differentiation.

The sum total of the literature presented above reveals that there is no clear-cut path towards resolving the tax consequences, if any, of ill-gotten income. The clear point of dissension between any scholar or court is on whether or not a taxpayer 'receives' income which he fraudulently acquires. The matter seems to be put to bed for those who believe that the dictionary interpretation of the word 'receive' does not canvas a unilateral taking, thus ill-gotten income should not be taxed. However, this argument fails to consider illegal activities in which the amount generated is not unilaterally taken. On the other hand, those for the taxation of the income have to grapple with the consequences of such a stance, including but not limited to issues to do with deductions and the possibility of self-incrimination.

Clearly, there is anything but consensus in the varying preceding legal opinions considered, when it comes to the issue as to whether income from illegal activities should be taxed. It is out of this murky pool that this research arises. This research will expand on the already

⁴¹ Mtshawulana (n18) 64.

⁴² *Riggs v Palmer* 1951 (4) SA 400 (AD) 40.

⁴³ *Hancock v General Reversionary and Investment Company* (1919), The United Kingdom Court of King's Bench as quoted in *Commissioner of Domestic Taxes v Kenya Maltings Limited* (2013) eKLR at paragraph 34.

⁴⁴ E Maina (n25 above) 111.

evident disconnect on the taxation of proceeds from illegal activity. It will also address the viability of a novel framework, if it can be found, which would better suit Zimbabwe.

1.9. Overview of the chapters.

This dissertation will be divided into five chapters. Chapter one will serve as an introduction to the dissertation. In this chapter the purpose, research questions, methodology and limitations of the study are set out. The structure of this dissertation is also set out.

Chapter two focuses on the meaning that has been attached to the phrase '*received by*' for both legal and illegal proceeds by Zimbabwean courts. This chapter will also proffer criticism on the interpretation method that the court in *COT v G* used to determine the taxability of income derived from illegal activities in Zimbabwe. It will go further and show the problems that arise as a result of a strict and blind application of the objective approach.

Chapter three will discuss the meaning which has been attached to the phrase 'received by' for illegal proceeds in South Africa and other jurisdictions like the USA. These jurisdictions have extensively developed on the notion of beneficial receipt or economic gains from ill-gotten income in assessing its taxability.

Chapter four is reserved to discuss the policy considerations that are taken when determining whether or not to tax income derived from illegal activities. This chapter will capture the varying policy considerations which is the essence as to why there is debate and a lack of a consensus on the subject. Considerations as to the deductibility of expenses incurred, self-incrimination and whether government should partake in forbidden fruit will be discussed therein.

Chapter five is the conclusion of the dissertation. After synthesising the preceding debate, it will offer recommendations as to which path Zimbabwe should take with regard to the taxation of illegal income.

CHAPTER TWO.

2.1 The taxation of income derived from illegal activities in terms of Zimbabwean law.

2.1.1 Introduction.

This Chapter will dissect the case of *COT v G* which reflects Zimbabwe's position on the taxation of income derived from illegal activities. It will evaluate the reasoning behind a finding that income derived from illegal activities cannot be classified as falling into the gross income of the taxpayer and therefore cannot be subject to taxation. This will be done by analysing the interpretation of the phrase 'received by' in the definition of gross income by as per the objective approach reflected in *COT v G*. This analysis is necessary because, the question of whether or not the government is entitled to impose tax on income is best answered by examining the phrase 'received by' and by applying it correctly to a set of presented facts. Lastly, criticism on the interpretation of 'received by' preferred in *COT v G* shall be presented.

2.1.2 The definition of Gross Income.

An inquiry into the taxability of income starts with the definition of gross income. Considering that the Act does not specifically provide guidance on the taxation of income derived from illegal activities, the subject of this research, the more imperative it is to begin the inquiry at such an elementary point. When debate arises as to the taxability of income derived from illegal activities, most elements of the gross income definition are not in dispute as they are self-effacing.⁴⁵ Uncertainty emerges on the meaning of the phrase 'received by'.⁴⁶

⁴⁵ JMP Venter, WR Uys & MC van Dyk 'MP Finance Group CC (In Liquidation) v C: SARS: Adding to the financial hardship of victims of illegal transactions' (2015) Vol 19 *Southern African Business Review: Tax Stories: Special Edition 1*, 128.

⁴⁶ Khumalo (n14 above) 13.

Since the Act does not define the terms used in the gross income definition, reliance will be placed on the meaning given to the phrase ‘received by’ by the judiciary, as interpreters of the law.⁴⁷

As already highlighted in the preceding Chapter, the statutory definition of gross income is provided for in section 8(1) of the Act, which provides;

*...the total amount received by or accrued to or in favour of a person or deemed to have been received by or to have accrued to or in favour of a person in any year of assessment from a source within or deemed to be within Zimbabwe...*⁴⁸

2.2. COT v G.

2.2.1 Brief Facts.

Over a period of four years, *G* was placed in a position of responsibility with the government which entailed his being entrusted with funds for secret operations. He took advantage of his position to obtain from government from time to time, more money than was legitimately required for official purposes and to appropriate it for himself, either by putting it into his own bank account or by using it to buy goods for himself. Over the period he stole some \$58 000. He was convicted and sentenced to imprisonment a part of which was suspended on condition of re-payment. The whole amount was repaid by the respondent. The respondent was assessed to tax on the amounts he stole, and to penalties in terms of section 35 of the Income Tax Act Chapter 181. The respondent (*G*) appealed to the Special Court, which allowed his appeal on the ground that the amounts stolen were not “received” by him within

⁴⁷ E Bonthuys and C Monteiro (n10 above) 664.

⁴⁸ Income Tax Act (n2 above) Section 8, See **Chapter 1 at 1.2.**

the meaning of that word in section 8(1) of the Act. It is against this decision that the appellant (*COT*) appealed to the Appellate Division of the High Court.⁴⁹

2.2.2 The Legal Question and the Commissioners Arguments.

The essential issue before the Court was whether or not the money stolen by the respondent from the government could be regarded as having been ‘received by’ him in terms of the definition of gross income. With the Commissioner arguing that the stolen amounts were taxable.

The argument of the Commissioner in the *court a quo* and the High Court was simple, he contended that gross income as defined by section 8(1) of the Act means every amount received by a person in any year of assessment, and what *G* stole, he received in terms of that definition. On appeal he concentrated his attack upon the *court a quo*’s part of the judgment which he said restricted the definition of gross income so as to include only money to which the taxpayer was entitled, or which was not claimable by someone else.⁵⁰

The Court rejected these contentions. Fieldsend, CJ, interpreted the meaning of the word ‘received’ in relation to stolen amounts as follows:

Whether or not the respondent in this appeal received the money on his own behalf and for his own benefit must depend not only on his own intention but on the intention of the person who passed the money to him...The intention of the taker cannot of itself result in him receiving the thing in his own right. He can only receive the thing in his own right if the giver intends that result as well.

Applying this to the present appeal, the Government never intended that any of the money it paid to the respondent should be his to do with it as he liked. It was paid to him to be applied to a specific Government purpose. Accordingly, at no time did the respondent receive it on his own behalf and for

⁴⁹ *COT* (n3 above) 167F – H; see also Khumalo (n14 above) 16.

⁵⁰ *COT* (n3 above) 168B.

*his own benefit. In my view, therefore, it did not fall within his gross income and he should not have been taxed on it.*⁵¹

In support of his judgment he made reference to *CIR v Genn & Co (Pty) Ltd*⁵² and *Geldenhuis v CIR*.⁵³ Important to note, however, is that the judgements he relied on are distinguishable from the matter he was deciding on. The two judgments did not relate to amounts generated from illegal activities this therefore means that his reasons for judgment and the interpretation of words he applied in *COT v G* were misguided.

2.2.3 The Meaning of ‘Received By’ when dealing with illegal Receipts as per *COT v G*.

The general rule applicable to income tax is that tax liability arises only when there is a ‘receipt’.⁵⁴ The complication arises from the fact that the phrase ‘received by’ is not defined in the Act and has been left to the mercy of judicial interpretation.⁵⁵ However, what becomes apparent is that, in pursuing a definition of ‘received by’, courts have often had to tussle with whether they should give the phrase its broadest meaning. This would mean a person who takes a loan from a bank has in everyday language, ‘received’ the money, though upon borrowing such money an obligation arises on the borrower to repay it.⁵⁶ It is on this principle that the Court in *COT v G* refused to accept that a stolen amount, or any ill-gotten gain, can be said to be ‘received by’ the taxpayer, as he lacks legal entitlement over it and has an obligation to repay it.

The objective approach which the Court utilised to define the phrase ‘received by’ has been succinctly captured as follows;

⁵¹ *COT* (n3 above) 171B – D.

⁵² *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) 301.

⁵³ *Geldenhuis* (n11 above) 260.

⁵⁴ *Khumalo* (n14 above) 14.

⁵⁵ SARS Interpretation Note (n4 above) 13.

⁵⁶ *Venter et al* (n45 above) 129.

*...any underlying obligation to repay or redeliver, either based on a contractual or delictual obligation (such as unjust enrichment), or for that matter any other action in terms of statutory or common law (such as the *condictio*), should indicate that the amount is not received for purposes of gross income.*⁵⁷

The Court found ‘receive’ to mean an act of giving and receiving.⁵⁸ The Court argued that the giver must have intended that the taxpayer take possession over the amount in order for the latter to ‘receive’ an amount. It interrogated the mutual intention of the taxpayer and the source of the amount in question.

The Court adopted a view which was propounded in *Geldenuys supra*;

*Technically it may be said that if the purchase price is paid to him it is “received by him”. ... the expression ‘received by him’ means that the money must be received by him in such circumstances that he becomes entitled to it.*⁵⁹

In that vein, in *COT v G*, Fieldsend CJ construed the word ‘received’ as follows:

*I can see no warrant on the face of the statute for construing the word ‘received’ in any way but its ordinary meaning. To extend it to cover a unilateral taking such as theft, which in any event confers no right upon the taker to the things taken, would be to give the word a meaning that could not be justified on any rational construction of the Act as a whole. In short, a thief takes, he does not receive, and that is what the respondent in this case did.*⁶⁰

Fieldsend CJ relied on the Oxford English Dictionary to give meaning to the word ‘received’.

Therein a receipt was described as something which is premised on offer and acceptance.⁶¹

Therefore, one has to deliver an amount to one who will receive and a unilateral taking does not satisfy the test. The Court further showed reluctance at adding meaning to the definition

⁵⁷ Muller (n5 above) 175.

⁵⁸ Classen (n22 above) 549.

⁵⁹ *Geldenuys* (n11 above) 269.

⁶⁰ *COT* (n3 above) 169H-170A.

⁶¹ Khumalo (n14 above) 16.

of ‘received by’ as it is the cornerstone of the Act. It held the proceeds of theft not to be a receipt because a thief ‘takes’ money.

2.3 Criticism of *COT v G*.

The starting point is the critical observation that income is generated in the furtherance of a ‘trade’ as defined in section 2(1) of the Act.⁶² Williams posits that if the taxpayer’s activities resemble ‘trading’, what he derives from that trade is taxable, notwithstanding that the taxpayer’s activities were illegal or not.⁶³ The base understanding being, fiscal law should apply regardless of legality or illegality of the source from whence income is derived. In *CIR v Pick ’n Pay Employee Share Purchase Trust*,⁶⁴ the Court observed that, whether or not a taxpayer was trading ‘must be determined by applying ordinary common sense and business standards’. Having said this, it is submitted that the Court failed to observe common sense on the obvious underlying issue. *G* was engaged in a scheme of profit making which involved repeated and intentional abuse of government funds which were entrusted to him.

This position is aptly supported by the United States Supreme Court in the case of *Rutkin v United States*⁶⁵ which held that extorted funds are taxable:

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 realizable economic value from it...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.

Furthermore, the mutual intention investigation adopted by the Court does not make much legal sense. The Court held ‘receive’ to require both the act of giving and receiving.⁶⁶ This

⁶² Income Tax Act (n2 above) section 2.

⁶³ RC Williams *Income tax in South Africa: Law and Practice* 4th ed (2006) 121.

⁶⁴ *Commissioner for Inland Revenue v Pick ’n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271 at 280.

⁶⁵ *Rutkin v. United States* 343 U.S. 130 (1952) 137.

⁶⁶ Classen (n22 above) 549.

meant that an amount can only be received by the taxpayer if the person giving it to them intends and is aware that they are enriching the taxpayer. It is submitted that the intention of the giver is immaterial in the test as to whether or not the taxpayer does 'receive' income fraudulently acquired. This is because, it does not affect the economic gain of the taxpayer once this income is in his possession. It is suggested that the meaning of 'received by' should be restricted to an amount received by a taxpayer "for his own benefit" by taking into account his own intentions.⁶⁷

⁶⁷ Muller (n5 above) 176.

CHAPTER THREE.

3.1 The taxation of income derived from illegal activities in South Africa and the USA.

3.1.1 Introduction.

The preceding Chapter has addressed the taxation of income derived from illegal activities in Zimbabwe. It has analysed at length the objective approach, which is the present position in Zimbabwe. The purpose of this Chapter is to review the subjective approach also termed the ‘economic gains’ approach in the USA or ‘beneficial receipt’ in South Africa. This Chapter will explore the contours of the subjective approach to taxing income derived from illegal activities. To these ends, regard will be had to South Africa and the USA which will be discussed in turn.

3.2 Definition of Gross Income in South Africa and USA.

As already established in preceding chapters, for an amount to be taxed under income tax statutes, it must fall within the definition of gross income, which definition is the cornerstone of income tax statutes in any jurisdiction. In South Africa gross income is defined as;

*The total amount in cash or otherwise, received by or accrued to or in favour of a person who is a resident, from any source, and in the case of a non-resident, from South Africa or deemed South African source, other than receipts or accruals of a capital nature.*⁶⁸

In the USA gross income is defined in the Internal Revenue Code 1939 under section 61 as follows:

*...except as otherwise provided in this subtitle, gross income means all income from whatever source derived; including (but not limited to) the following items...*⁶⁹

⁶⁸ South African Income Tax Act (n19 above) section 1.

⁶⁹ Internal Revenue Code of the USA (1939) section 61.

3.3 The treatment of income from illegal activities in South Africa.

3.3.1 *MP Finance Group CC (In liquidation) v Commissioner for South African Revenue Service.*

3.3.2 Brief Facts.

In short, the facts were as follows; a businesswoman ran a pyramid scheme. Unsuspecting clients would pay amounts to her under the impression that they would get huge returns. Her particular scheme was in the form of entities, some incorporated, others not. The entities became insolvent. In order to facilitate the administration of the various entities, they were bundled into MP Finance Group CC ('the corporation') by an order of court. All claims that had been proved against the original entities during the insolvency procedures were to be treated as claims against the new, consolidated corporation. The South African Revenue Service (hereinafter SARS) assessed the corporation for income tax originally due by the respective entities during the 2000, 2001 and 2002 years of assessment. The liquidators objected to these assessments on the basis that the amounts paid to the pyramid scheme had not been 'received' within the meaning of the definition of gross income in the Income Tax Act. The Commissioner disallowed the objection. The corporations' appeal to the Tax Court in Durban was dismissed. The corporation then sought leave from the court *a quo* to appeal to the SCA.⁷⁰

3.3.3 Decision of the Tax Court.

The court *a quo*⁷¹ decided that the illegal amounts taken by the operators of a pyramid scheme were 'received' within the definition of gross income. The Court's reasoning was

⁷⁰ Khumalo (n14 above) 20.

⁷¹ *Income Tax Court 1789 (2005) 67 SATC 205.*

focused on the intention of the taxpayer and that regardless of the lack of legal entitlement over them, she derived economic gain from them and thus the income was taxable.⁷²

3.3.4 The Legal Question and Taxpayers Arguments on Appeal in the SCA.

The issue for determination before the SCA was whether or not the investor deposits that had been obtained by the corporation could be regarded as having been ‘received by’ the corporation within the definition of gross income.

The main argument made by the corporation was that, in law the deposits by the investors were repayable at the moment they were granted. The deposits had never been ‘received’ in terms of the Act. It relied on *Fourie v Edeling*,⁷³ It argued that a court cannot enforce illegal contracts and thus investments made into the scheme are not taxable as they arose out of an illegal contract. In any event the corporation argued, the investors would have a claim in terms of the relevant *condictio*, and that the scheme upon receipt of the amounts immediately became liable to repay them.

The Court rejected the contentions based on *Fourie v Edeling*. The *Fourie* case was distinguishable from the case under determination the SCA decided. In the present case the Court had to interrogate the nature of the obligations between a taxpayer and the fiscus and not the corporation and its investors as was in *Fourie*. Therefore, as in *CIR v Insolvent Estate Botha*⁷⁴ this illegal contract had fiscal consequences if the receipts fell within the literal meaning of the Act. As such, the SCA found amounts taken by this illegal scheme were ‘received’ within the meaning of the income tax Act.⁷⁵

⁷² *ITC 1789* (n71 above) 205.

⁷³ *Fourie v Edeling* 2005 (4) All SA 393 (SCA).

⁷⁴ *Commissioner for Inland Revenue v Insolvent Estate Botha* (1990 (2) SA 548 (A) at 556C-557B).

⁷⁵ *Khumalo* (n14 above) 22.

3.4 The treatment of income from illegal activities in the USA.

The Income Tax legislation in the USA used to make reference to the legality of the business for purposes of determining income tax.⁷⁶ The Revenue Act of 1913⁷⁷ stated the following:

The net income of a taxable person shall include gains, profits and income...from...the transaction of any lawful business carried on for gain or profit or gains or profits and income derived from any source whatever...

This statute was amended in 1916 and it deleted the term ‘lawful’ from the section. In light of that amendment, the USA Supreme Court stated the following:

*This revealed we think the obvious of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest labourer taxed and gains of the dishonest immune.*⁷⁸

In assessing whether or not ill-gotten gains had income tax consequences, courts in the USA developed the ‘claim of right’ doctrine. The decision of the Supreme Court in *James v United States*⁷⁹ crafted this approach;

Income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition.

The Court simply meant that, regardless of the obligation to repay the amount, if the taxpayer stood to have an ‘economic gain’ and in his mind he regarded the money to be his and did not intend to retribute the amount, then he was taxable. Based on this ruling, the phrasing of the

⁷⁶ Black, CK ‘Taxing Crime: The Application of Income Tax to Illegal Activities’ (2005) Vol 20 *Australian Tax Forum* 456.

⁷⁷ Revenue Act of 1913, ch. 16, 38 Stat. 114.

⁷⁸ *Commissioner for Inland Revenue v AKON* (1990) SATC 497, 506.

⁷⁹ *James v United States* 1961 U.S 213.

Internal Revenue Code; ‘*all income from whatever source derived*’⁸⁰ means that it canvasses any receipt by the taxpayer over which he has opportunity to dispose as he pleases.⁸¹

The legislature in the USA enabled the assessment of taxable income by paying regard to the intention of the taxpayer. It is only required that there be a claim to an amount by a taxpayer regardless of obligations to repay, and not a right to claim an amount. This is the doctrine of ‘claim of right’.⁸²

3.5 The jurisprudence behind the subjective approach in South Africa and the USA.

The self-evident starting point is the understanding of the notion of ‘receipt of an amount’, without which, there will be no legal grounds to subject an individual to the clutches of income tax. In South Africa, the SCA in *Geldenhuis v CIR*, took a literal interpretation of the phrase ‘received by’. This was held to mean that any person who has engaged in an activity during the year of assessment and has derived income from such activity, he will be liable to tax.⁸³ A strict application of this definition leads to absurd scenario where, one who receives an amount in a fiduciary capacity would be liable to tax. In *MP Finance*, South Africa abandoned this understanding of a ‘receipt’, that one must be ‘entitled’ to an amount.

According to the SCA in the *MP Finance*, entitlement is not relevant in assessing the tax liability of ill-gotten proceeds;

*The amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Act. In other words, it does not matter for present purposes that the scheme was not entitled...to retain the money.*⁸⁴

⁸⁰ Revenue Code (n69 above) section 61.

⁸¹ *Commissioner v Glenshaw Glass* 348 U.S. 426, 431.

⁸² Mntwana (n36 above) 38.

⁸³ *Geldenhuis* (n11 above) at 260.

⁸⁴ *MP Finance* (n6 above) 145.

In short according to the SCA, if a person accepts an amount with the intention of retaining it for his benefit, then he has received it, regardless of whether he is entitled to an amount or not.

In the USA, the application of the subjective approach is best reflected in the case of *Aldrich Ames v CIR*⁸⁵ involving a Central Intelligence Agency agent spying on behalf of the then Soviet Union. Therein, the Applicant attempted to argue that taxing his ill-gotten gains amounted to double jeopardy as he had already been convicted of espionage on the same facts raising the tax evasion charges. The court held that;

*The imposition of a Federal income tax liability is remedial and not a punishment.*⁸⁶

In finding that tax liability is remedial, the reasoning is clearly that tax law looks at the practicalities of a situation as opposed to a theoretical operation of the law favoured by the objective approach. That is, an obligation to repay an ill-gotten amount exempts one from tax liability. The subjective approach works on a completed set of facts, if one receives an amount in whatsoever way and derives a benefit from it, income tax law remedies visit one.

From this background the jurisprudence in the USA then evolved into the ‘right of claim’ or ‘economic gains’ doctrine as evidenced by *James supra*. The jurisprudence behind the subjective approach can be aptly summed up as follows;

...by following the subjective approach all illegal income 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. This approach will also be consistent with public policy. Surely it is not in the interest of public policy that a trader who cheats his customer in the course of his

⁸⁵ *Aldrich Ames v CIR* 112 United States Tax Court No. 20.

⁸⁶ *Ames* (n85 above) 22.

*business should be subject to income tax while one who actually steals from them should enjoy exemption from income tax.*⁸⁷

3.6 Conclusion.

In light of the foregoing discussion it becomes apparent that, it is most likely that the subjective intention has been adopted as a tool to ensure equity between law abiding citizens and those who engaged in illicit activities such as theft and embezzlement. This is because those who engage in illegal activities stand to benefit more financially because they could not be liable to tax by virtue of the entitlement requirement in terms of the objective approach. The real reason for a reference to the subjective approach by the courts in South Africa and USA could be for public policy reasons, and the desire to ensure that a thief does not benefit from stealing. This reasoning makes a lot of sense when one observes that the subjective approach has only been applied in cases relating to income derived from illegal activities.⁸⁸ At no point has the objective approach been utilised in assessing the taxability of income stemming from legal activities.⁸⁹

⁸⁷ Muller (n5 above) 177.

⁸⁸ *ITC 1972* (2005) 68 SATC 236).

⁸⁹ Muller (n5 above) 170.

CHAPTER FOUR.

4.1 The policy considerations surrounding the taxation of income which is derived from illegal activities.

4.1.1 Introduction.

Thus far it is clear from the preceding Chapters, that as far as taxing income derived from illegal activities is concerned, two polar schools of thought prevail. Whether one chooses to tax or not to tax ill-gotten gains, there are concrete arguments in support of either one of the positions. It is in light of this, that it has been observed of the USA system that;

...the federal income tax statutes have contained no clear congressional mandate on this issue and that therefore the question may appropriately be resolved from a policy standpoint.⁹⁰

The purpose of this Chapter is to examine the various policy considerations that have spurred debate on the taxability of unlawful gains. Owing to the abundance of literature on these policy considerations, this research, for the purposes of cogency and academic brevity, has focused on the salient and predominant policy standpoints from which arguments for and against taxing ill-gotten gains have stemmed.

4.2 The various policy concerns that are to be considered.

4.2.1 Does the government become a “silent partner” in an unlawful business by taxing its profits? (legitimising the illegitimate).

Courts have acknowledged that taxing an activity seems inconsistent with prohibiting it,⁹¹ and that it might be thought degrading for the government to become a “silent partner” in an

⁹⁰ Bittker (n7 above) 130.

⁹¹ *Steinberg v United States* 14 F.2d 564, 566 (2d Cir. 1926).

unlawful business by taxing its profits.⁹² Al Capone whose case spurred the debate into this area of tax law in the USA,⁹³ made a comment around his case to the effect that;

*Income tax law is a lot of bunk. The government cannot collect legal taxes from illegal money.*⁹⁴

This logic has been relied upon by the taxpayers who hold the belief that income derived from illegal activities should not be subject to taxation. This line of argument was furthered in *Steinberg supra*;

*It is hard to conceive of Congress ever having had in mind that the government be paid a part of the income, gains, or profits derived from successfully carrying on this crime, or entering into a combination with the person engaged in this unlawful business to ascertain how and to what extent he shall be taxed...*⁹⁵

It is unfathomable indeed that, lawmakers in any jurisdiction crafting income tax statutes, would have in their astuteness, envisaged the State strolling arm in arm to the bank with a criminal. However, this argument has been debunked. The notion that the government becomes a “silent partner” renders itself a convenient excuse for those seeking to escape tax liability.⁹⁶

Taxation of proceeds of an enterprise, especially illegal enterprises, does not signal approval of the illegal activity. Just as how confiscation of illegal merchandise does not mean the government is part and parcel of the illegal activity, the same should be applied to taxation of proceeds from illegal activities.⁹⁷ In *Mann v Nash*,⁹⁸ in which an argument to the effect that

⁹² *Steinberg* (n91 above) 569.

⁹³ Bittker (n7 above) 141. ‘The author therein makes reference to the Al Capone syndrome. This refers to a phenomenon where tax law is used to target criminals and prosecute them in instances in which the State cannot prove the taxpayers criminal activities. The phrase is derived from the fact that the State in the USA relied on tax evasion charges to imprison Al Capone as they could not prove his true crimes of murder and bootlegging.’

⁹⁴ *Capone v United States* (1932) 56 F 2d 927 cited in, R Cahan *A Court That Shaped America: Chicago’s Federal District Court from Abe Lincoln to Abbie Hoffman* (2002) 87.

⁹⁵ *Steinberg* (n91 above) 569.

⁹⁶ Bittker (n7 above) 145.

⁹⁷ Bittker (n7 above) 145.

the government should not partake of the forbidden fruit (ill-gotten gains) was advanced, Rowlatt J rejected it while asserting that:

*The Revenue representing the State, is merely looking at an accomplished fact. It is not condoning it...*⁹⁹

The reasoning seems to be that, there is no reason why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay.¹⁰⁰

4.2.2 What regard is to be given to the Constitutional protection against self-incrimination?

Section 70(1)(i) of the Zimbabwean Constitution provides for the right to remain silent and not to testify or be compelled to give self-incriminating evidence.¹⁰¹ This provision is no way unique to Zimbabwe, therefore the jurisprudence found in the USA and South Africa in relation to the balance to be struck between this right and the interests of the revenue authority is relevant in Zimbabwe. The scope of the privilege against self-incrimination, so far as tax returns are concerned, remains unresolved to this day.¹⁰²

Proceeding from an assumption that illegal income is taxable, the initial policy understanding was that the privilege against self-incrimination, granted by the fifth amendment (right to remain silent in the USA constitution), protects the taxpayer from filing a tax return that requires him to state his illegal businesses.¹⁰³ As a practical matter, this position evidently means that the government cannot carry out its' statutory mandate to collect revenue because one has not disclosed owing to engaging to illegal activities. This withholding of information by the taxpayer is absurd for two reasons. Firstly, the taxpayer is cushioned from the law

⁹⁸ *Mann* (n26 above) 530.

⁹⁹ *Mann* (n26 above) 530.

¹⁰⁰ *United States v Sullivan* 274 U.S. 2591 (1927) 263 – 4.

¹⁰¹ Constitution (n37 above) section 70(1)(i).

¹⁰² Bittker (n7 above) 133.

¹⁰³ Bittker (n7 above) 132.

because he is engaged in an illegal activity and secondly, it does not also attract penalties as it would for the legitimate taxpayer. Both scenarios could not be what the law intended. This means that the taxpayer engaged in an illegal activity is only penalised for filing a demonstrably false return instead of none at all.¹⁰⁴ It is submitted that this position does not appear to be good policy. This is because, the privilege against self-incrimination appears to work in favour of the criminal as opposed to the honest taxpayer. He is protected from a failure to file a tax return, whereas the honest taxpayer is penalised for either failing to file a tax return or filing a false one or both.

However, the above operation of the protection against self-incrimination was viewed to be unmeritorious in the appeal of *Sullivan supra* wherein it was argued that;

*Most of the items [called for by the return] warranted no complaint. It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime...*¹⁰⁵

In *Garner v United States*,¹⁰⁶ a case which attempted to birth what is good policy as regards self-incrimination, the Court allowed the prosecution to present as evidence a taxpayer's tax returns to substantiate its case in a non-tax-related criminal matter. The accused person was convicted on the basis of these tax returns.¹⁰⁷

However, the Court of Appeal found that a wilful submission to the statutory requirement to disclose information in an income tax return constituted a voluntary waiver of Fifth Amendment protections, especially if such right is not raised at the time of disclosure.¹⁰⁸ For taxpayers to effectively waive a privilege they must be aware of its existence and waive it

¹⁰⁴ *Sullivan* (n100 above) 263.

¹⁰⁵ *Sullivan* (n100 above) 263.

¹⁰⁶ *Garner v United States* 424 U.S. 648 (1976).

¹⁰⁷ E Maina (n25 above) 117.

¹⁰⁸ North Western University School of Law 'Reporting Illegal Gains as Taxable Income: A Compromise Solution to a Prosecutorial Windfall' (1974-1975) Vol 69 *Nw. U. L. Rev.* 111 at 133.

voluntarily and knowing the implications of such a waiver.¹⁰⁹ Therefore the right against self-incrimination operates at the time of being requested to file a tax return and does not operate to protect one who has failed to file a return and is being prosecuted for such failure.

It thus appears from the above that the policy consideration should be that, the privilege against self-incrimination cannot be used to refuse to file a tax return at all, but it can be invoked to refuse to give certain incriminating information in the tax return. Practically though such refusal will inevitably lead to an investigation of the taxpayer by the revenue authorities.

4.2.3 Who has better title over ill-gotten gains, the revenue collector or the victim of the fraud?

The preliminary point is obviously that, this is a non-issue if proceeds of illegal activities were to be immunised from tax consequences. If governments are to take a policy position that illegal receipts are to be taxed a complication arises, as to who has better title, the victim of the fraud who has a civil remedy of restitution or the revenue man who has a statutory right to the proceeds. Bittker asserts that it is a reasonable ground for appeal if the governments tax claim to the lawbreaker's assets was preferred over the right of his victims to be reimbursed by him for their losses.¹¹⁰

In *Wilcox supra*, the court asserted;

*Taxability is determined from the circumstances surrounding the receipt and holding of the money rather than by the disastrous use to which it is put.*¹¹¹

If the above reasoning were to be followed, the victims chance of recovering from the wrongdoer would be ruined if the wrong doer was required satisfy his tax obligations arising

¹⁰⁹ Mtshawulana (n18 above) 87.

¹¹⁰ Bittker (n7 above) 147.

¹¹¹ *Wilcox* (n32 above) 409.

from such ill-gotten gains. It is submitted that the revenue authorities should only have a claim over an amount if, the taxpayers obligation to retribute the victim is extinguished by the Statute of Limitations (the equivalent statute in Zimbabwe being the Prescription Act¹¹²) or by an act of forgiveness on the part of the victim.¹¹³

This matter becomes even more so complicated when the taxpayer refunds the illegal income. It is submitted that perhaps, this is the main consideration behind decisions to the effect that illegal income does not qualify as gross income, as for instance in *COT v G* where the taxpayer had already repaid the funds stolen by him.

The USA has attempted to come up with a solution for this, which perhaps is a sensible policy considering the preceding discussion. The proposed position is to the effect that, if the taxpayer actually made restitution to his victim, and if such restitution is made in the year of assessment it must be deemed a permissible deduction.¹¹⁴ However, it is interesting to observe the gap in policy in a country like South Africa which has not yet developed this position. For instance, in the case *ITC 1789*¹¹⁵ which involved an illegal microfinance scheme, the Court included the total receipts of the taxpayer as gross income, not only the commissions appropriated therefrom. Thus, the initial deposits of a capital nature made by the victims of this scheme were made liable to tax. In such a scenario it remains to be seen what happens to the victim of this fraudulent scheme of profit making who has a remedy of restitution.

¹¹² Prescription Act of Zimbabwe [Chapter 8:11], “An Act to provide for the acquisition of ownership of things by prescription, the acquisition and extinction of servitudes by prescription and the extinction of debts by prescription; and to make provision for matters connected therewith...”.

¹¹³ Bittker (n7 above) 134.

¹¹⁴ *James* (n79 above) 366.

¹¹⁵ *ITC 1789* (n71 above) 205.

4.2.4 Does the nature of the illegal activity have any bearing on the tax consequences?

Income is derived in the furtherance of trade, this is common cause in any tax jurisdiction. It would thus appear that, *prima facie*, if the taxpayer's activities constitute 'trading' any income from that trade is assessable for income tax, notwithstanding that the taxpayer's activities were illegal or not.¹¹⁶ In the spirit of ascertaining which is good policy when it comes to this contentious issue of ill-gotten gains, it is submitted that it is imperative to thoroughly analyse this preceding proposition on the notion of a 'trade'.

A tax statute is not a criminal statute, it is not crafted for the purposes of defining or encompassing criminal activity.¹¹⁷ Bearing this in mind, it is hard to imagine that the lawmakers in crafting the definition of a trade, meant to encompass a florist and a paid assassin in the same bracket. Surely it does not satisfy any sense of policy to believe otherwise. In this vein, Lord Denning considered the operation of a gang of burglars in *J P Harrison (Watford) Ltd v Griffiths*,¹¹⁸ in the following way:

Take a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade...

In *Wilcox supra*, the dissenting judges therein attempted to make a distinction between the "regular business profits" of a sustained criminal activity, which they regarded as taxable, and the "sporadic loot" of embezzlers, extortioners, and robbers, which they would not include in "income." It is uncertain whether they intended to draw the line between "business profits" based on the *type* of unlawful activity engaged in by the taxpayer and "sporadic loot" based

¹¹⁶ RC Williams (n63 above) 121.

¹¹⁷ Mtshawulana (n18 above) 7.

¹¹⁸ *J P Harrison (Watford) Ltd v Griffiths* [1962] 40 TC 281 at 299.

on the *number* of transactions.¹¹⁹ In any event, it is difficult to justify such a differentiation, and even more difficult to see how it could be effectively administered. Unlawful receipts be they be sporadic or regular are likely to be retained by the taxpayer and are of the same economic value. In any event, as the business of the taxpayer is unlawful, it would be difficult to ascertain whether he is engaged in a "regular business" or only in "sporadic" criminal activities.¹²⁰

To further show the constraints of the above differentiation, a hypothetical situation is put forward. What regard is to be had to the income a company director makes, when he uses insider information to purchase shares that bring him an economic gain. Here is a man whose business is wholly legitimate but has engaged in a peripheral illegal activity. Will his sporadic loot be ignored and he be allowed to benefit from his wrong doing? While on the one hand a paid assassin is going to be taxed because his is a sustained criminal activity? It would appear as though tax consequences are based on what is abhorrible to society as opposed to a true legal determination as to whether the amount in question is income or not.

4.2.5 Does the government lose more than it makes in enforcing tax laws on illegal activities?

In taxing income from unlawful activity, it should be noted that the exercise is being conducted against an individual who has an affinity to treachery. As such it is not asinine to recognise that such income, will not be accurately reported by its recipients. It is very probably that the taxpayer will conceal his treachery and refuse to disclose it relying on the right against self-incrimination. As a result, the taxing authorities will have to investigate such an individual with no assurance that they will recover more than they will spend investigating and as such tax will be used as a tool to attack individuals the government has a

¹¹⁹ Bittker (n7 above) 135.

¹²⁰ Bittker (n7 above) 138.

special interest in.¹²¹ For instance, in Zimbabwe a moratorium was issued and investigations lodged into the business dealings of persons and companies who were suspected of corruption, so as to quell political discontent. Thus, if any tax consequences arose on those parties, it would have been as a result of the tax machinery being used to pursue political ends.¹²²

It is submitted that this could be an argument for a policy immunizing ill-gotten gains from fiscal investigation and subsequent taxation. Recipients of unlawful income do not tend to keep written records. This absence of a paper trail will undoubtedly be an impediment to the investigations of the revenue authorities.¹²³ However, lawbreakers often make unusual purchases that permit the estimation of their income. Once such an assessment has been made, the taxpayer has the burden of disproving the agent's computation.¹²⁴ At *this* point, the taxpayer's lack of records hampers him more than the revenue agent. Thus, though seemingly arbitrary, it may after all not prove to be an exorbitant exercise as imagined.

4.2.6 Upon disclosure of his previous illegal dealings, does the taxpayer get a fair trial which is constitutionally guaranteed?

In considering whether to tax income from illegal activities, regard must be had to other peripheral issues. It is undoubted that an assessment and taxation of ill-gotten gains will spill into a trial, since there is no prescribed statutory formula on how to deal with such income. This trial will entail the revelation of all of the taxpayer's criminal dealings generating the income in question, some of which may not be the cause of action in court, will this make it impossible for the taxpayer to get a fair trial by an impartial court?

In *Rutkin supra*, the judge made an observation that;

¹²¹ Bittker (n7 above) 139.

¹²² 'Mnangagwa issues cash return ultimatum' New Zimbabwe 28 November, 2017.

¹²³ Bittker (n7 above) 142.

¹²⁴ JC Rogers, 'P-H TAX Gr. REP. & MEM. DEC. (43 P-H Tax Ct. Mem.)' (1974) ~ 74,004.

*...the fantastic story of supposed extortion...would probably not have been accepted by a jury if presented in a trial uncoloured by the manifold other inflammatory matters which took up 887 of the 900 pages in this tax evasion case.*¹²⁵

This observation is quite cogent, the State gets an assist in its prosecution by colouring the character of the defendant by raising past illegal dealings of the taxpayer, with the effect of moving the burden upon the taxpayer to prove his innocence as opposed to the State having to prove his guilt.

The potential of an unfair trial is not imagined it is real, however, it does not necessarily follow that exempting all illegal income from tax is the most appropriate remedy. An outright immunisation from tax consequences for everyone who imagines they will be treated unfairly by the courts is intolerable.¹²⁶ Thus, the solution, it is submitted, would be to abandon criminal sanctions in those cases, leaving the defendant subject to the normal civil remedies. At least civil penalties are not comparatively harsh as compared to criminal sanctions which may involve imprisonment.

4.2.7 Is it wise to use Tax Law to reinforce Criminal Law, does it risk being abused?

Tax is a tool generally used by governments to ‘raise revenue, to provide incentives or disincentives for certain activities and to correct market failures’.¹²⁷ From a laymen’s perspective, who is quite often the taxpayer, it would appear as though tax can be used as a tool to reduce crime when it used to tax ill-gotten gains. The reason being that one engages in

¹²⁵ *Rutkin* (n65 above) 147.

¹²⁶ *Bittker* (n7 above) 144.

¹²⁷ N Prasad, ‘Policies for redistribution: the use of taxes and social transfers’ (2008) Discussion Paper Number 194 *International Institute for Labour Studies*, 6 – <http://www.oit.org/wcmsp5/groups/public/-dgreports/-inst/documents/publication/wcms_193159.pdf> (accessed 21 March 2018.).

illegal activities to derive profits from them. Thus, by imposing tax on such profits, it is a means for reducing such profits, the tax becomes punitive.¹²⁸

Tax has been used to combat organised crime, it has been used by law enforcement authorities and revenue authorities simultaneously to reach the funds raised through organised crime.¹²⁹ The use of tax law to tax illegal income has been referred to as the Al Capone syndrome.¹³⁰ Tax has also been used as a tool to help the law enforcement authorities catch certain criminals when all else fails. It was used in the USA with the famous criminal Al Capone in the 1930s to incarcerate him for crimes such as bootlegging and gambling which could not be conclusively proven in a criminal trial.¹³¹ As a result tax law, came in handy to achieve a welcome sanction against a taxpayer.

However, it is imperative to note that using tax law in this manner is not entirely failproof. It is wise to note that there is an element of unreality in the expectation that tax consequences upon discovery of the illegal activity will deter criminals in engaging in illegal activities that generate income.¹³²

4.2.8 Deductions.

The issue surrounding deductions is best introduced by Judge Manton in *Steinberg supra*, he asserts that taxing an illegal activity is unbecoming to the government, calculating ill-gotten gains is dirty business for the government. If this income is taxed he argues, then it naturally follows that he should be allowed to *deduct* any bribes paid by him.¹³³ Thus the debate begins as to whether deductions on amounts that are ill-gotten should be permitted.

¹²⁸ E Maina (n25 above) 119.

¹²⁹ K DeMattei 'The use of taxation to control organized crime' (1951) Vol 39 *California Law Review*, 233.

¹³⁰ Explanatory note on Bittker (n7 above) in (n79 above) 141.

¹³¹ <http://www.history.com/topics/al-capone> (accessed 21 March 2018.).

¹³² L Siska 'Deductions Arising from Illegal Activities' (2003) Vol 13 *Revenue Law Journal*, 24.

¹³³ *Steinberg* (n91 above) 569.

In South Africa, ill-gotten gains are not deductible. The reason behind this prohibition is that, the SARS does not believe illegal activities are a trade. SARS argues that such income is not derived from *normal* commercial activities which generate income after the provision of good and services.¹³⁴ As already alluded in Chapter one of this research, this reasoning is very narrow because it fails to envisage varying forms of illegal activities.¹³⁵ Granted that in instances such as theft there is no provision of a service or a good, however, the same is not true in situations where the taxpayer is selling a prohibited substance for profits. As such, this position by SARS does not fully address the varying situations in which an assessment of whether expenditure is deductible is to be made.

However, in *Commissioner of Taxation v La Rosa*,¹³⁶ it was held that as a general principle it is for the legislature, rather than the Courts, to determine whether deductions should be prohibited or permitted after considerations of public policy.¹³⁷ In this case deductions were allowed for as long as they fit within the literal interpretation of the statute.

The USA has gradually developed a distinction between *deductible* legal expenses of an illegal business such as rent and its *non-deductible* “illegal” expenses such as bribes.¹³⁸ It is submitted that this policy is questionable for the following reason; the reason why one would have arrived at having to consider whether to allow or disallow deductions of an illegal enterprise, is because they have assessed that such illegal receipts are taxable income. It is baffling why courts in the USA would want to apply a literal interpretation in ascertaining taxable income and then choose to follow a purposive approach for deductions. Since there is

¹³⁴ SARS Interpretation Note (n4 above) 16.

¹³⁵ See **Chapter 1** at **1.1** (n7 above) wherein it has been argued that the phrase illegal activities is not self-defining. Illegal activities exist in varying extremities.

¹³⁶ *Commissioner of Taxation v La Rosa* 2003 FCAFC 125.

¹³⁷ T Sibley, ‘Breaking the Law and ‘Writing it off’: Should Fines and Penalties be Deductible Under the Income Tax Act?’ (2002) Vol 65 *Saskatchewan Law Review* 236.

¹³⁸ ‘Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code’ (1962) Vol 72 *YALE Law Journal* 108.

no reason why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay,¹³⁹ then the same should apply for deductions.

Further, if it is against public policy to allow deductions of illegal businesses, if the taxpayer reimburses his victim, should that repayment not qualify as an allowable deduction?¹⁴⁰ In light of this, a blanket refusal to allow deductions of illegal businesses even when such deductions intended are for restitution would raise the question on what the true meaning of public policy is. Granted, what constitutes public policy varies from jurisdiction to jurisdiction. However, it is submitted that the what is consistent public policy in relation to taxation is the consideration that no one should derive economic gain from their own fraud.¹⁴¹

In *Wilcox supra*, it appears as though such restitution should qualify as an allowable deduction in the year in which it is made. This would not violate public policy as the taxpayer has not benefitted from the ill-gotten gains as they have left their possession and been paid over to the victim of the fraud.

In order to determine the deductibility of expenses incurred from undertaking illegal activities, the question is whether considerations of public policy should deny a person involved in illegal activities the deduction of the expenses they incur in deriving their income illegal activities. It is submitted that, considerations of public policy may prevent the deduction of expenses relating to an illegal activity. The reason behind the denial of deductions is that the government does not want to allow taxpayers to benefit from their illegal activities through the tax law.¹⁴² It is submitted that the reason a taxpayer engages in

¹³⁹ *Sullivan* (n77 above) 263.

¹⁴⁰ *Muller* (n5 above) 177.

¹⁴¹ *Riggs* (n42 above) 40.

¹⁴² *Mtshawulana* (n18 above) 64.

fraudulent activities is to derive a profit from them, and thus if the profits are taxed it will decrease the profitability of the activity.¹⁴³

In light of this, it is salient to consider that, generally a taxpayer is not entitled to deduct certain fines and penalties. The policy behind the enactment of this provision seems to be that a 'penalty' is imposed as a punishment and that a person should not indirectly benefit from paying a penalty by gaining a tax deduction.¹⁴⁴ Reconciling this with the public policy consideration in prohibiting deductions, it appears as though public policy is being used as punitive measure, a fine. That entirely defeats the purpose of fiscal policy which is to apply uncoloured on a completed set of facts without imposing unfettered penalties which are not within the statute but are made on public policy grounds.

4.3 Conclusion.

It is without a shred of doubt, a fastidious exercise sifting the various policies that are taken into consideration in the debate over whether or not to tax proceeds from illegal activities. A few things suffice as constants in this policy consideration; for every argument for pursuing a particular line of reasoning, there exists an exact and true opposite and secondly it would be erroneous to attempt to seek a law of universal application in this regard. Thus far, suffice to say that, a case by case analysis, though walking a tight rope, is a safe bet, as opposed to committing to one school of thought.

¹⁴³ Khumalo (n14 above) 26.

¹⁴⁴ RH Woellner, S Barkoczy et al, *Australian Taxation Law* 13th Ed. (2003), 721.

CHAPTER 5.

5.1 Conclusion and Recommendations.

5.1.1 Introduction.

At the close of the foregoing discussion, the primordial question that must have been answered by this stage is; Is the government entitled to tax illegal income and if yes, is it justified in so doing?

From the arguments put forward in the preceding Chapters, it is evident that this question does not have a ready and absolute answer. To be taxed, fraudulently earned receipts must fall within the ambit of the definition of gross income in section 8(1) of the Act. As already argued in Chapter Two, most fraudulent receipts comply with the definition of gross income, with the problem arising on the meaning of ‘received by’.¹⁴⁵

To resolve this quagmire, two schools of thought are prominent, the objective approach and the subjective approach. At this point of the discussion, an assessment of the degree of contribution towards answering the research question of these two approaches will be undertaken. Lastly recommendations on which position would be ideal for Zimbabwe shall be made, based on the observations made during the course of the research.

5.2 Objective Approach.

The interpretation of the term ‘received by’ under the objective approach has been in revealed in Chapter One to be determined by legal entitlement over the amount in order for such an amount to be taxable.¹⁴⁶

The most recognisable weakness with this approach is that, it is blind to the very reason behind tax law, to raise revenue for the government.¹⁴⁷ Though the trade is illicit, the money

¹⁴⁵ D Warneke (n30 above) 17; see also **Chapter 2** at **2.1.2**.

¹⁴⁶ *Geldenhuy*s (n11 above) 413; see also **Chapter One** at **1.2**.

changing hands is legitimate and has the same economic consequence as that in circulation in trade that is legal. In light of this observation, it is an affront to logic to expect the government to refrain from taxing income derived from illegal trades.

Furthermore, the theoretical obligation upon the taxpayer to pay over the amount to another is one that only begins to practically exist upon the discovery of the fraudulent business. As such, the individual engaged in illegal activities should not be allowed to raise this seeming obligation to repay the amount as an escape from tax obligations. The reason for this prohibition being, this obligation did not exist in his mind and in practice before the discovery of his illegal enterprise.

Lastly, the objective approach negates the fact that the accordion of what constitutes an illegal activity stretches and squeezes differently in every case. So, though it may be argued that an embezzler does not receive an amount as the victim of embezzlement desires their amount back, the same cannot be said to one who is hired to perform illegal services for profit. The person remunerating the taxpayer, intends to enrich him for performing the illegal activity.

It would appear therefore, that perhaps the answer lies with the subjective approach.

5.3 Subjective Approach.

The subjective approach utilises a common law principle that is used in criminal law and delict to ascertain wrongfulness on an individual.¹⁴⁸ In that, it interprets the mind of the taxpayer towards the amount in question. It is on this ground alone that the first flaw with the subjective intention emerges. The definition of gross income is not determined by wrongfulness, but by what the ordinary meaning of 'received by' in the Act is.

¹⁴⁷ Prasad (n127 above) 6.

¹⁴⁸ E Chawira, *'Taxation of illegal schemes: - should the term 'received by' in the definition of gross income be interpreted with reference to the taxpayer's subjective intention?'* Unpublished LLM Thesis, University of Pretoria, (2011).

It is also evident from the discussion in the preceding chapters that courts have adopted this approach so to ensure equity in taxation. A law-abiding citizen should not bear the tax burden whilst the dishonest citizen benefits from his chicanery. However, there is no equity in tax, presumptions or implications.¹⁴⁹ Only the language of the Act must determine the true position. It is thus clear from the preceding that the subjective approach is not without loopholes.

This therefore means that perhaps there may be a hybrid tax system to deal with ill-gotten gains that can be used by Zimbabwe, these are the recommendations that this research now proceeds to address below.

5.4 Recommendations.

In proposing recommendations for this research, one thing is apparent. There exists a problem, that is the phenomenon of ill-gotten gains. There is a seeming solution, the Income Tax Act. However, going by the preceding research, the applicability of the Act to the problem is not satisfactory. The absence of express provisions relating to ill-gotten gains in the Act clearly points out that, the Act was not crafted to solve the problem at hand.

As a recommendation to solve this problem, it submitted that income regardless of its source must be subject to taxation. This is because a dollar from illegal activities is worth the same as a dollar from a legitimate activity and thus government should be entitled to any revenue regardless of the source it is derived from. This becomes even more relevant in the context of Zimbabwe, where the informal and more commonly illegal sector of the economy is booming and the government is missing out on much needed revenue.¹⁵⁰

¹⁴⁹ *Cape Brandy Syndicate IR Comms*, ITC 353. (1921) KB 64 at 71.

¹⁵⁰ 'ZIMRA to tax informal sector.' The Financial Gazette 27 April, 2017.

The recommendation is thus, for Zimbabwe there is need to craft an Act dedicated only to the taxation of illegal activities and their subsequent proceeds. *Ab initio*, the Act must create an independent statutory body, with clear terms of reference and endowed with the power to investigate crimes and activities likely tainted with illegality and their fiscal consequences. This is not a novel idea, South Africa, a jurisdiction relied on for comparative purposes in this research, has an arm referred to as the HAWKS which can be used as a model for this statutory body.¹⁵¹ In like manner, the USA has the Internal Revenue Service which investigates varying taxpayer activities and the fiscal obligations rising therefrom.¹⁵²

Done right, this independent body could be self-sufficient in terms of how it will be sustainably funded. The tax which it imposes on ill-gotten gains and the ill-gotten gains it confiscates should be directed towards its financial requirements in any year of assessment.

This Act must provide a definition of gross income that is all encompassing. The Act should be crafted in the direction that the USA took submitted in Chapter Three of this research. At one stage, the USA made specific reference to the legality of the business for purposes of determining income tax. *The Tax Act of 1913 supra* provided that the net income of a taxable person shall include gains from transaction of any *lawful* business carried on for gain or profit.¹⁵³ This special qualification that the business be *lawful* was subsequently deleted to encompass any form of activity.¹⁵⁴ The recommendation is that, Zimbabwe should also take a similar position in redefining the meaning of gross income in the suggested Act to deal with illegal activities.

¹⁵¹ ‘The Directorate for Priority Crime Investigation has been established as an independent directorate within the South African Police Service in terms of Section 17C of the South African Police Service Act, 1995. It targets organized crime, *economic crime*, *corruption* and other serious crimes.’ available at <https://www.saps.gov.za/dpci/index.php> (accessed on 15 May 2018).

¹⁵² See <https://www.irs.gov/> (accessed on 15 May 2018).

¹⁵³ Black (n76 above) 256; see also **Chapter 3** at **3.4**.

¹⁵⁴ AKON (n78 above) 596.

As regards the contentious policy considerations discussed in Chapter Four of this research such as deductions, as already highlighted, as a general principle it is for the legislature, rather than the courts, to determine the applicability various policy considerations on income derived from illegal activities.¹⁵⁵ The same stance should be adopted in crafting this Act which would deal with income derived from illegal activities. The legislature is vested with powers in terms of Section 117(2)(b) of the Constitution¹⁵⁶, to craft a statute which would iron out the varying contentious policy considerations relating to the taxation of such ill-gotten income.

It is submitted that the above suggestion could steer Zimbabwe clear from the uncertainty surrounding the tax consequences of ill-gotten gains before the courts are called upon to make a determination using the current Act.

5.5 Conclusion.

In summation, refraining from taxing income owing to the fact that it is drawn from illegal activities is falling out of favour in numerous jurisdictions. Courts are more willing to stretch the wording of the tax legislation to cover ill-gotten gains than they are to watch the taxman lose revenue to an illegal enterprise. However, the problem with stretching the tax legislation, is that as it stretches thin, cracks begin to show, in the form of ununiform application of the law and at times illogical and arbitrary. Thus, the recommendation that there needs to be a statute to specifically address this phenomenon. This is, however, not to say that this would be an easy route to follow. There will be varying and complex policy issues, raised in Chapter Four, which will need to be expertly dealt with.

¹⁵⁵ *La Rosa* (n136 above) 125; see also **Chapter 4** at **4.2.8**.

¹⁵⁶ Constitution (n37 above) section 117(2)(b), ‘... to make laws for the peace, order and good governance of Zimbabwe;’.

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