

**TAXATION OF ILLEGAL INCOME: THE DUTY TO DISCLOSE INCOME  
DERIVED FROM ILLEGAL ACTIVITY AND THE CONSTITUTIONAL  
RIGHT AGAINST SELF-INCRIMINATION.**

By

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## DECLARATION

I, **Samkelo Callaway Mtwana**, declare that the work presented in this dissertation is original. It has never been presented to any other University or Institution. Where other people's works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the LLM degree in Tax Law.

Signed.....

Date.....

Supervisor: Prof Annet Wanyana Oguttu

Signature.....

Date.....

## DEDICATION

I dedicate this work to Pindie, with love, and to my beloved son, Nika, and beautiful daughters Yamkela and Intle. I love you all.

I also dedicate this work to the treasured memory of my three dear departed brothers: Nceba Goodman 'Ta Ncesh', Jacob Mncedisi 'Bra Mnce' and Mluleki Joseph 'Bhura'. I miss you *nto zika Tishala* (sons of The Teacher), and wish you were here to share this moment with me.

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I also thank the library staff in the University of South Africa, in the NPA Library, as well as in the University of Fort Hare (East London Campus) for assisting me in conducting my research. May God bless you all.

## LIST OF ABBREVIATIONS

<b>CIR</b>	Commissioner for Inland Revenue
<b>COT</b>	Commissioner of Taxes
<b>CSARS</b>	Commissioner for the South African Revenue Service
<b>CSAPS</b>	Commissioner for the South African Police Services
<b>DPP</b>	Director of Public Prosecutions
<b>FNB</b>	First National Bank of South Africa Ltd
<b>IRC</b>	Internal Revenue Code of 1986
<b>IRS</b>	Internal Revenue Service
<b>NDPP</b>	National Director of Public Prosecutions
<b>NEMB Act</b>	National Environmental Management: Biodiversity Act 10 of 2004
<b>POCA</b>	Prevention of Organised Crime Act 121 of 1998
<b>RSA</b>	Republic of South Africa
<b>SAPS</b>	South African Police Services
<b>SARS</b>	South African Revenue Service
<b>SOCPA</b>	Serious Organised Crime and Police Act of 2005
<b>TAB</b>	Tax Administration Bill
<b>TMA</b>	Taxes Management Act of 1970
<b>UK</b>	United Kingdom
<b>USA</b>	United States of America
<b>VAT</b>	Value-Added Tax
<b>VAT Act</b>	Value-Added Tax Act 89 of 1991

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# CHAPTER 1: INTRODUCTION AND GENERAL STATEMENT OF THE PROBLEM

## 1.1 Introduction

'It is clear that income received is subject to tax notwithstanding the fact that it is tainted with illegality or is received from illegal activities,' observed Malan J in the Johannesburg Tax Court judgment in *Tax Case IT 11282*, referring to various judicial decisions to support this conclusion.<sup>1</sup> However, the question of taxability of illegally derived amounts is far from being settled.<sup>2</sup> Even the celebrated decision of the Supreme Court of Appeal in *MP Finance Group CC (In Liquidation) v CSARS*,<sup>3</sup> although settling in the affirmative the question whether amounts paid to an illegal pyramid scheme are considered to be 'received' within the meaning of the Income Tax Act,<sup>4</sup> left a lot of questions regarding the blanket taxability of income derived from illegal activities unresolved.<sup>5</sup>

Nevertheless, this work does not seek to address the question of whether amounts derived from illegal activities or that are otherwise tainted with illegality, are taxable. Moving from the premise that such amounts are taxable, the purpose of this analysis is to tackle the next pertinent question: whether a taxpayer, compelled to disclose the manner in which such illegal income is derived in the income tax return, enjoys sufficient protection in our law against any adverse consequences that may flow from such disclosure. Since this question is not unique to South Africa and its tax system, it

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<sup>1</sup> *CIR v Delagoa Bay Cigarette Co Ltd* 1918 TPD 391 at 394; *Commissioner of Taxes v G* 1981 (4) SA 167 (ZA) 168C-169H; *CIR v Insolvent Estate Botha t/a 'Trio Kulture'* 1990 (2) SA 548 (A) 556-557; ITC 1545, 54 SATC 464 (C) 474-5; ITC 1624, 59 SATC (T) 373 at 377-8; *Minister of Finance v Smith* 1927 AC 193 at 197-8; *Mann v Nash (Inspector of Taxes)* 1932 1 KB 752 at 757-8; *Partridge v Mallandaine* (1886) 18 QBD 276; *Southern (Inspector of Taxes) v AB* 1933 1 KB 713 at 718-9.

<sup>2</sup> LG Classen 'Legality and Income Tax – Is SARS "Entitled to" Levy Income Tax on Illegal Amounts "Received by" a Taxpayer?' (2007) 19 *SA Merc LJ* 534 where the learned author points out the controversy existing on the issue of whether or not such proceeds should be subject to income tax.

<sup>3</sup> 2007 (5) SA 521 (SCA).

<sup>4</sup> Sec 1 Act 58 of 1962.

<sup>5</sup> Classen op cit note 2 at 553.

is important to tackle it with reference to other tax jurisdictions that have experienced the same problem.

The laws governing taxation cannot be looked at in isolation but must be seen within the body of other legal principles, including the Constitution of the Republic of South Africa (the Constitution) that is the supreme law of the land.<sup>6</sup> The Constitution of the United States of America (USA) and the uncodified Constitution of the United Kingdom (UK) also reign supreme in their respective jurisdictions. These constitutions guarantee the citizens of the USA and the UK, respectively, protection against giving self-incriminating evidence. It is because of this constitutional supremacy and guaranteed right against self-incrimination that these two tax jurisdictions are studied in this work for comparison with the South African tax system.

On the one hand the Bill of Rights in the Constitution guarantees a right to everyone who is arrested for allegedly committing an offence, not to be compelled to make any confession or admission that could be used in evidence against that person.<sup>7</sup> It also guarantees a right to every accused person not to give self-incriminating evidence.<sup>8</sup> On the other hand the South African Revenue Service Act (SARS Act),<sup>9</sup> gives SARS the mandate to collect all revenues that are due, ensure maximum compliance with the legislation, and provide a customs service that will maximise revenue collection, protect our borders and facilitate trade.<sup>10</sup> The consequence of such a mandate is that SARS requires every taxpayer to disclose all his income (including income from illegal activities such as proceeds from drug dealing) in his tax return.<sup>11</sup> If the

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<sup>6</sup> Sec 2 of the Constitution of the RSA, 1996. In terms of sec 1(1) of the Citation of Constitutional Laws Act 5 of 2005, no Act number is to be associated with the Constitution.

<sup>7</sup> Sec 35(1) (c) of the Constitution; B Croome *Taxpayers' Rights in South Africa* (2010) at 14; M Sinjela 'The Process of Democratization in South Africa and the Protection of Human Rights under the New South African Constitution' (1997) *5 African Yearbook of International Law* 175 at 187.

<sup>8</sup> Sec 35(2) (j) of the Constitution.

<sup>9</sup> Act 34 of 1997.

<sup>10</sup> South African Revenue Service 'Mandate and Vision', available at <http://www.sars.gov.za/home.asp?pid=201> (accessed 22 March 2011).

<sup>11</sup> Sec 75 Income Tax Act.

taxpayer does not report the income and the illegal profits are discovered, the taxpayer can be charged with income tax evasion. If the taxpayer reports the income, he reveals his illegal activities. The incriminating report in the tax return can, upon direction of a competent court, be used against him in a possible criminal proceeding.<sup>12</sup> This gives rise to the question whether this situation does not infringe on the rights guaranteed in section 35(1) (c) and 35(2) (j) of the Constitution as mentioned above.<sup>13</sup> One South African writer has even alluded to the possibility of a conflict between the duty to file annual returns and the right of the taxpayer not to be compelled to give self-incriminating evidence.<sup>14</sup>

Unlike the position in South Africa, in the USA it has been argued that the requirement by the Internal Revenue Service (IRS) that income from illegal activities be disclosed does not violate the Fifth Amendment.<sup>15</sup> This is because the courts have held that a taxpayer may elect to claim the Fifth Amendment privilege as to certain specific entries on his return if the disclosure could reasonably expose him to the risk of criminal prosecution.<sup>16</sup> In the UK it has been held that taxpayers have a constitutional right to be protected against use of information in their tax returns in criminal prosecutions where such use may amount to self-incrimination.<sup>17</sup> However, in South Africa taxpayers who have illegal income remain exposed to criminal prosecution based on information obtained from their tax returns.

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<sup>12</sup> Proviso to sec 4(1B) Income Tax Act.

<sup>13</sup> Notes 7 and 8 *supra*.

<sup>14</sup> B Ger 'Taxpayers Have Rights Too' (2003) *De Rebus*, available at [http://lexhqpta/nxt/gateway.dll/zkfaa/bsxha/7zjba/ywlba/ozoba/72mda/82mda?f=templates\\$fn=document-frameset](http://lexhqpta/nxt/gateway.dll/zkfaa/bsxha/7zjba/ywlba/ozoba/72mda/82mda?f=templates$fn=document-frameset) (accessed 20 April 2011).

<sup>15</sup> Amendment 5 to the Constitution of the United States of America, an equivalent of our section 35 (1) (c).

<sup>16</sup> *United States v Josephberg* 459 F.3d 350 (2d Cir. 2009); *United States v Sullivan* 274 U.S. 259 (1927) at 264; *Garner v United States* 424 U.S. 648 (1976) at 666; SA Berson *Federal Tax Litigation* (2003) at 13-42.

<sup>17</sup> *The DPP v Michael Collins*. Unreported Circuit Court judgment delivered on 27 September 2007.

## 1.2 Problem Statement

In the Republic of South Africa (RSA) the courts have for decades now, been grappling with the question of whether income from illegal activities should be included in 'gross income' for purposes of taxation.<sup>18</sup> Such inclusion is regarded as a prerequisite for taxation because only income falling within the ambit of 'gross income' as defined in section 1 of the Income Tax Act will be taxable.<sup>19</sup> This is because the Income Tax Act does not specifically provide for taxability of income derived from illegal activity.<sup>20</sup> As mentioned above, the USA has a remedy to this problem as set out in the Fifth Amendment. However, there is no South African equivalent to the American assertion of the Fifth Amendment protection as to entries on tax returns where disclosure could reasonably expose the taxpayer to criminal prosecution. There is also no South African equivalent to the UK protection against use of self-incriminatory tax information in criminal prosecutions.

Although some protection is afforded such a taxpayer in the form of the preservation of secrecy clauses in our fiscal legislation,<sup>21</sup> it is the effectiveness and efficiency of these clauses in protecting a taxpayer's constitutional right against self-incrimination that needs to be examined. This is because the veil of secrecy can be pierced by, firstly the SARS Commissioner who may in terms of Section 4(1B) of the Income Tax Act make an *ex parte* application to a judge in chambers for permission to disclose such information to the National Commissioner of the South African Police Services (SAPS) or to the National Director of Public Prosecutions (NDPP). Secondly the veil of secrecy can be pierced by the National Commissioner of the SAPS or by the NDPP in terms of section 4(1E) of the Income Tax Act in the investigation and

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<sup>18</sup> G Goldswain 'Illegal Activities – Taxability of its Proceeds' (2008) 22 *Tax Planning* 143.

<sup>19</sup> D Warneke & D Warden 'Fraudulent Transactions – Are the Receipts Taxable?' (2003) 17 *Tax Planning* 26. See also J Silke 'Illegal and Secret Profits – Gross Income?' (2005) 19 *Tax Planning* 114.

<sup>20</sup> Ibid.

<sup>21</sup> Sec 4 Act 58 of 1962 and sec 6 of Act 89 of 1991 guarantee, under pain of punishment for non-compliance, preservation of secrecy with regard to all matters that may come to the knowledge of SARS employees in carrying out their duties, including information contained in income tax returns. See also sec 69 of the Tax Administration Bill, 2011 (Bill No.11 of 2011) as introduced in Parliament on 23 June 2011 (TAB).

prosecution of any serious non-tax offence,<sup>22</sup> or investigation of evidence of an imminent and serious public safety or environmental risk.<sup>23</sup>

### **1.3 Rationale**

This work contributes to the debate about the effect of the Constitution on tax law using a vertical application argument ‘based on the state’s duty to protect the fundamental rights of citizens against infringements’.<sup>24</sup> In this regard the contribution is by analysing the instances where income tax returns continue to be used in criminal prosecutions, especially in terms of the preservation of secrecy provisions of the Income Tax Act.<sup>25</sup> The objective is to come up with some recommendation on ways of how taxpayers can avoid incriminating themselves in illegal activities by invoking the provisions of the Bill of Rights. The objective is also to come up with other alternative recommendations that will effectively put an end to the current situation, such as possible statutory immunity.

### **1.4 Methodology**

The research conducted for this work is essentially a literature review of textbooks, journal articles and case law. There is a focus on the existing body of literature relating to the obligation to report all income including income generated by illegal activity, on the one hand, and the constitutional right of individuals not to incriminate themselves in criminal offences, on the other. The research is, therefore, mainly library based with documented facts on this subject being explored, while various electronic articles are consulted for relevant up-to-date data and information. The research, however, has found that there is not much written on the subject of the relationship between taxation laws and the Constitution. Consequently there is a

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<sup>22</sup> Note that in terms of section 4(1B) (a) an offence is sufficiently serious to warrant disclosure of taxpayer information if it is an offence in respect of which a court may impose a sentence of imprisonment exceeding five years. See also sec 71(2) (a) TAB op cit note 21.

<sup>23</sup> Sec 4(1B) (b) Act 58 of 1962; sec 71(2) (c) TAB.

<sup>24</sup> AJ van der Walt *Constitutional Property Law* (2005) at 440.

<sup>25</sup> Sec 4 Act 58 of 1962.

limited supply of reference works, more especially of text books dealing with the subject. Nevertheless, as the subject under consideration is of particular pertinence both to the current tax regime and to the preservation of constitutional democracy in the RSA and elsewhere, this work is not of academic interest only.

## **1.5 Scope**

This work is limited to the analysis of the disclosure and taxation of income derived from illegal activity in the RSA, the USA and the UK. Receipt and accrual of income other than illegal income also, of necessity, receive some coverage to clarify issues pertaining to 'gross income' as defined in the Income Tax Act.

## **1.6 General Remarks**

It is important to note that none of the rights entrenched in the Bill of Rights of the Constitution are absolute; they are all subject to limitation.<sup>26</sup> This includes the right against self-incrimination. However, any limitation of constitutional rights has to be reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom.<sup>27</sup> Furthermore anyone called upon to limit a constitutional right should take into account the nature of the right, the importance of the purpose of the limitation, the nature and extent of the limitation, the relation between the limitation and its purpose, and should investigate the possibility of adopting means that are less restrictive than the limitation to achieve the purpose.<sup>28</sup>

As indicated above, SARS has a mandate to collect taxes, and in carrying out that mandate SARS requires taxpayers to make disclosures that may, in certain

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<sup>26</sup> B Croome 'Tax Administration Bill and Taxpayers' Rights (Part I)', available at <http://bericcroome.blogspot.com/2010/11/tax-administration-bill-and-taxpayers.html> (accessed 9 June 2011).

<sup>27</sup> Sec 36 of the Constitution.

<sup>28</sup> Ibid.

circumstances, be inconsistent with the constitutional rights of the taxpayer.<sup>29</sup> In such circumstances questions arise whether such infringements are justifiable in terms of the limitation clause (section 36) of the Constitution, or whether less restrictive means should be adopted to achieve the important purpose of tax collection. It is in this context that the constitutionality of taxing illegally derived income is discussed in the next chapter.

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<sup>29</sup> Ger op cit note 14.

## CHAPTER 2: THE CONSTITUTIONALITY OF TAXING ILLEGAL INCOME IN SOUTH AFRICA

### 2.1 Introduction

The Republic of South Africa (RSA) is a constitutional democracy. This means that the Constitution is the supreme law of the land and all other laws must be consistent with it to be valid.<sup>30</sup> The Constitutional Court will declare any statute, including a fiscal statute, invalid if such statute is found to be inconsistent with the Constitution.<sup>31</sup>

Chapter 2 of the Constitution contains the Bill of Rights, which is the cornerstone of democracy in RSA.<sup>32</sup> Section 35 falls under Chapter 2 and deals with the rights of arrested, detained and accused persons. Section 35(3) guarantees every accused person a right to a fair trial, which, in terms of sub-section (3) (j) of that section, includes the right not to be compelled to give self-incriminating evidence.<sup>33</sup> Furthermore, evidence obtained in a manner that violates any right in the Bill of Rights must be excluded if the admission of that evidence would render the trial unfair or otherwise be detrimental to the administration of justice.<sup>34</sup>

Current revenue laws in RSA require taxpayers to make full disclosures to SARS regarding taxable income. A taxpayer who fails to make full disclosure may be charged with the offence of tax evasion. Tax evasion has been defined as an illegal non-disclosure of income, the rendering of false returns, and the claiming of unwarranted deductions.<sup>35</sup> It ‘connotes the use of illegal and dishonest means to

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<sup>30</sup> Sec 2 of the Constitution.

<sup>31</sup> J Silke ‘Light at the End of the Constitutional Tunnel – Fiscal Provisions and Disciples’ (2003) 17 *Tax Planning* 44; Croome op cit note 26.

<sup>32</sup> Sec 7(1) of the Constitution.

<sup>33</sup> Sec 35(3) (j) of the Constitution.

<sup>34</sup> Section 35(5) of the Constitution.

<sup>35</sup> AW Oguttu ‘Transfer Pricing and Tax Avoidance: Is the Arm’s-length Principle Still Relevant in the E-Commerce Era?’ (2006) 18 *SA Merc. LJ* 138.

escape tax'.<sup>36</sup> Full disclosure will therefore in this sense have to include honest disclosure of the manner in which the income is derived, to avoid rendering false returns. However, in some instances the income is derived from unlawful activities, or is otherwise tainted with illegality. In such instances the disclosure of the manner in which the income is derived would expose the taxpayer to a possible prosecution for a non-tax criminal offence such as drug trafficking, prostitution or even robbery.

The discussion in this Chapter firstly shows, as portrayed in legal literature and case law, that the principle of taxability of income derived from unlawful activities is well established in South African law. Thereafter the focus shifts to how the current laws fail to sufficiently protect taxpayers (who acquire income unlawfully or whose declared income is otherwise tainted with illegality) from use of their tax disclosures as self-incriminating evidence. To this end provisions of various fiscal statutes compelling disclosure are discussed, as well as statutory provisions that purport to preserve secrecy of such disclosures. Decided cases that demonstrate how the courts have had to pronounce on the admissibility of tax disclosures in criminal prosecutions are also discussed. It is argued that the use of tax disclosures in criminal prosecutions against the taxpayer violates the constitutional right to a fair trial because it amounts to self-incriminating evidence. It is suggested in conclusion that some concrete safeguards need to be adopted from other jurisdictions that have had to deal with the same problem.

## **2.2 Taxation of Income Derived from Illegal Activities**

### **2.2.1 Background**

The contentious issue of taxability of illegal income or income derived from unlawful activities stems from the belief of some, notably Alphonse Gabriel “Al” Capone (Al

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<sup>36</sup> WA Joubert & TJ Scott *The Law of South Africa* (1992) Vol 22 Part I at 365; K Huxham & P Haupt *Notes on South African Income Tax* (2011) at 454.

Capone), the Italian-American gangster who led a Prohibition-era crime syndicate.<sup>37</sup> Al Capone argued that governments should not benefit from the proceeds of crime as States prohibit their citizens from engaging in criminal activity.<sup>38</sup>

However, the unanimous opinion of tax authorities and other influential writers (as specified below) appears to be that proceeds of crime and of other unlawful activities should be subject to taxation in the same manner as income derived from lawful enterprises. Even Michael Pampallis,<sup>39</sup> who appears to question the morality of taxing earnings derived illegally from prostitution, agrees that such earnings qualify as 'gross income' for the purposes of the definition of this term in section 1 of the Income Tax Act.<sup>40</sup> Pampallis argues that if income from prostitution is good enough for the *fiscus* to tax, then the prostitute should also be allowed to go about her business of prostitution unhindered by the law. This seems to be an argument more for legalising prostitution than against taxation of earnings from prostitution.

Olivier,<sup>41</sup> discussing *ITC 1789*,<sup>42</sup> points out that according to case law there is a requirement for an amount to form part of gross income of a taxpayer, namely that such amount has to be received by that taxpayer on his behalf and for his own benefit. The learned author contends, however, that the subjective intention of the recipient (of the amount in question) is not decisive. She opines that 'to hold otherwise would mean, for example, that money received by a person who trades on a Sunday in contravention of municipal by-laws would be deemed to have never been received'.<sup>43</sup>

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<sup>37</sup> The Longman Dictionary of Contemporary English, New Ed (2009) at 1388 defines Prohibition as the period of time from 1919 to 1933 in the USA when the production and sale of alcoholic drinks was illegal. See also the Oxford Advanced Learner's Dictionary 7<sup>th</sup> Ed (2006) at 1162.

<sup>38</sup> Goldswain op cit note 18 at 143.

<sup>39</sup> M Pampallis 'What's Good for the Goose – Earnings from Prostitution' (1990) 4 *Tax Planning* 122.

<sup>40</sup> Ibid.

<sup>41</sup> L Olivier 'Law of Taxation' (2005) *Annual Survey of SA Law* 793.

<sup>42</sup> (2005) 67 SATC 205. This was the decision of the court *a quo* that led to the appeal in *MP Finance* op cit note 3.

<sup>43</sup> Olivier op cit note 41 at 793-4.

Goldswain,<sup>44</sup> while steering clear of the merits of the argument of Al Capone (mentioned above), does make the point that if that argument held sway in South Africa, it would mean that criminals are living in their own little tax haven in this country.

Donaldson,<sup>45</sup> writing about the cricket ‘match fixing’ scandal involving Hansie Cronje, agrees. Cronje was the former RSA national cricket team captain who was involved in fraudulent conspiracies with international bookmakers to irregularly influence cricket match results. Donaldson suggests in a rather tongue in cheek tone that the former captain should be allowed to continue with his dodgy dealings provided he declares his ill-gotten income for tax purposes. ‘A man should be allowed to do what he has to do to put food on the table – as long as he pays his taxes too,’ he opines, suggesting the introduction of an ‘Ill-Gotten Gains’ tax.<sup>46</sup> Pugsley,<sup>47</sup> writing on the same topic a year later, also agrees with Donaldson. The latter author sees in the scandal ‘a golden opportunity to plump up the State’s coffers’ by assessing Hansie for tax on the income derived from ‘match fixing’.<sup>48</sup>

Classen,<sup>49</sup> submits that the phrase ‘accrued... in favour of a person’ as it appears in the Income Tax Act definition of ‘gross income’, could be relied on to levy tax on illegally produced income. The learned author points out,<sup>50</sup> that the reason income derived illegally would usually not be taxed is not because it is not taxable, but because the revenue authorities are not aware of its existence since it is excluded from tax returns in most cases. It is only after the perpetrators of such illegal activities have been caught out that the decision has to be made on whether to levy tax on their income.<sup>51</sup>

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<sup>44</sup> Op cit note 18 at 143.

<sup>45</sup> H Donaldson ‘Hansie and the Taxman – Funds for the Fiscus’ (2000) 14 *Tax Planning* 81.

<sup>46</sup> Ibid at 82.

<sup>47</sup> S Pugsley ‘Selling the Game IV – Income from Illegal Services’ (2001) 15 *Tax Planning* 89.

<sup>48</sup> Ibid at 91.

<sup>49</sup> Op cit note 2.

<sup>50</sup> At 536.

<sup>51</sup> Ibid.

What follows is a discussion of the position of the RSA courts regarding the taxation of income derived from illegal activities. The aim is to demonstrate that taxpayers in RSA have no choice but to declare their taxable income, regardless of the legality of the means by which they derive that income.

### **2.2.2 Case law**

As has been stated above, the Income Tax Act does not specifically provide for taxation of proceeds of illegal activities. This has resulted in our courts having to enquire, in each case, whether such proceeds are covered by the definition of ‘gross income’ in section 1 of the Act,<sup>52</sup> before arriving at a decision as to their taxability. The cases that have dealt with this matter are, however, limited in number.

In *CIR v Delagoa Bay Cigarette Co Ltd*,<sup>53</sup> the first decided case on the issue, the taxpayer was a company that sold packets of cigarettes. The price was inflated considerably on a batch of these packets. Each packet in the batch contained a numbered coupon that put the buyer in line to win a monthly prize. The issue was whether two-thirds of the inflated price, allocated by the taxpayer for the distribution of prizes, would be included in its gross income, since the amount had been received in contravention of an Act regulating lotteries. It was held that the transaction between the taxpayer and the purchasers of the cigarettes was essentially a sale and that when the company distributed prizes, these were not refunds of the purchase price. 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.

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<sup>52</sup> Goldswain op cit note 18. Sec 1(1) of the Income Tax Act defines ‘gross income’ in relation to any year or period of assessment as meaning ‘the total amount, in cash or otherwise, received by or accrued to or in favour of’ (a resident).

<sup>53</sup> 1918 TPD 391.

In *COT v G*,<sup>54</sup> a 1981 Zimbabwe High Court decision, the court had to decide whether a government agent, who had misappropriated funds meant for secret operations, had ‘received’ those funds for the purposes of income tax. The court seemed to assume that it is possible to tax proceeds of illegal activity, but held that the term ‘received’ should be given its ordinary meaning and that no logical reading would take it to mean a unilateral taking such as theft.<sup>55</sup> The court went on to rely on the decision in *Geldenhuis v CIR*,<sup>56</sup> in holding that it was clear that ‘received by’ must mean received by the taxpayer on his own behalf and for his own benefit. The court held that in deciding whether the taxpayer has received an amount on his own behalf and for his own benefit, it was not only his (the taxpayer’s) intention that was important, but also the intention of the giver. In this case it was clear that the government had never intended for the thief to keep the funds in question and to do with them as he liked, so the thief could not be said to have received the funds at all.

In *ITC 1624*,<sup>57</sup> a 1997 decision, the taxpayer rendered services to a customer, which included the payment to Portnet of wharfage fees, to be recovered from the customer. In a particular year of assessment, the taxpayer fraudulently rendered accounts, ostensibly in respect of wharfage fees, to the customer and in this way received amounts which it was not legally entitled to. The taxpayer then sought to rely on *COT v G* (supra) to argue that it had not received anything for the purposes of gross income, since the amounts had not been received by it ‘on its own behalf and for its own benefit’. The court held that none of the cases relied upon by the taxpayer (including *COT v G*) were authority for the proposition that where a trader receives payment of money in the course of carrying on its trade which it obtains by making a fraudulent or negligent misrepresentation to a customer, it does not intend to receive

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<sup>54</sup> 1981 (4) SA 167 (ZA).

<sup>55</sup> Warneke & Warden op cit note 19.

<sup>56</sup> 1947 (3) SA 256 (C). In that case a usufructuary of a flock of sheep sold, with the consent of the heirs, such flock at a time when its numbers were below its proper complement, and converted it into cash. She was held not to have acted in pursuance of her legal rights as usufructuary or quasi-usufructuary, and the proceeds from such sale were held not to accrue to her personally but to the heirs. The proceeds could therefore not be included in her taxable income.

<sup>57</sup> 59 SATC 373.

it as part of its business and in the course of its business. The court then held that the amount in question had to be included in the taxpayer's income for income tax purposes. *COT v G* was thus distinguished. *ITC 1624* was discussed in full by Michael Stein,<sup>58</sup> who saw inconsistencies in the approaches adopted by the courts in this case and in *COT v G*. Stein expressed the view that 'we may very well not yet have heard the last word from our courts on this fascinating subject'.<sup>59</sup>

Indeed the Supreme Court of Appeal, in *MP Finance*,<sup>60</sup> provided some certainty on the subject.<sup>61</sup> The facts in that case were briefly that the taxpayer had operated an illegal and fraudulent investment enterprise commonly known as a pyramid or Ponzi scheme.<sup>62</sup> The objective of the scheme was to part investors from their money by promising irresistible but unsustainable returns on various forms of ostensible investments. The scheme paid returns for a while to some of the investors out of new investors' deposits before finally collapsing, owing many millions. Substantial amounts of the deposits were appropriated by the taxpayer. The perpetrators of the scheme were aware at the time they took the deposits that it was insolvent, that it was fraudulent, and that it would be impossible to pay all the investors what they had been promised.

The taxpayer contended that because the scheme was liable in law immediately to refund the deposits, there was no basis on which it could be said that the deposits

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<sup>58</sup> M Stein 'Tax on the Fruits of Fraud – A Tale of Two Cases' (1998) 12 *Tax Planning* 114.

<sup>59</sup> Ibid at 116; Webber Wentzel Attorneys 'The Taxation of Illegal Proceeds', available at <http://www.wwb.co.za/wwb/view/wwb/en/page1874?oid=1929&sn=Detail&pid=1874> (accessed 7 June 2011).

<sup>60</sup> Op cit note 3.

<sup>61</sup> The authors M Stiglingh, A Koekemoer, L Van Schalkwyk, JS Wilcocks, RD de Swardt & K Jordaan *Silke: South African Income Tax* (2009) assume, at 18, that the position adopted in the *MP Finance* case is the correct reflection of the law.

<sup>62</sup> TA Woker 'If It Sounds Too Good to Be True It Probably Is: Pyramid Schemes and Other Related Frauds' (2003) 15 *SA Merc LJ* 237. A Ponzi scheme is a fraudulent investment operation that pays returns to investors from their own money or money paid by subsequent investors rather than from any actual profit earned. The result is that the few at the top benefit at the expense of the majority late comers who lose their 'investments', thus taking the shape of a pyramid, hence the name pyramid scheme. The scheme is named after Charles Ponzi, who became notorious for using the technique after emigrating from Italy to the United States of America in 1903. Although he did not invent the scheme, his operation took so much money that it was the first to become known throughout the United States.

were ‘received’ within the meaning of the Income Tax Act and they were consequently not subject to tax. The court drew a difference between the relationship between the investor and the scheme operator on the one hand, and that between the scheme operator and the *fiscus* on the other. It was held that an illegal contract is not without all legal consequences and that it can have fiscal consequences. The enquiry, as between the scheme operator and the *fiscus* was whether the amounts paid to the scheme operator in the years of assessment in issue came within the literal meaning of the Income Tax Act. The court held that they did: The amounts paid to the scheme operators were accepted with the intention of retaining them for their own use and benefit and, notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Income Tax Act and were duly taxable. This decision effectively overruled *COT v G* (above) by doing away with the ‘intention of the giver’ consideration.

This case, therefore, finally decided that proceeds of unlawful activities are taxable provided that the taxpayer had an intention to appropriate the proceeds on his own behalf and for his own benefit.

Moreover, the penalties prescribed for failing to disclose income in tax returns apply equally to failure to disclose illegally derived income.<sup>63</sup>

### **2.3 Self-incrimination: A brief background**

The Latin maxim ‘*nemo tenetur seipsum accusare*,’ which means ‘no one is bound to accuse himself,’<sup>64</sup> is the source of today’s right against self-incrimination. This right is premised on the belief that if someone is to be accused of some wrongdoing, then he should not be forced or induced to provide the evidence that is required to convict

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<sup>63</sup> M Vanek ‘SARS After Your Illegal Income Too’, available at [www.moneywebtax.co.za/moneywebtax/vie/moneywebtax/en/page259?oid=2815&sn=Detail](http://www.moneywebtax.co.za/moneywebtax/vie/moneywebtax/en/page259?oid=2815&sn=Detail) (accessed 28 February 2010).

<sup>64</sup> Justitia.com ‘Self-Incrimination: Development and Scope’, available at <http://supreme.justitia.com/constitution/amandment-05/07-self-incrimination.html> (accessed 7 December 2010).

him of that wrong-doing. It ‘serves two interrelated interests: the preservation of an accusatorial system of criminal justice, which goes to the integrity of the judicial system, and the preservation of personal privacy from unwarranted governmental intrusion’.<sup>65</sup>

The right against self-incrimination consists of a relative immunity awarded to a person, who then becomes entitled to selectively decline to answer questions which might inculcate him in criminal wrongdoing, or otherwise expose him to imposition of a penalty, or the forfeiture of an estate. This right is a natural result of an accusatorial, adversarial system of criminal justice that relies on a presumption of innocence and a right of accused persons to a fair trial.<sup>66</sup>

However, as has been stated above, governments have enacted statutes compelling taxpayers to disclose all income, by including such income in their tax returns, whether it is generated by lawful means or not. The problem starts where disclosure of income derived through illegal means leads, or might possibly lead, to the taxpayer’s conviction in a criminal prosecution.<sup>67</sup>

As is discussed below, the existing tax laws in South Africa do not protect taxpayers sufficiently against such a possibility, and this appears to be inconsistent with the constitutional right against self-incrimination.<sup>68</sup>

## **2.4 Self-incrimination: Legislation**

### **2.4.1 Background**

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<sup>65</sup> Ibid.

<sup>66</sup> C Theophilopoulos ‘The Corporation and the Privilege against Self-Incrimination’ (2004) 16 *SA Merc LJ* 17.

<sup>67</sup> MS Stone ‘Self-incrimination: Income Tax: The Fifth Amendment and Statutory Self-disclosure: Reporting Illegal Gains on Federal Income Tax Return’ (1974) 23 *Emory LJ* 1119 at 1119-1120.

<sup>68</sup> Ibid at 1120.

The present tax structure allows for two types of taxes to be levied by the tax authorities in RSA, namely direct and indirect taxes. Direct taxes are levied directly on the income and wealth of persons,<sup>69</sup> while indirect taxes are levied on certain commodities and transactions. The test of whether a tax is direct or indirect is simply whether the impact and incidence of the tax fall on the same person or not. In the case of direct taxes both the impact and the incidence of the tax fall on the same person, while in the case of indirect taxes the impact of the tax falls on the seller, and the consumer bears the incidence as he ultimately pays the tax.<sup>70</sup> An example of an indirect tax is value-added tax (VAT) as it is levied on a vendor, while the person who ultimately pays it is the consumer.<sup>71</sup> Income tax, being a tax that the government levies on the very person who should pay it, is therefore a direct tax. Income tax is so named because it is the levy imposed on a person's income from various sources.<sup>72</sup>

It is necessary for the tax authorities to be aware of the existence and extent of any income in order to be able to determine any tax liability. To make this possible, taxpayers are required by law to make disclosures to the authorities in terms of the relevant tax Acts. In the discussion below, the specific provisions requiring disclosure of income in four of the South African tax statutes are discussed, as are the corresponding penal provisions, with special emphasis on the provisions of the Income Tax Act. The intention is to show how such compelled disclosures can lead to self-incrimination and possibly be at odds with the Constitution.

#### **2.4.2 The Income Tax Act**

Income tax is the most important source of direct taxation and is, along with the donations tax and the capital gains tax,<sup>73</sup> levied and governed in terms of the

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<sup>69</sup> The word 'persons' in this context connotes taxpayers, whether they are natural or juristic persons.

<sup>70</sup> EM Stack, M Cronje & EH Hamel *The Taxation of Individuals and Companies* 16<sup>th</sup> Ed (2003) at 2.

<sup>71</sup> Ibid.

<sup>72</sup> D Meyerowitz *Meyerowitz on Income Tax* (2008-2009) 1-1.

<sup>73</sup> The capital gains tax was introduced with effect from 1 October 2001.

provisions of the Income Tax Act 68 of 1962 (as amended). The administration of this Act, and of all other revenue statutes, is the responsibility of the Commissioner for the South African Revenue Service (the CSARS). The CSARS may exercise the powers conferred and perform the duties imposed by the Act personally or by any officer under his control, direction or supervision.<sup>74</sup>

As stated above, the powers conferred by any law, including the Income Tax Act, have to be consistent with the Constitution to be valid.<sup>75</sup> However, ‘although some progress has been made in amending the provisions in the Income Tax Act that either breach certain provisions of the 1996 Constitution, or that are not justifiable limitations in terms of section 36 of the Constitution, there are still some provisions that are *prima facie* unconstitutional’.<sup>76</sup>

As discussed below, various offences are created by sections 75, 76 and 104 of the Income Tax Act.<sup>77</sup> There are also corresponding penalties (discussed below) that are prescribed for those offences. These sections have the effect of compelling disclosure of income and the manner in which it is derived by providing, inter alia, that a taxpayer shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding twenty-four months if he:

- Fails or neglects to furnish, file or submit any return or documents as and when required under the Income Tax Act.<sup>78</sup>
- Without just cause refuses or neglects to furnish, produce or make available any information, documents or things, to reply or answer truly and fully any questions put to him or to attend and give evidence as and when required.<sup>79</sup> It is

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<sup>74</sup> Stack, Cronje & Hamel op cit note 70 at 626.

<sup>75</sup> Sec 2 of the Constitution.

<sup>76</sup> L van Schalkwyk ‘Constitutionality and the Income Tax Act’ (2001) 9 *Meditari Accountancy Research* 285 at 297.

<sup>77</sup> Act 58 of 1962.

<sup>78</sup> Sec 75 (1) (a) Act 58 of 1962; B Croome & L Olivier *Tax Administration* (2010) at 119.

<sup>79</sup> Sec 75(1) (b) Act 58 of 1962.

worth noting that the onus of showing the existence of a just cause rests with the taxpayer.<sup>80</sup>

- Fails to show in a return made by him any portion of the gross income received by or accrued to him or in his favour or to disclose to the CSARS, when making his return, any material facts that should have been disclosed.<sup>81</sup> Or
- Fails to show in any return prepared or rendered by him on behalf of any other person any portion of the gross income received by or accrued to or in favour of that other person or to disclose to the CSARS, when preparing or making the return, any facts that, if disclosed, might result in increased taxation.<sup>82</sup>

In practice SARS sends forms to all taxpayers who rendered returns in respect of the previous year of assessment or who appear to the CSARS for any other reason liable to render a return.<sup>83</sup>

In terms of section 76 of the Income Tax Act, should a taxpayer default in rendering a return in respect of any year of assessment, he is liable to pay an extra amount that is equal to double the amount of tax for which he was originally liable on his income for the year of assessment in question.<sup>84</sup>

If the taxpayer omits from his return an amount which ought to have been included therein, he shall be liable to pay an extra amount that is equal to double the difference between the tax as calculated in respect of the taxable income returned by him and the tax properly chargeable in respect of his taxable income as determined after the amount that he had omitted has been included.<sup>85</sup>

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<sup>80</sup> Ibid.

<sup>81</sup> Sec 75(1) (c) Act 58 of 1962.

<sup>82</sup> Sec 75(1) (d) Act 58 of 1962. See RC Williams 'The Tax Consequences of a Fraudulent Claim to Deduct Overseas Travelling Expenses' (2001) 13 *SA Merc LJ* 445 at 446.

<sup>83</sup> Meyerowitz op cit note 72 at 32 - 6.

<sup>84</sup> Sec 76(1) (a) Act 58 of 1962.

<sup>85</sup> Sec 76(1) (b) Act 58 of 1962.

In the event of an incorrect statement in a return resulting or that would, if accepted, result in a lesser tax amount than the chargeable one, the taxpayer shall be liable to an extra amount that is equal to double the difference between the tax assessed in accordance with the return made by him and the tax that would be properly chargeable.<sup>86</sup> This makes the taxpayer liable in all for triple the amount of tax that he would ordinarily have had to pay.<sup>87</sup> The Witwatersrand Local Division held, in *Van der Walt v S*,<sup>88</sup> that the interests of justice did not require a taxpayer who has paid these heavy financial penalties to the *fiscus* to be sentenced to pay a further amount to the State by way of a fine.<sup>89</sup>

Where the statement in question relates to the manner in which the relevant income was derived, the taxpayer would be compelled to disclose that information in the return, even if it is tainted with illegality and could expose him to prosecution for criminal wrong-doing. In that event the taxpayer would have been compelled to make a self-incriminating statement in his tax return.

### **2.4.3 The Value-Added Tax Act (VAT Act)**

VAT is levied in terms of the provisions of the VAT Act.<sup>90</sup> Section 28 of the VAT Act provides for submission of a return in the form prescribed by the CSARS within twenty-five days after the end of the tax period.<sup>91</sup>

Section 58, on the other hand, classifies certain activities as offences for which the punishment upon conviction is a fine or imprisonment for a period not exceeding twenty-four months. These offences include failure to comply with the provisions of section 28(1) and (2) which provide for rendition of tax returns.<sup>92</sup> The effect is

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<sup>86</sup> Sec 76(1) (c) Act 58 of 1962.

<sup>87</sup> Williams op cit note 82 at 446.

<sup>88</sup> 52 SATC 186.

<sup>89</sup> Ibid at 193.

<sup>90</sup> Act 89 of 1991.

<sup>91</sup> Stiglingh et al op cit note 61 at 854.

<sup>92</sup> A De Koker & D Kruger *Value-Added Tax in South Africa – Commentary* (2009) 20-3.

therefore the same as with the provisions of the Income Tax Act discussed above, namely the compulsion of disclosure and the possible self-incrimination.

In addition to the offences provided for in section 58, a further list of tax evasion related activities is classified as offences in terms of section 59. A person shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding sixty months if he:

- Makes or causes or allows to be made a false statement or entry in any return rendered in terms of the VAT Act or signs a statement or return so rendered without there being reasonable grounds for the belief that it is true.<sup>93</sup> Once again the taxpayer is compelled to make a correct statement or entry in his return. In the event that such statement relates to where or how the income is derived, the taxpayer would be compelled to incriminate himself if the income was derived unlawfully.
- Gives a false answer, whether orally or in writing, to a request for information made under the Act by the CSARS or any person duly authorized by him or any officer acting under his control, direction or supervision.<sup>94</sup> I submit that should the request for information relate to how the income was derived, the taxpayer would be required to answer truthfully, even where such answer would be self-incriminatory.
- Prepares or maintains or authorizes the preparation or maintenance of false books of account or other records or authorizes the falsification of books of account or other records.<sup>95</sup>
- Makes use of any fraud, art or contrivance whatsoever or authorizes the use of such fraud, art or contrivance.<sup>96</sup>
- Makes any false statement for the purposes of obtaining any refund of or exemption from tax.<sup>97</sup>

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<sup>93</sup> Sec 59(1) (a) Act 89 of 1991.

<sup>94</sup> Sec 59(1) (b) Act 89 of 1991.

<sup>95</sup> Sec 59(1) (c) Act 89 of 1991.

<sup>96</sup> Sec 59(1) (d) Act 89 of 1991.

<sup>97</sup> Sec 59(1) (e) Act 89 of 1991.

- Receives, acquires possession of or deals with goods or accepts the supply of a service, knowing or with reason to believe that tax on the supply has been or will be evaded.<sup>98</sup>
- Knowingly issues any tax invoice, debit note or credit note required under the Act that is in any material respect erroneous or incomplete.<sup>99</sup>
- Knowingly issues a tax invoice showing an amount charged as tax when the taxable supply will not take place.<sup>100</sup>

A conviction for one or more of the offences set out in section 59, with a resultant fine or imprisonment, will not render the person so convicted exempt from having to pay any tax, additional tax or other penalty or interest otherwise payable by him in terms of the provisions of the Act.<sup>101</sup>

#### **2.4.4 The Estate Duty Act**

Estate duty is levied in terms of the provisions of the Estate Duty Act.<sup>102</sup> The relevant section compelling disclosure in this Act is section 28. In terms of this section a person shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding two years if he:

- Makes any fraudulent or false statement or representation knowing it to be fraudulent or false in relation to any matter dealt with in the Act.<sup>103</sup> Thus the person, in order to escape guilt under this section, is required to make true statements even where these would constitute self-incrimination.
- Fails to submit within the prescribed period a return required to be submitted in terms of section 7 if he has been called upon to do so by the Commissioner in terms of that section.<sup>104</sup>

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<sup>98</sup> Sec 59(1) (f) Act 89 of 1991.  
<sup>99</sup> Sec 59(1) (g) Act 89 of 1991.  
<sup>100</sup> Sec 59(1) (h) Act 89 of 1991.  
<sup>101</sup> Sec 59(3) Act 89 of 1991.  
<sup>102</sup> Act 45 of 1955.  
<sup>103</sup> Sec 28(1) (a) Act 45 of 1955.  
<sup>104</sup> Sec 28(1) (b) Act 45 of 1955.

- Omits to include in a tax return any particulars required by the Act to be included therein.<sup>105</sup>

It may be possible that such particulars relate to information that may expose the person submitting the return to prosecution. In that event the person would have been compelled to incriminate himself without receiving any immunity from prosecution.

#### **2.4.5 The Customs and Excise Act**

Customs and Excise duties are levied in terms of the provisions of the Customs and Excise Act.<sup>106</sup> In terms of this Act a person shall be guilty of an offence and liable on conviction to a fine not exceeding R8 000 or treble the value of the goods in question, whichever is the greater, or to imprisonment for a period not exceeding two years, or to both such fine and such imprisonment if he contravenes or fails to comply with the provisions of section 15 of the same Act (discussed immediately below).<sup>107</sup> In addition the goods in question and any other goods contained in the same package as well as the package itself shall be liable to forfeiture.

Section 15(1) provides for unreserved declaration by any person entering or leaving the RSA of all goods upon his person or in his possession at the time of such entering;<sup>108</sup> and before leaving, all goods which he proposes taking with him beyond the borders of the Republic.<sup>109</sup> In both instances the person is required to declare even those goods that are prohibited, restricted or controlled under any law.<sup>110</sup> The person is further required to furnish a customs officer with full particulars of the goods in question, answer fully and truthfully all questions put to him by such officer and, if

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<sup>105</sup> Ibid. Sec 7 of Act 45 of 1955 provides for every executor or any person called upon by the Commissioner to do so, any person having the control of or any interest in any property included in the estate, to submit to the Commissioner a return disclosing the amount claimed by the person submitting the return to represent the dutiable amount of the estate together with full particulars regarding the property of the deceased as at the date of his death; property which is deemed to be property of the deceased as at that date; and any deduction claimed.

<sup>106</sup> Act 91 of 1964.

<sup>107</sup> Sec 81 Act 91 of 1964.

<sup>108</sup> Sec 15(1) (a) Act 91 of 1964.

<sup>109</sup> Sec 15(1) (b) Act 91 of 1964.

<sup>110</sup> SS 15(1) (a) (iii) and 15(1) (b) (iii) Act 91 of 1964.

required by such officer to do so, produce and open such goods for inspection by the said officer.

By requiring the person to declare even those goods that are prohibited by law, this section in effect requires the person to incriminate himself in unlawful conduct, namely possession of prohibited goods. It will be noted that there is no provision in this section granting the person possible immunity against prosecution should he declare such prohibited goods.

In terms of section 84 of the Customs and Excise Act a person shall be guilty of an offence and liable on conviction to a fine not exceeding R40 000 or treble the value of the goods in question, whichever is the greater, if he makes a statement that is false in connection with any matter dealt with under this Act, or makes use for the purposes of this Act of a declaration or document containing any such false statement (unless he proves that he was ignorant of the falsity of such statement and that such ignorance was not due to negligence on his part). In addition to the above, the goods in respect of which such false statement was made or such false declaration or document was used shall be liable to forfeiture.<sup>111</sup> The effect of this section is to compel the person to make true statements in connection with every matter dealt with under this Act. In the event of goods that have been obtained illegally or which are otherwise tainted with illegality, the person would possibly be compelled to incriminate himself in an illegal activity without any immunity from prosecution.

## **2.5 Self-incrimination: Preservation of secrecy**

Closely related to the compulsory disclosure provisions are the so-called preservation of secrecy provisions of fiscal legislation. Where the law-giver seeks to compel taxpayers to disclose all income (as well as how the income was derived) by means of

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<sup>111</sup> Sec 84 (1) Act 91 of 1964.

disclosure provisions, the law-giver seeks to prohibit the tax authorities from disclosing such information to third parties, by means of the secrecy provisions.

An example of a secrecy provision is section 4 of the Income Tax Act, in terms of which the CSARS or any officer of SARS is prohibited from disclosing any information pertaining to the tax affairs of a taxpayer, to anybody other than the taxpayer himself.<sup>112</sup> Section 6 of the VAT Act contains similar provisions.<sup>113</sup> It should be noted that both these sections in the respective Acts contain offending provisions in capital letter subsections, indicative of later insertion. Indeed these subsections were introduced in 2001 by the Second Revenue Laws Amendment Act.<sup>114</sup>

The secrecy provisions are supposed to complement the disclosure provisions by encouraging taxpayers to make complete disclosures to SARS with regard to their taxable income, knowing that such information will not be passed over to third parties.<sup>115</sup> The purpose of these provisions was identified in *Sackstein v SARS*<sup>116</sup> as being 'the optimum collection of the State's revenue'.<sup>117</sup> The court went so far, in *Welz & Another v Hall and Others*,<sup>118</sup> as to include in the target category those taxpayers 'who carry on illegal trades or have illegally come by amounts qualifying as gross income'.<sup>119</sup> In this sense the common understanding is that the taxpayer makes full disclosure of his tax affairs, in return for which he receives a guarantee

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<sup>112</sup> Sec 4 Act 58 of 1962; Croome op cit note 7 at 163; Croome & Olivier op cit note 78 at 10; LexisNexis *Professional Tax Handbook* (2010/2011) at 39-40.

<sup>113</sup> Sec 6 Act 89 of 1991; LexisNexis op cit note 112 at 504-506.

<sup>114</sup> Act 60 of 2001. Sec 4(1B) of the Income Tax Act is inserted by paragraph (b) of sec 19, while sec 6(2A) of the VAT Act is inserted by paragraph (b) of sec 150, of the Second Revenue Laws Amendment Act.

<sup>115</sup> B Croome 'Sounds of Silence – Secrecy Provisions' (2009) 23 *Tax Planning* 2; Croome op cit note 7 at 156.

<sup>116</sup> 2000 (2) SA 250 (SE), 62 SATC 206.

<sup>117</sup> At 257 G-H.

<sup>118</sup> 1996 (4) SA 1073 C.

<sup>119</sup> As quoted by Croome op cit note 115.

that the information so disclosed will not be used against him. The fiscus also benefits by being 'able to obtain its proper share of the total income of' the taxpayer.<sup>120</sup>

The problem, however, is that the 'preservation of secrecy' provisions do not preserve any secrecy when the information in the possession of the CSARS is considered relevant to an investigation or prosecution of a serious criminal offence. In such an event the CSARS may disclose such information to the NDPP or to the CSAPS.<sup>121</sup> Indeed section 4(1B) of the Income Tax Act provides as follows:

The Commissioner may apply *ex parte* to a judge in chambers for an order allowing him or her to disclose to the National Commissioner of the South African Police Service, contemplated in section 6(1) of the South African Police Service Act, 1995 (Act No.68 of 1995), or the National Director of Public Prosecutions, contemplated in section 5(2) (a) of the National Prosecuting Authority Act, 1998 (Act No.32 of 1998), such information, which may reveal evidence-

(a) that an offence, other than an offence in terms of this Act or any other Act administered by the Commissioner or any other offence in respect of which the Commissioner is a complainant, has been or may be committed, or where such information may be relevant to the investigation or prosecution of such an offence, and such offence is a serious offence in respect of which a court may impose a sentence of imprisonment exceeding five years; or

(b) of an imminent and serious public safety or environmental risk, and where the public interest in the disclosure of the information outweighs any potential harm to the taxpayer concerned should such information be disclosed: Provided that any information, documents or thing provided by a taxpayer in any return or document, or obtained from a taxpayer in terms of section 74A,

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<sup>120</sup> RG Bricout 'The Preservation of Secrecy Provisions: Still Worth It?' (2002) *Acta Juridica* 247 at 278.

<sup>121</sup> Sec 4(1B) and (1E) Act 58 of 1962. Sec 71(1) TAB provides that SARS 'must' (not 'may') disclose such information to CSAPS or NDPP.

74B or 74C, which is disclosed in terms of this subsection, shall not, *unless a competent court otherwise directs*, [my emphasis] be admissible in any criminal proceedings against such taxpayer, to the extent that such information, document or thing constitutes an admission by such taxpayer of the commission of an offence contemplated in paragraph (a).

Section 6(2A) of the VAT Act contains identical provisions.

It follows that should the taxpayer who disclosed the incriminatory information to SARS be the subject of the investigation and/or prosecution of a ‘serious offence’, then he would have been compelled to incriminate himself in criminal wrongdoing should the public interest in the disclosure be deemed to outweigh potential harm to him, and should a ‘competent court’ direct that such information is admissible. A hypothetical situation in my view would be if taxpayer X has declared information, in his tax return, of profits from unlawful trading in rhinoceros horns. (At the time of writing this work there is a furore over organised illegal hunting of rhinoceros for their horns, commonly known as ‘poaching’, hence this hypothetical case).<sup>122</sup> If an investigation later ensues into taxpayer X’s activities, in terms of section 4(1B) this information would most probably be disclosed by the CSARS to the CSAPS or the NDPP because:

- Firstly the unlawful hunting of rhinoceros is an offence in terms of section 101(1) (b) read with section 57(2) of the National Environmental Management: Biodiversity Act (NEMBA Act),<sup>123</sup> further read with regulation 24 of the Threatened or Protected Species Regulations published in Government Notice 152 of 23 February 2007.<sup>124</sup> Neither is the NEMBA Act administered by the CSARS, nor would the CSARS be a complainant in an offence in terms thereof.

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<sup>122</sup> A Spath ‘Who Cares about Rhinos Anyway?’ available at <http://m.news24.com/news24/Columnists/AndreasSpath/Who-cares-about-rhinos-anyway-20110309> (Accessed 5 April 2011. See also A Fisher ‘Suspect Arrested over Illicit Rhino Horn’ available at <http://www.sars.gov.za/home.asp?PID=65442&ToolID=2&ItemID=69956> (accessed 11 July 2011).

<sup>123</sup> Act 10 of 2004.

<sup>124</sup> In terms of sec 57(2) of Act 10 of 2004 the Minister (of Environmental Affairs and Tourism) may by notice in the *Gazette*, prohibit the carrying out of any activity which is of a nature that

- Secondly the unlawful hunting of rhinoceros poses a serious environmental risk.<sup>125</sup> Consequently there is presently an overwhelming public interest in the identities of people involved in rhinoceros ‘poaching’ activities.
- Thirdly, in terms of the penal provisions set out in section 102 of the NEMB Act, a person convicted of an offence in terms of section 101 of that Act is liable to a fine of up to ten million rand or imprisonment for a period of up to ten years, or to both such fine and such imprisonment.<sup>126</sup> And
- Fourthly, and most importantly for present purposes, after a short trial-within-a-trial, any ‘competent court’ would be likely to rule that the information in X’s tax returns is admissible as evidence, especially since X was never really forced, in the literal sense, to include the information in question in the tax returns.

The fact that the application for the order is made *ex parte*, is also worrying, since all it means is that not only is the affected taxpayer not given a chance to respond to the application, but he will probably not even be aware that there is such an application.<sup>127</sup> The tax returns would at the relevant time of the application be in the possession of SARS, and therefore the taxpayer would not be in a position to destroy or otherwise temper therewith. There is thus no justification for making the application *ex parte*.

Even before the advent of subsections 4(1B) and 4(1E) of the Income Tax Act, the Appellate Division decided, in *Ontvanger van Inkomste, Lebowa, en `n Ander v De Meyer*,<sup>128</sup> that the preservation of secrecy provisions set out in section 4(1) could, in

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may negatively impact on the survival of a listed threatened or protected species, and which is specified in the notice. Sec 101(1) (b) of this Act makes it an offence to contravene or fail to comply with a provision of a notice published in terms of section 57(2). The Minister has, by regulation 24 of the Threatened or Protected Species Regulations promulgated in terms of Act 10 of 2004, prohibited certain activities involving all species of rhinoceros, including the hunting, breeding and trading in those species. Further, the Minister has, by notice in *Government Gazette 31301* dated 8 August 2008 declared a national moratorium on the trade of individual rhinoceros horns within South Africa.

<sup>125</sup> Spath op cit note 122.

<sup>126</sup> Sec 102 Act 10 of 2004.

<sup>127</sup> Bricout op cit note 120 at 279.

<sup>128</sup> 1993 (4) SA 13 (A).

the exercise of a judicial discretion, be relaxed in an appropriate case by a competent court. In this case the Receiver of Revenue appealed against an order granted against him by a provincial division in terms of section 4(1) of the Income Tax Act directing him to make taxpayers' information available to a commission of inquiry for purposes of investigating *inter alia* misappropriation of the Lebowa revenue fund. The Court held that the interests of clean administration weighed more heavily than any of the interests raised by the Receiver of Revenue, including the interests of the taxpayers in having the secrecy of their tax affairs preserved.

In the *Welz* case, referred to above,<sup>129</sup> guidelines for the granting of an order directing an official of the Revenue to disclose information imparted to him by a taxpayer were set out. However, none of those guidelines related to the question of constitutionality of such disclosures. In fact, none of those guidelines relate to the balancing of the scales between the interests of the administration of justice and those of the taxpayers' right against self-incrimination. On the contrary, the guidelines in question strive to strike a balance between the competing interests of the litigants and those of the *fiscus*. This may be attributed to the fact that none of the litigants in *Welz* raised the constitutionality of the disclosures as an issue to be decided by the court.

More recently in the Western Cape High Court, in *S v Marinus and Others*,<sup>130</sup> the defence in a fraud trial objected to the admission of tax returns and other documents of the accused supplied by SARS to the NDPP on request in terms of section 71(1) of the Prevention of Organised Crime Act (POCA).<sup>131</sup> The main ground of objection was that SARS should have invoked the preservation of secrecy provisions of the Income Tax Act and refused to hand over the documents. A second ground of

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<sup>129</sup> Op cit note 118.

<sup>130</sup> 2010 (2) SARS 92 (WCC).

<sup>131</sup> Act 121 of 1998. Sec 71(1) empowers the NDPP to request, from any person employed or associated with a Government Department or statutory body, information that may reasonably be required for any investigation in terms of POCA. Such person shall furnish the NDPP with such information notwithstanding anything to the contrary contained in any law which prohibits or precludes him or her from disclosing any information relating to the activities, affairs or business of any other person; or from permitting any person to have access to any registers, records or other documents, or electronic data which have a bearing on the said activities, affairs or business.

objection was that the request related in part to tax returns submitted and documents gathered by SARS during a period prior to the commencement of POCA. This second ground of objection was based on the fact that the relevant POCA provisions do not have a retrospective application. Ngcobo CJ ruled that copies of the accused's tax returns and documents forming part of such returns, covering the tax years after POCA came into operation, were admissible in evidence. In effect the Court rejected the main ground of objection based on the preservation of secrecy provisions; while upholding the objection based on the non-retrospective application of POCA. Once again, in *Marinus*, counsel for the defence, with respect, failed to take the opportunity to attack the constitutionality of section 4(1B) with regard to the possible self-incriminatory nature of the tax returns.

The scales in the balance between the duty of each taxpayer to disclose all income, irrespective of the legality or otherwise of the manner in which it is derived, as required by the SARS mandate, on one hand, and the constitutional right of the taxpayer not to be compelled to make any confession or to give self-incriminating evidence, are therefore tipped too heavily against the taxpayer.<sup>132</sup> It is time to find a better balance between the conflicting interests.<sup>133</sup>

However, this problem is not unique to the RSA tax system. Other jurisdictions have been grappling with the same problem for some time, and it is possible to learn something from those jurisdictions that have tackled the conflict. In the next two chapters comparative studies are undertaken of the positions in the USA and in the UK. These two jurisdictions have been chosen for comparison because they have constitutionally guaranteed rights similar to the South African one with regards to self-incrimination. The courts in these jurisdictions have had to weigh the interest of the State in raising taxes from all types of income, against the interests of the taxpayer in having his right against self-incrimination protected. The indications are that although neither of these jurisdictions might have a claim to a perfect solution to the

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<sup>132</sup> Croome op cit note 7 at 14 and 163.

<sup>133</sup> L Olivier 'Constitutional Review of SARS's Power to Collect Outstanding Income Tax' (2010) 1 *De Jure* 157 at 168.

problem, the compromise positions they have adopted to try and find an acceptable balance between the conflicting interests could be usefully adopted, and adapted, to the South African situation.

### **CHAPTER 3: THE CONSTITUTIONALITY OF TAXING ILLEGAL INCOME IN THE UNITED STATES OF AMERICA (USA)**

#### **3.1 Introduction**

The USA is a constitutional democracy. This means that the Constitution of the USA is the supreme law and all State and Federal laws should be consistent with it to be valid. This chapter considers how the Fifth Amendment to the Constitution of the USA guarantees protection against self-incrimination with regard to tax return information.

In *Miranda v Arizona*,<sup>134</sup> a non-tax case (referred to here for its constitutional relevance) which became a landmark decision of the USA Supreme Court, the Court ruled that the Fifth Amendment privilege against self-incrimination requires law enforcement officials to advise a suspect interrogated in custody of his rights to remain silent and to obtain legal representation. The effect would be that both inculpatory and exculpatory statements made in response to interrogation by a defendant in police custody will be admissible at trial only if the prosecution can show that the defendant was informed of the right to consult with a legal representative before and during questioning and of the right against self-incrimination prior to questioning by police, and that the defendant not only understood these rights, but voluntarily waived them. This decision had a significant impact on law enforcement in the USA, by making what became known as the Miranda rights a part of routine police procedure to ensure that suspects were informed of their rights.

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<sup>134</sup> 384 U.S. 436 (1966).

The 1976 International Covenant on Civil and Political Rights,<sup>135</sup> which came into force on 23 March 1976, guarantees everyone the right ‘not to be compelled to testify against oneself or to confess guilt’.<sup>136</sup> Article 8 of the American Convention on Human Rights of 1978,<sup>137</sup> as ratified by member states, also provides for the right to presumption of innocence of every person accused of a criminal offence, until his guilt has been proven according to law. Every such person is guaranteed the right to ‘a fair trial, which includes the right not to be compelled to be a witness against himself or to plead guilty’.<sup>138</sup>

However, the Internal Revenue Code of 1986 (IRC),<sup>139</sup> which is the main body of domestic statutory tax law of the USA, provides for total disclosure of information regarding income, including income that has been derived unlawfully and that can, therefore, lead to prosecution of the person disclosing it. The Sixteenth Amendment to the Constitution of the USA<sup>140</sup> also empowers Congress to levy and collect taxes on all income ‘from whatever source derived’.<sup>141</sup> This eliminates any doubts that may have existed as to the intention of the USA law-givers that the revenue authorities should tax all income, including income derived from unlawful activities.<sup>142</sup>

## 3.2 Taxation of Income Derived from Illegal Activities

### 3.2.1 A brief background

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<sup>135</sup> Available at <http://www2.ohchr.org/english/law/ccpr.htm> (accessed 20 April 2011).

<sup>136</sup> Art 14(3) (g) International Covenant on Civil and Political Rights; TL Smith & WG McCollom ‘Counter-discovery in Criminal Cases: Fifth Amendment Privileges Abridged’ (March 1968) 54 *ABA Journal* 256 at 259.

<sup>137</sup> Available at [http://www.wunrn.com/reference/pdf/American\\_convention\\_Human\\_Rights.PDF](http://www.wunrn.com/reference/pdf/American_convention_Human_Rights.PDF) (accessed 20 April 2011).

<sup>138</sup> Art 8(2) (g) American Convention on Human Rights of 1978.

<sup>139</sup> Available at [http://www.law.cornell.edu/uscode/html/uscode26/usc\\_sup\\_01\\_26.html](http://www.law.cornell.edu/uscode/html/uscode26/usc_sup_01_26.html) (accessed 20 April 2011).

<sup>140</sup> Amendment 16 to the US Constitution.

<sup>141</sup> Sec 61(a) IRC echoes this wording in its definition of ‘gross income’.

<sup>142</sup> MSN Money ‘Bribes, Thefts and Other Taxable Income’, available at <http://articles.moneycentral.msn.com/Taxes/Advice/BribesTheftsAndOtherTaxableIncome.aspx> (accessed 24 February 2010). See, however, FW Daily *Tax Savvy for Small Businesses* (2010) at 34, where the learned author argues that in the USA a taxpayer does not have to state the illegal method of deriving income.

As has been stated above, the Sixteenth Amendment to the Constitution of the USA provides for the levying and collection of taxes on income from whatever source derived. Based on the language used in the Sixteenth Amendment, the IRC broadly defines the term ‘gross income’ to include all income from whatever source derived except as otherwise provided.<sup>143</sup> Consequently the American tax law contains an all-inclusive definition of gross income whereby income can only be excluded from ‘gross income’ if the IRC has specifically provided for such exclusion. It follows from this definition that as long as the IRC does not specifically exclude proceeds of illegal activities from ‘gross income,’ such proceeds will form part of gross income and will, therefore, be taxable.<sup>144</sup>

### 3.2.2 Case law

The following summaries of some of the interesting decisions of the USA Supreme Court in the past decade should provide some indication of how income derived from unlawful activities, or that is otherwise tainted with illegality, is taxable in the USA:

In *James v United States*,<sup>145</sup> the Supreme Court held that an embezzler was required to include his ill-gotten gains in his ‘gross income’ for Federal income tax purposes. In reaching this decision, the Court looked to the seminal case setting forth the tax code’s definition of gross income, *Commissioner of Internal Revenue v Glenshaw Glass Co.*,<sup>146</sup> in which the Supreme Court held that taxpayers had gross income when they had ‘an accession to wealth, clearly realized, and over which the taxpayers have complete dominion’.<sup>147</sup> At the time the embezzler acquired the funds, he did not have a consensual obligation to repay, or any restriction as to his disposition of the funds. The court found that if the embezzler had acquired the funds under the same circumstances legally, there would have been no question as to whether he should

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<sup>143</sup> Sec 61 IRC.

<sup>144</sup> AD Sharp ‘Tax Accounting for Illegal Activities (Income, Taxation, Gross income), available at <http://www.entrepreneur.com/tradejournals/article/1133065.html> (accessed 26 February 2010).

<sup>145</sup> 366 U.S. 213 (1961). See also Bittker ‘Taxing Income from Unlawful Activities’ (1974-1975) 25 *Case W. Res. L. Rev.* 130 at 136.

<sup>146</sup> 348 U.S. 426 (1955).

<sup>147</sup> *James v United States* op cit note 145 at 219 (quoting the *Glenshaw Glass* decision supra).

have gross income. Therefore the Court held that the embezzler had gross income under the tax code, even though the application of another body of law would later force him to return the money.

This decision followed the earlier decision of the USA Supreme Court in *Sullivan*,<sup>148</sup> where the Court held that gains derived from illicit traffic were taxable income under the 1921 Internal Revenue Act. Justice Holmes, delivering the unanimous judgment, saw no reason why the fact that a business is unlawful should exempt it from paying the taxes that it would have had to pay were it lawful.<sup>149</sup> Consistent with this judgment, although not without dissent, was the ruling in *Rutkin v United States*,<sup>150</sup> that money obtained by extortion is income taxable in the hands of the extortioner under section 22 (a) of the Internal Revenue Code.

In *United States v Kearns*,<sup>151</sup> the Court found a corollary to the rule that embezzled funds constitute income taxable in the hands of the embezzler, namely that to the extent that the victim recovers back the misappropriated funds, there is a reduction in the embezzler's taxable income.

In *United States v Mueller*,<sup>152</sup> the court restated the position that gain, whether lawful or unlawful, constitutes taxable income when its recipient has such control over it that, practically he derives readily realizable economic value from it.

In *United States v Briscoe*,<sup>153</sup> it was held that embezzled income is attributable as income in the hands of the embezzler in the year of assessment in which the embezzlement in question is carried out, regardless of what happens to the money after it is misappropriated.

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<sup>148</sup> Op cit note 16.

<sup>149</sup> Ibid at 263; Bittker op cit note 145 at 132

<sup>150</sup> 343 U.S. 130 (1952); Bittker op cit note 145 at 134.

<sup>151</sup> 177 F.3d 706.

<sup>152</sup> 74 F.3d 1152.

<sup>153</sup> 65 F.3d 576.

In *United States v Thompson*,<sup>154</sup> corporate receipts diverted for personal use were held to constitute income to the taxpayer in his individual capacity.

In *Webb v IRS, USA*,<sup>155</sup> a taxpayer who embezzled government loan proceeds from his business trust and applied the proceeds to his personal use was held to have failed to show that he intended to repay the trust, making the proceeds taxable in the year of embezzlement. The taxpayer failed to produce any evidence that the trust formally loaned him the money or that the trust, as a putative 'lender,' consensually recognized taxpayer's obligation to repay the funds.

In *Collins v Commissioner of Internal Revenue*,<sup>156</sup> a betting parlour employee's theft of racing tickets for purpose of placing personal bets was held to give rise to 'gross income' for income tax purposes, even though the employee's bets resulted in net loss. The court ruled that the gambling loss was not relevant to and did not off-set employee's gain in the form of opportunities to gamble that he obtained by virtue of his theft. It was held that larceny of any kind resulting in unrestricted gain of monies to wrongdoers is a taxable event.

In *United States v Hammes*,<sup>157</sup> the court held that an assessment of higher federal wagering tax rate on illegal gambling than on legal gambling was rationally related to legitimate interest of discouraging illegal gambling and, therefore, did not violate principles of equal protection. Thus the court in this case did not only confirm taxability of illegal income, but went further to approve of a higher tax on illegal income than on income derived lawfully.

In *Blohm v Commissioner of Internal Revenue*,<sup>158</sup> a 1993 decision, money received as kickbacks was held to be taxable.

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<sup>154</sup> 23 F.3d 1225.

<sup>155</sup> 15 F.3d 203 (1<sup>st</sup> Cir. 1994).

<sup>156</sup> 3 F.3d 625 (2<sup>nd</sup> Cir.1993).

<sup>157</sup> 3 F.3d 1081 (7<sup>th</sup> Cir. 1993).

<sup>158</sup> 994 F.2d 1542 (11<sup>th</sup> Cir. 1993).

Money skimmed from a wholly owned corporation was held, in *United States v Toushin*,<sup>159</sup> to become ‘taxable income’ in the hands of the owner at the time he exercises dominion and control over the funds.

In the USA not only are persons engaged in illegal activities compelled to report their ill-gotten gains as income for tax purposes, but they are also allowed tax deductions for costs relating to their criminal activities. An example is the decision in *Commissioner v Tellier*,<sup>160</sup> where a taxpayer was found guilty of engaging in business activities that violated the Securities Act of 1933. The taxpayer subsequently tried to deduct from his gross income the legal fees he spent while defending himself. The Supreme Court held that the taxpayer was allowed to deduct the legal fees from his gross income because they met the requirements of section 162 (a) of the IRC, which allowed the taxpayer to deduct all the ‘ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.’<sup>161</sup> The reasoning of the Court was that it was ‘ordinary and necessary for a person engaged in a business to expect to have legal fees associated with that business, even though such things may only happen once in a lifetime’.<sup>162</sup> Therefore, the taxpayer in *Tellier* was allowed to deduct his legal fees from his gross income, even though he incurred the fees because of his crime. The Court in *Tellier* reiterated that the purpose of the tax code was ‘to tax net income, not punish unlawful behaviour’.<sup>163</sup> The Court went on to suggest that if this was not the case, ‘Congress would change the tax code to include special tax rules for illegal conduct’.<sup>164</sup>

Having demonstrated the taxability of unlawfully derived income, the next step will be to show how the American courts have weighed this taxability against the taxpayer’s privilege against self-incrimination as guaranteed by the Constitution of the USA.

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<sup>159</sup> 899 F.2d 617 (7<sup>th</sup> Cir.1990).

<sup>160</sup> 383 U.S. 687 (1966).

<sup>161</sup> Sec 162 (a) IRC.

<sup>162</sup> *Toushin* op cit note 159 at 690.

<sup>163</sup> *Ibid* at 692.

<sup>164</sup> *Ibid* at 695.

### 3.3 Self-incrimination: Legislation

#### 3.3.1 The Internal Revenue Code (IRC)

The IRC covers the income tax, payroll taxes,<sup>165</sup> gift taxes,<sup>166</sup> estate taxes,<sup>167</sup> and statutory excise taxes.<sup>168</sup>

In terms of the IRC an individual taxpayer required to pay any tax or to make a return, keep records, or supply any information, shall be guilty of a misdemeanour and, upon conviction thereof, shall be sentenced to a fine of up to \$25 000 or to imprisonment for up to one year, or to both such fine and such imprisonment, together with the costs of prosecution, if he wilfully fails to pay such tax, make such return, keep such records, or supply such information at the time or times required by law.<sup>169</sup>

In terms of section 7206 of the IRC an individual shall be guilty of a felony and, upon conviction thereof, shall be sentenced to a fine of up to \$100 000, or to imprisonment for up to three years, or to both such fine and such imprisonment, together with the costs of prosecution, if he:

- Wilfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter;<sup>170</sup> or
- Wilfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under the internal

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<sup>165</sup> Commonly known as 'Pay as you earn' in South Africa.

<sup>166</sup> Known as 'donations tax' in South Africa.

<sup>167</sup> The equivalent of South African estate duty.

<sup>168</sup> What we know as excise duty in South Africa. The IRC is published as Title 26 of the United States Code, and is also known as the Internal Revenue Title. Its implementing agency is the IRS.

<sup>169</sup> Sec 7203 IRC.

<sup>170</sup> Sec 7206(1) IRC.

- revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document;<sup>171</sup> or
- Simulates or falsely or fraudulently executes or signs any bond, permit, entry, or other document required by the provisions of the internal revenue laws, or by any regulation made in pursuance thereof, or procures the same to be falsely or fraudulently executed, or advises, aids in, or connives at such execution thereof;<sup>172</sup> or
  - Removes, deposits, or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for or in respect whereof any tax is or shall be imposed, or any property upon which levy is authorized by section 6331,<sup>173</sup> with intent to evade or defeat the assessment or collection of any tax imposed by this Code;<sup>174</sup> or
  - Wilfully conceals from any officer or employee of the United States any property belonging to the estate of a taxpayer or other person liable in respect of tax;<sup>175</sup> or receives, withholds, destroys, mutilates, or falsifies any book, document, or record, or makes any false statement relating to the estate of financial condition of the taxpayer or other person liable in respect of tax,<sup>176</sup> in connection with any compromise under section 7122,<sup>177</sup> or offer to compromise, or in connection with any closing agreement under section 7121,<sup>178</sup> or offer to enter into such agreement.

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<sup>171</sup> Sec 7206(2) IRC.

<sup>172</sup> Sec 7206(3) IRC.

<sup>173</sup> Sec 6331 provides *inter alia* for collection of tax by levy upon property and property rights of a taxpayer who neglects or refuses to pay tax within ten days after notice and demand.

<sup>174</sup> Sec 7206(4) IRC.

<sup>175</sup> Sec 7206(5) IRC.

<sup>176</sup> Ibid.

<sup>177</sup> Sec 7122 (a) authorizes the Secretary (for Internal Revenue) to compromise any civil or criminal case arising under the internal revenue laws prior to reference to the Department of Justice for prosecution or defence, and the Attorney General or his delegate to compromise any such case after reference to the Department of Justice for prosecution or defence.

<sup>178</sup> Sec 7121 (a) authorizes the Secretary (for Internal Revenue) to enter into an agreement in writing with any person relating to the liability of such person (or the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

### 3.4 Self-incrimination: Case law

Earlier USA Supreme Court case law indicates the application of the privilege against self-incrimination. It is observed from the following judgments that the Courts have for years been grappling with the question, firstly, of whether a taxpayer can invoke the Fifth Amendment to refuse to file tax returns or to answer certain questions therein; and secondly whether information received as a result of compelled tax disclosures is admissible in evidence in subsequent tax or non-tax prosecutions:

The first decided case to deal with the question of whether the filing of an income tax return violated a taxpayer's constitutional right against self-incrimination was *United States v Sullivan*.<sup>179</sup> In *Sullivan* the respondent ran an illicit liquor-selling business during Prohibition.<sup>180</sup> He had been convicted by a federal district court of the offence of wilfully refusing to file a return on his net income. The conviction was reversed by the Court of Appeals on the ground that, although income derived from illegal activities was subject to income tax, the requirement that respondent file a return violated his Fifth Amendment rights against self-incrimination, 'since any disclosure made by him on the return could tend to incriminate him'. In a further appeal the Supreme Court indicated that although a taxpayer could not claim a Fifth Amendment exemption from filing a return, the taxpayer could decline to answer certain questions on the return if those disclosures would be self-incriminating. The Court stated that if the respondent 'had been provided with a return form that called upon him to make specific disclosures that he was privileged from making, he could have raised the objection in the return, but could not refuse to file any return at all'.<sup>181</sup>

In *Lawn v United States*,<sup>182</sup> indictments returned by a grand jury in 1952, charging appellants with evading and conspiring to evade federal income taxes, were dismissed by a district court on the ground that their constitutional privilege against self-incrimination had been violated by requiring them to testify and produce records

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<sup>179</sup> Op cit note 16.

<sup>180</sup> See note 37 *supra*.

<sup>181</sup> *Sullivan* op cit note 16 at 263.

<sup>182</sup> 355 U.S. 339 (1958).

before that grand jury while criminal proceedings for tax evasion were pending against them, without being warned of their constitutional privilege. In 1953 the appellants were indicted by another grand jury for substantially the same offences, and they were convicted in a federal court. Both before and at the beginning of their trial, they moved firstly for a hearing to determine whether, in procuring the indictment, the prosecution had used testimony given or documents produced by them before the 1952 grand jury or leads and clues furnished thereby, and secondly, to suppress the use at the trial of all such evidence and all evidence derived therefrom. The court denied both of these motions, but said that if, during the trial, appellants ‘had reason to believe that illegally obtained material was being or might be used against them,’ they could object at that time. They were subsequently convicted and appealed against such convictions *inter alia* on the grounds of denial of these motions. The Supreme Court upheld the convictions. It appears that the Court based its decision on the ground that counsel for the appellants ‘consciously and intentionally waived objection’ to the use of the self-incriminating evidence,<sup>183</sup> rather than on a principle that such use was unobjectionable.

In *Marchetti v United States*,<sup>184</sup> the appellant had been convicted of a conspiracy to evade payment of occupational tax relating to wagers, for evading such payment, and or failing to register annually with the IRS and to supply detailed information for which a special form was prescribed. Payment of the occupational taxes was declared not to exempt persons from federal or state laws which prohibited wagering, and federal tax authorities were required to furnish prosecuting officers with lists of those who had paid the occupational tax. Appellant, whose alleged wagering activities subjected him to possible state or federal prosecution, contended that the statutory requirements to register and to pay occupational tax violated his privilege against self-incrimination. The Supreme Court, having found that ‘the recognized principle that taxes may be imposed upon unlawful activities’ was not at issue in this case,<sup>185</sup>

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<sup>183</sup> Ibid at 355.

<sup>184</sup> 390 U.S. 39 (1968).

<sup>185</sup> Ibid at 44. See also RL Young ‘Review of Recent Supreme Court Decisions’ (April 1968) 54 *ABA Journal* 396 at 397.

held that appellant's assertion of his Fifth Amendment privilege against self-incrimination barred his prosecution for violating the federal wagering tax statutes.<sup>186</sup> In effect the Supreme Court in *Marchetti* permitted a taxpayer with unlawful income to refuse to file or to report taxable income in circumstances where the self-incriminating tax information had to be passed over by the tax authorities to the prosecuting authorities for the purposes of use in prosecuting the taxpayer.

In *Mathis v United States*,<sup>187</sup> the appellant had been interrogated in custody by an IRS investigator about certain tax returns. There was no prior warning that any evidence he might give could be used against him, that he had a right to remain silent and a right to legal representation. Subsequently documents and statements obtained from the appellant were introduced in his criminal trial where he was charged for filing false claims for tax refunds. He was convicted, and his conviction was upheld by the court of appeals. He appealed to the Supreme Court, which held, citing *Miranda* above, that the appellant had been entitled to warnings of his right to remain silent and right to legal representation. The Court stated that tax investigations, which frequently lead to criminal prosecution, are not immune from the *Miranda* warning requirement to be given to a person in custody, whether or not such custody is in connection with the case under investigation.

In *United States v Milder*,<sup>188</sup> a district court recognized that the reporting of illegal gains was incriminating and dealt with the issue of the applicability of the privilege against self-incrimination to the required disclosures of the federal income tax. Milder was convicted of attempting to evade payment of federal income taxes by filing false returns. He failed to report and to pay tax on embezzled funds, although he did file returns and report lawfully derived income. The court reasoned that, by reporting the embezzled income, he would have been supplying incriminating information. It therefore held that the reporting of embezzled income would have incriminated the taxpayer by supplying the government with a link in the chain of evidence. On

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<sup>186</sup> Ibid at 61.

<sup>187</sup> 391 U.S. 1 (1968).

<sup>188</sup> 329 F. Supp. 759 (D. Neb. 1971).

appeal,<sup>189</sup> the United States Supreme Court emphasized that it would be ‘an extravagant application of the Fifth Amendment’ to allow a taxpayer to refuse flatly to file a return at all. The Court went further to hold that the privilege against self-incrimination was ‘inapplicable where compelled disclosures were filed but falsified’.<sup>190</sup>

In *Couch v United States*,<sup>191</sup> appellant challenged an Internal Revenue Service (IRS) summons directing an accountant, an independent contractor with numerous clients, to produce business records that she had been giving to him for preparation of her tax returns from 1955 to 1968, when the summons was issued. A district court and a court of appeals having concluded that the privilege against self-incrimination asserted by the appellant was not available, the Supreme Court held, on the facts of this case, that where appellant had effectively surrendered possession of the records to the accountant, there was ‘no personal compulsion against appellant to produce the records’. It was the view of the Court that the Fifth Amendment constitutes no bar to the production of the records by the accountant, even though the IRS tax investigation might entail possible criminal, as well as civil, consequences. Holding, further, that appellant, who was aware that much of the information in the records had to be disclosed in her tax returns, ‘did not have any legitimate expectation of privacy that would bar production under either the Fourth or Fifth Amendment,’ the Court upheld the decision of the court of appeals. This decision, therefore, states that where it is not the taxpayer himself but a third party or agent who is compelled, then the privilege against self-incrimination becomes unavailable to the taxpayer.

*Garner v United States*,<sup>192</sup> the first decision to explore the *Sullivan* judgment in depth, involved an appellant who had stated his occupation in tax returns as ‘professional gambler’, and declared substantial income from ‘gambling’ and

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<sup>189</sup> *Milder v United States* 459 F.2d 801 (8<sup>th</sup> Cir. 1972).

<sup>190</sup> North Western University School of Law ‘Reporting Illegal Gains as Taxable Income: A Compromise Solution to a Prosecutorial Windfall’ (1974-1975) 69 *Nw. U. L. Rev.* 111 at 131.

<sup>191</sup> 409 U.S. 322 (1973).

<sup>192</sup> 424 U.S. 648 (1976).

‘wagering’.<sup>193</sup> When the appellant was later indicted for a conspiracy to violate various gambling laws, the returns in question were admitted in evidence as proof of appellant’s familiarity with gambling in order to rebut his claims that his relationship with the other conspirators was an innocent one. He was convicted and appealed on the grounds that the admission of the returns into evidence violated his Fifth Amendment right against self-incrimination, despite the fact that he had made the disclosures without claiming the privilege on them. He argued that even if he had invoked the Fifth Amendment against self-incrimination on his tax returns, he would have been prosecuted for wilful failure to file a return. The Supreme Court held that the possibility of the appellant being prosecuted for failure to file a return did not sufficiently deny him freedom to claim the privilege against self-incrimination because even if he were so prosecuted, a valid and timely claim of the privilege would still be available to him in that proceeding.<sup>194</sup> The Court confirmed the conviction and it was held that appellant’s privilege against compulsory self-incrimination was not violated. Since appellant made incriminating disclosures on his tax returns instead of claiming the privilege, as he had the right to do, his disclosures were not compelled incriminations. Here, where there is no factor depriving appellant of the free choice to refuse to answer, the general rule applies that, if a witness does not claim the privilege, his disclosures will not be considered as having been ‘compelled’ within the meaning of the Fifth Amendment. The appellant was therefore held to have impliedly waived the privilege.<sup>195</sup>

Three years later the court delivered a similar ruling in *United States v Barnes*.<sup>196</sup> The facts of this case were similar to those of *Garner* in that Barnes had made incriminating disclosures on his tax returns that were used in evidence to convict him in a non-tax criminal prosecution. Barnes had argued that although he did not assert his Fifth Amendment privilege on his tax returns, the court should have upheld his reliance on the privilege in objecting to the returns being admitted in evidence during

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<sup>193</sup> Ibid at 649-50.

<sup>194</sup> Ibid at 665.

<sup>195</sup> North Western University School of Law op cit note 190 at 133.

<sup>196</sup> 604 F.2d 121 (2d Cir. 1979).

his trial. The Supreme Court relied on the *Garner* rule to hold that Barnes could claim the Fifth Amendment privilege against self-incrimination only at the time of filing his returns.<sup>197</sup> Since Barnes did not assert the privilege when he filed his returns, the privilege was lost and the incriminating disclosures were admissible in evidence at the trial.

### 3.5 General remarks

From the court decisions discussed in this Chapter one observes a gradual development of American case law from the rigid approach in the application of the Fifth Amendment privilege against self-incrimination in *Lawn* towards a more realistic examination of the privilege in *Milder*, and finally to an established principle in *Garner* and *Barnes*. In the two latter cases the courts, whilst on the one hand recognising that the requirement to include income derived from illegal activities in tax returns may give rise to self-incrimination by the taxpayer, have on the other hand been alive to the State's interest in raising tax even from illegal gains. The court in *Garner* went so far as to examine the possibility of adopting a 'use restriction' in the application of the privilege against self-incrimination.<sup>198</sup> A 'use restriction' (or use immunity) requires the prosecution to prove that evidence introduced in a criminal trial was obtained completely independent of the compelled disclosure.<sup>199</sup> It is in this sense a narrower and more acceptable restriction than immunity from prosecution, the granting of which has an effect of 'allowing the taxpayer to escape the consequences of any criminal activities disclosed'.<sup>200</sup> While it is unfortunate that the concept of a use restriction was only suggested by the panel decision in *Garner* but not applied, it is nevertheless laudable that the Supreme Court formulated a rule in that case, which was later confirmed in *Barnes*, to the effect that a taxpayer may not invoke his Fifth

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<sup>197</sup> Ibid at 147-48.

<sup>198</sup> North Western University School of Law op cit note 190 at 142.

<sup>199</sup> JF Hanzel 'Self-incrimination and the Use of Income Tax Returns in Non-tax Criminal Prosecutions' (1973) 30 *Wash. & Lee L. Rev.* 182 at 191.

<sup>200</sup> Stone op cit note 67 at 1149.

Amendment privilege to refuse to file a tax return at all, but can invoke it to refuse to give specific incriminating answers in his tax return form.<sup>201</sup>

## **CHAPTER 4: THE CONSTITUTIONALITY OF TAXING ILLEGAL INCOME IN THE UNITED KINGDOM (UK)**

### **4.1 Introduction**

The UK is a constitutional monarchy where the monarch acts as head of state but is legally bound by the constitution. There is no single core constitutional document, therefore the country has an uncodified, or *de facto* constitution. The constitution of the UK is made up of the set of laws and principles under which the country is governed.<sup>202</sup>

In the UK the privilege against self-incrimination, also referred to as the right to silence, is an individual's right not to make a statement of information or produce a document that would expose that individual to criminal prosecution or penalty. The privilege does not apply where there is only a risk of exposure to civil liability.<sup>203</sup>

In the UK the privilege against self-incrimination is based on the so-called right to silence. The *nemo tenetur prodere seipsum* principle remains in use. This principle originally served as a guarantee that individuals would not be required to become the source of their own public prosecution and it was also a means of keeping over-zealous government officials in check.<sup>204</sup> The Civil Evidence Act of 1968, which provides a declaration of the scope of the privilege against self-incrimination at common law, refers to the right of a person in civil proceedings to refuse to answer

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<sup>201</sup> Ibid.

<sup>202</sup> The British Constitution, available at [http://historylearningsite.co.uk/british\\_constitution1.htm](http://historylearningsite.co.uk/british_constitution1.htm) (accessed 6 April 2011).

<sup>203</sup> G Duggan 'Disclosure to Revenue and the Privilege against Self-incrimination' (2008) March *Irish Tax Rev.* 70 at 73.

<sup>204</sup> Goliath 'Right to Silence or Privilege against Self-incrimination – A Comparative Analysis of the Right in the USA, UK, France and Germany – Part 1, available at [http://goliath.ecnext.com/coms2/gi\\_0199-4772841/Right-to-Silence-or-Privilege.html](http://goliath.ecnext.com/coms2/gi_0199-4772841/Right-to-Silence-or-Privilege.html) (accessed 6 April 2011).

any question or produce any document or thing which might incriminate him.<sup>205</sup> In addition to this, the right of an accused person to a fair trial set out in the 1998 Human Rights Act includes *inter alia*, the right not to be compelled to give self-incriminating evidence.<sup>206</sup> However, the privilege against self-incrimination is in some instances limited by legislative means on the basis of parliamentary sovereignty.<sup>207</sup> This limitation will usually apply where the person who incriminates himself has not been ill-treated into doing so, and no confession has been extracted from him by dubious means.<sup>208</sup> The field of taxation, together with the fields of corporate activity, banking, property protection, creditor rights, serious fraud and insolvency, is where the limitations mostly apply.<sup>209</sup> Information disclosed for tax purposes would thus most probably fall into this category when the disclosure is not achieved by ill-treatment or other dubious means.

In this Chapter case law is, firstly, discussed to show that income derived from unlawful activities is taxable in the UK. Secondly the chapter portrays that although the privilege against self-incrimination is an integral part of the principles that form the uncodified constitution of the UK, statutes such as the Taxes Management Act of 1970 (TMA) and the Serious Organised Crime and Police Act of 2005 (SOCPA) compel disclosures by individuals, including the production of documents and answering of questions. The statutory restrictions on the use of evidence obtained by means of such compulsion are discussed, as well as the approach of the courts in balancing the individual's interests to protection against self-incrimination on the one hand, and the state's interest in raising taxes on the other.

## 4.2 Taxation of Income Derived from Illegal Activities

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<sup>205</sup> Sec 14 Civil Evidence Act of 1968.

<sup>206</sup> S Ramage 'The Privilege against Self-incrimination – A Comparative Perspective', available at <http://www.indymedia.org.uk/en/2005/09/323584.html> (accessed 8 December 2010).

<sup>207</sup> C Theophilopoulos 'The European Convention on Human Rights and the Right to Silence: The Lesson for South Africa' (2003) 36 *De Jure* 372 at 376.

<sup>208</sup> *Ibid*. The learned author quotes a passage from *AT and T Istel Ltd v Tully* (1993) AC 45 in support of this contention.

<sup>209</sup> *Ibid* at 377.

In the Queen's Bench Division decision of *Partridge v Mallandaine*,<sup>210</sup> referred to with approval in the South African *Delagoa Cigarette* case above,<sup>211</sup> the court came up with a bold ruling that the taxability of a receipt is not affected by the legality or illegality of the business through which it was derived.

Many years later, in *Southern (Inspector of Taxes) v AB*,<sup>212</sup> the King's Bench Division had to decide whether income from street betting and ready-money betting, which were wholly illegal, was assessable for tax. It was held that there was a 'trade' carried on by the respondents within the meaning of the Income Tax Act of 1918, and, that being so, the fact that that trade was illegal did not prevent the profits arising therefrom being assessable for income tax.

In *Inland Revenue Commissioners v Aken*,<sup>213</sup> the taxpayer had substantial undeclared earnings derived from many years of working as a prostitute. In 1980 her 'enterprise' came to the attention of the revenue authorities and assessments were raised on her for a number of years between 1973 and 1983 in respect of 'profits of prostitution'. In 1981 an agreement was reached between a tax inspector and the taxpayer, acting through an accountant, as to the amount payable pursuant to section 54 of the Taxes Management Act of 1970. The agreed amount was not paid and the revenue authorities issued a writ claiming payment and sought summary judgment. A deputy judge having entered judgment for the revenue authorities, the taxpayer appealed on the grounds, inter alia, that firstly the judge was wrong to find that the taxpayer was carrying on at any material time a trade or profession such as would lawfully give rise to a liability by her to pay income tax; secondly that in order to constitute a trade for income tax purposes there needed to be present all the normal attributes of a trade including the attribute that the trade was for a lawful purpose and that persons engaging in it could enter into enforceable contracts; thirdly that where an activity was a crime or was unlawful and contra bonos mores by its very nature, it did not

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<sup>210</sup> Op cit note 1.

<sup>211</sup> Op cit note 1.

<sup>212</sup> Op cit note 1.

<sup>213</sup> [1990] 1 W.L.R. 1374.

amount to a trade for tax purposes; and that if the taxpayer was not carrying on a trade or profession rendering her liable to pay income tax, the Crown had no power to claim payment of tax from her and the question of the taxpayer's liability could be raised in the High Court without using the tax ladder provided by the Taxes Management Act of 1970.

Adopting the words of Rowlatt J in *Mann v Nash (Inspector of Taxes)*,<sup>214</sup> the Court held that the revenue authorities, representing the state, only look at an accomplished fact, and not condone it or partake in it. They merely find profit made from what appears to be a trade, and the revenue laws say that profits from a trade are to be taxed. The appeal thus failed.<sup>215</sup>

In the *Aken* case, however, the Court found it unnecessary to deal with the question whether the illegality of the activities which constitute a trade would prevent it from being a trade within the meaning in the tax legislation, citing the fact that prostitution was not illegal under English law, and that that fact was not in dispute in that case.<sup>216</sup>

Based on the above case law, one can say that the courts in the UK have reached some clarity that income will be taxed as long as it arises or accrues from a trade, regardless of the legality or otherwise of that trade. This position should be lauded for moving away from the mindset that suggests that the State, by taxing proceeds of illegal activities, keeps its revenue eye open and its eye of justice closed, to a new mindset that understands that the State should not allow perpetrators of wrong to benefit from advantages that the hardworking honest citizen has no access to.

### **4.3 Self-incrimination: Legislation**

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<sup>214</sup> Op cit note 1 at 758.

<sup>215</sup> Ibid at 1383 to 1384.

<sup>216</sup> Ibid at 1382.

The UK, like the USA and RSA, does have some statutory provisions (discussed below) which make it compulsory, under pain of penalty, to make disclosures to the fiscus. Such disclosures do not only relate to existence of income that may be taxable, but may also relate to other particulars such as the manner in which such income is derived. It is noteworthy that in cases where disclosure of particulars relating to how income is derived is compelled, these provisions do not discriminate between legally and illegally derived income. Examples from two of the most prominent of these statutes are discussed hereunder:

#### **4.3.1 The Taxes Management Act (TMA)**

In terms section 93 of the TMA, as amended,<sup>217</sup> a taxpayer shall be liable to a penalty of 100 Pounds if he, having been required by notice served under or for the purposes of section 8 or 8A of this Act<sup>218</sup> to deliver a return, fails to comply with the notice.<sup>219</sup>

If the General or Special Commissioners, upon application by a relevant tax officer, so direct, the taxpayer shall be liable to a further penalty or penalties not exceeding 60 Pounds for each day on which the failure continues after the day on which he is notified of the direction.<sup>220</sup> A further 100 Pounds penalty shall be levied where the failure by the taxpayer to comply with the notice continues after the end of the period of six months beginning with the filing date if no application is made under section 93(3) above before the end of that period.<sup>221</sup>

Without prejudicing any penalties under subsections (2) to (4) of Section 93, should the failure by the taxpayer to comply with the notice continue after the anniversary of the filing date, and the return would have reflected tax liability, the taxpayer shall be

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<sup>217</sup> The Taxes Management Act (TMA) 1970 was promulgated on 12 March 1970, and amended by the Finance Act 1994.

<sup>218</sup> Sec 8 and sec 8A of the TMA, respectively, provide for submission of personal returns and trustee's returns.

<sup>219</sup> Sec 93(1) & (2) TMA 1970.

<sup>220</sup> Sec 93(3) TMA 1970.

<sup>221</sup> Sec 93(4) TMA 1970.

liable to a penalty in an amount not exceeding the amount of tax liability that would have been so reflected.<sup>222</sup>

In terms of section 93A of the TMA, the penalties applicable to an individual taxpayer shall *mutatis mutandis* apply to a partnership that carries on any trade, profession or business.<sup>223</sup>

In terms of section 95 of the TMA a taxpayer shall be liable to a penalty not exceeding the amount of the difference between the amount of tax payable by the taxpayer for the relevant tax years and the amount which would have been the amount payable had the return, statement, declaration or accounts submitted by the taxpayer been correct, if he fraudulently or negligently:

- Delivers any incorrect return of the kind mentioned in section 8 or 8A (or either of those sections as extended by section 12 of the TMA).<sup>224</sup>
- Makes any incorrect return, statement or declaration in connection with any claim for any allowance, deduction or relief in respect of income tax or capital gains tax.<sup>225</sup>Or
- Submits to an inspector or the Board or any Commissioners any incorrect accounts in relation to ascertaining his liability to income tax or capital gains tax.<sup>226</sup>

Section 99 imposes a penalty not exceeding 3000 Pounds on any person who assists in or induces the preparation or delivery of any information, return, accounts or documents which he knows will be, or is likely to be, used for any purpose of tax, when he knows it to be incorrect.<sup>227</sup>

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<sup>222</sup> Sec 93(5) TMA 1970.

<sup>223</sup> Sec 93A TMA 1970.

<sup>224</sup> Sec 95(1) (a) TMA 1970. Sections 8 & 8A respectively provide for submission of personal and trustee's returns.

<sup>225</sup> Sec 95(1) (b) TMA 1970.

<sup>226</sup> Sec 95(1) (c) TMA 1970.

<sup>227</sup> Sec 99 TMA 1970.

In Scotland any person shall be liable, on summary conviction, to imprisonment for a term not exceeding six months if he knowingly makes any false statement or false representation for the purposes of obtaining any allowance, reduction, rebate or repayment in respect of tax, either for himself or for any other person, or in any return made with reference to tax.<sup>228</sup>

#### **4.3.2 The Serious Organised Crime and Police Act of 2005 (SOCPA)**

The Investigating Authority, comprised of the offices of the Director of Public Prosecutions (DPP), the Director of Revenue and Customs Prosecutions, and the Lord Advocate, has in terms of the provisions of SOCPA powers to compel individuals to co-operate with investigations by producing documents and answering questions.<sup>229</sup>

In terms of section 60 of SOCPA the DPP may issue a disclosure notice in connection with an investigation, including an investigation of offences under section 170 of the Customs and Excise Management Act of 1979 or section 72 of the VAT Act of 1994.<sup>230</sup> A disclosure notice is a notice in writing requiring the person to whom it is given to answer questions with respect to any matter relevant to the investigation; provide information with respect to any such matter as is specified in the notice; and/or produce such documents, or documents of such descriptions, relevant to the investigation as are specified in the notice.<sup>231</sup>

A statement made by a person pursuant to a disclosure notice may not be used in evidence against him in any criminal proceedings other than proceedings for any offence of failing to comply with a disclosure notice; proceedings for the offence of perjury; or proceedings for some other offence than the one investigated, where the person, when giving evidence, makes a statement inconsistent with the relevant

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<sup>228</sup> Sec 107 TMA 1970.

<sup>229</sup> Sec 60(5) SOCPA.

<sup>230</sup> Sec 61(1) (d) SOCPA.

<sup>231</sup> Sec 62(3) SOCPA.

statement and evidence relating to that statement is adduced, or a question is asked about it by or on behalf of the person.

#### **4.4 Self-incrimination: Case law**

As recently as 2007, the courts in the UK have had to pronounce on the application of the privilege against self-incrimination.

In *The DPP v Michael Collins*,<sup>232</sup> the DPP sought to have disclosures made by the taxpayer to revenue authorities regarding existence of unlawful off-shore accounts, resulting in undeclared tax liabilities, into evidence at a criminal trial where he was charged with the offence of obtaining a tax clearance certificate under false pretences. The disclosures in question had been made on the understanding that he would not be subject to criminal prosecution for holding such accounts or for any other undeclared tax liabilities disclosed therewith. The taxpayer objected to the admission of this evidence and invoked the privilege against self-incrimination. The court ruled the disclosures inadmissible in evidence as they failed the test of voluntariness in that they were made on the inducement held out by persons in authority (the Revenue Commissioners) that operated in the mind of the taxpayer that he would not be prosecuted if he confessed to the existence of the accounts.

#### **4.5 General remarks**

It appears from the above discussion that a taxpayer can be compelled to make disclosures not only to the tax authorities, but also to the prosecuting authorities. This state of affairs can constitute a violation of the individual's right not to self-incriminate if the disclosed information was to be used in any criminal prosecution against him. From what appears above, this seems to be more than just a remote

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<sup>232</sup> *The DPP v Michael Collins* op cit note 17. Duggan op cit note 203 discusses this decision at length.

possibility. Examples of provisions that can expose the taxpayer to possible self-incriminations are section 107 of TMA, which provides for criminal liability for false statements made to obtain allowances; and section 65 of SOCPA, which provides for a statement made pursuant to a disclosure notice to be used in criminal proceedings against that person in certain circumstances.

It is of importance to note that in the Collins case discussed above the taxpayer was not subsequently charged with the offence he had been promised immunity from prosecution for. The Court found that he had been induced to make disclosures by promises not to be subject to prosecution for unlawfully holding off-shore accounts and for any other undeclared tax liabilities incidental to such accounts. However, the court ruled such disclosures inadmissible in evidence on a charge for the offence of obtaining a tax clearance certificate under false pretences, an offence the prosecution for which he had not been promised any indemnity by the revenue commissioners.

The approach adopted by the court in the Collins case seems to be consistent with the application of the 'use restriction' discussed in the Conclusion in Chapter 3 above. As the Collins case is a recent decision of the UK Circuit Court, it appears to constitute the correct exposition of the current position in that jurisdiction.

## **CHAPTER 5: SUMMARY OF THE COMPARATIVE STUDY**

### **5.1 Introduction**

In this work three tax jurisdictions were studied, namely the RSA, USA and the UK. It has been established that in all three jurisdictions the principle of taxation of all income, irrespective of the legality of the source thereof, is well established. These jurisdictions have, however, all experienced problems in balancing the conflicting interests of the desire to effectively collect maximum revenue through voluntary compliance by citizens with the tax laws on the one hand, and the obligation to protect the constitutional right of those citizens not to have incriminating information provided in tax returns used against them in non-tax criminal prosecutions. The following is a very brief summary of the findings of the study in each jurisdiction, regarding compulsion to disclose information in tax returns, the possibility of that information being used in non-tax prosecutions, and the available measures to curb or minimize the possible violation of the constitutional right against self-incrimination.

### **5.2 The Republic of South Africa (RSA)**

In RSA all fiscal statutes studied contain provisions compelling not only the filing of tax returns, but also complete, full and accurate disclosure of information in those returns.<sup>233</sup> The confidentiality that is supposed to be preserved by the so-called secrecy provisions in the tax legislation is rendered ineffective for purposes of avoiding self-incrimination by the fact that the same sections provide for admissibility of tax return information against the taxpayer if a competent court so

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<sup>233</sup> SS 75, 76 and 104 Income Tax Act 58 of 1962; ss 28, 58 and 59 VAT Act 89 of 1991; sec 28 Estate Duty Act 45 of 1955; and ss 15 and 81 Customs and Excise Act 91 of 1964.

directs.<sup>234</sup> In RSA a taxpayer who has income gained by unlawful means can neither invoke his constitutional right against self incrimination to refuse to file tax returns, nor to refuse to supply specific information therein that may be incriminatory. There are no safeguards in place to protect the taxpayer from being compelled to disclose information for tax purposes that may later be used against him in a non-tax prosecution. An order obtained by *ex parte* application to a judge in chambers will allow the SARS Commissioner to disclose tax return information to the SAPS Commissioner or to the NDPP.<sup>235</sup> Furthermore, any competent court may direct that the tax return information so disclosed is admissible in evidence against the taxpayer who provided it in the tax return.<sup>236</sup>

The duty to disclose income derived from illegal activity is, therefore, strictly enforceable while the taxpayer's right against self-incrimination does not enjoy sufficient protection. Neither is there any hope of improvement under the Tax Administration Bill (TAB) when it becomes law. This is because, as has been shown in Chapter 2, TAB contains provisions similar to the provisions of the current tax laws in so far as preservation of secrecy and self-incrimination is concerned. However, as Olivier so succinctly put it, 'South Africa will be much poorer if the Government's interest in collecting revenue overrides the taxpayer's fundamental rights'.<sup>237</sup>

### 5.3 The United States of America (USA)

In the USA the IRC compels taxpayers to disclose all information regarding their income, including information regarding income that derives from illegal activities. The IRC does this by *inter alia* making it a misdemeanour punishable by prescribed fines and imprisonment to fail to pay tax, file a return or keep records where these

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<sup>234</sup> Sec 4 Income Tax Act 58 of 1962 and sec 6 VAT Act 89 of 1991.

<sup>235</sup> Sec 4(1B) Income Tax Act and sec 6(2A) VAT Act.

<sup>236</sup> Provisos to ss 4(1B) Income Tax Act and 6(2A) VAT Act. Although sec 72 TAB provides that an admission of the commission of an offence contained in a tax return, application or other document submitted to SARS by a taxpayer will not be admissible in criminal proceedings against that taxpayer, this section adds 'unless a competent court otherwise directs'.

<sup>237</sup> Olivier op cit note 133 at 168.

actions are required by law.<sup>238</sup> However, the Fifth Amendment to the USA Constitution does protect the taxpayer from self-incriminatory use of their tax return information in no-tax criminal prosecutions. Although a taxpayer can not invoke the Fifth Amendment to refuse to file a tax return, he can use it to object to giving specific incriminatory answers to questions contained in the tax return form. USA case law has demonstrated that the courts in that jurisdiction have been prepared to give effect to the constitutional protection afforded the taxpayers by the Fifth Amendment, in striving to struck the required balance between the duty to disclose income derived from illegal activities and the constitutional right against self incrimination.<sup>239</sup>

#### **5.4 The United Kingdom (UK)**

As is the case with the rest of the jurisdictions studied, the tax system in the UK enforces a system of voluntary compliance. This means that taxpayers are required to voluntarily disclose information about their income, to enable the revenue authorities to make proper assessments of each taxpayer's obligations. However, the body of laws that form the uncodified Constitution of the UK uphold the right of a person in civil proceedings to refuse to answer any questions or produce any document or thing which might incriminate him.<sup>240</sup> The courts in the UK also recognize the constitutional right of taxpayers to be protected against use of the information in their tax returns that may amount to self-incrimination.<sup>241</sup>

The UK has thus been able to strike the balance between the duty to disclose income derived from illegal activities and the constitutional right against self-incrimination.

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<sup>238</sup> Sec 7203 IRC.

<sup>239</sup> E.g. *Garner v United States* and *United States v Barnes*.

<sup>240</sup> E.g. the Civil Evidence Act of 1968.

<sup>241</sup> *The DPP v Michael Collins* op cit note 17.

## CHAPTER 6: CONCLUSION AND RECOMMENDATIONS FOR CHANGE IN SOUTH AFRICA

### 6.1 Conclusion

To paraphrase Stone,<sup>242</sup> the current situation in South Africa as demonstrated by the discussion in Chapter 2 can be said to present the following ‘cruel trilemma’:<sup>243</sup>

A taxpayer who has income derived from unlawful activities, or whose income is otherwise tainted with illegality can elect one of three possible courses of action: Firstly he can elect not to disclose the illegal income in his tax returns; secondly he can fully comply by disclosing the illegal income as well as the manner in which it is derived; or thirdly he can disclose the income but not state the illegal means by which it is derived.<sup>244</sup>

If he chooses the first option he could be prosecuted for failing or neglecting to furnish, file or submit a return and, in terms of section 75 of the Income Tax Act, face a fine or imprisonment for a period of up to twenty-four months.<sup>245</sup> If he opts for the second alternative he faces possible self-incrimination as the information in the tax returns can, if considered relevant to an investigation or prosecution of a serious non-tax criminal offence, be disclosed to the law enforcement authorities, namely the NDPP or the CSAPS.<sup>246</sup> Significantly, the offence investigated or prosecuted will be considered serious enough to warrant the disclosure of the information in the tax

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<sup>242</sup> Op cit note 67 at 1127.

<sup>243</sup> Stone op cit note 67 at 1127 attributes the phrase ‘cruel trilemma’ to the judgment of Justice Goldberg in *Murphy v Waterfront Comm’n*, 378 U.S. 52 at 55.

<sup>244</sup> Stone op cit note 67 at 1127.

<sup>245</sup> Sec 75(1) (a) Act 58 of 1962.

<sup>246</sup> Sec 4(1B) and (1E) Act 58 of 1962. Huxham & Haupt op cit note 36 at 652-653.

returns to the NDPP or the CSAPS if it is an offence in respect of which a court may impose a sentence of imprisonment exceeding five years.<sup>247</sup> It is submitted that most criminal offences carry similar or even more serious penalties. In a typical drug trafficking offence where the value of the drugs in question is more than fifty thousand rand, the court may impose a minimum sentence of imprisonment for fifteen years in the case of a first offender.<sup>248</sup> It follows then that in most cases where the proceeds of the unlawful activity have warranted declaration for tax purposes in the first place, the offence investigated or prosecuted will be ‘serious’ enough to warrant the disclosure to the law enforcement authorities in terms of the provisions of sections 4(1B) and (1E) of the Income Tax Act.

If the taxpayer opts for the third possible course of action, he would have to state false means by which the income is derived, thereby exposing himself to a possible charge of refusing or neglecting without just cause to reply or answer truly and fully questions put to him.<sup>249</sup> To make things worse for the taxpayer, he would then be burdened with the onus of showing the existence of a just cause for such refusal or neglect.<sup>250</sup>

Although the taxpayer has a constitutional right not to give self-incriminating evidence, the current fiscal legislation does not give him an option to invoke this right and either:

- refuse to file a tax return, or
- file a return and refuse to give answers that would tend to self-incriminate.

Moreover, the fact that the rights in section 35 of the Constitution are guaranteed only in respect of arrested, detained and accused persons complicates the situation further.<sup>251</sup> This is because at the stage of filing his tax return the taxpayer is neither

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<sup>247</sup> Sec 4(1B) (a) Act 58 of 1962.

<sup>248</sup> Sec 51(2) (a) (i) read with Schedule 2 of the Criminal Law Amendment Act 105 of 1997.

<sup>249</sup> Sec 75(1) (b) Act 58 of 1962. Note that in terms of sec 57(1) TAB a person may not refuse to answer a question during an inquiry on the grounds that it may incriminate the person.

<sup>250</sup> Ibid.

<sup>251</sup> Sec 35 of the Constitution.

arrested, nor detained nor is he an accused person. He can therefore not invoke any of the section 35 rights, including the right against self-incrimination guaranteed in terms of section 35(3) (j), at that stage.<sup>252</sup>

As has been stated above, the Constitution is the supreme law of the land with which all other laws must be consistent to be valid. The constitutional court will declare any law that is inconsistent with the constitution, including any fiscal law, invalid. This was demonstrated in *FNB of SA v SARS; FNB v Minister of Finance*,<sup>253</sup> which dealt with the provisions of section 114 of the Customs and Excise Act.<sup>254</sup> This section provided that the goods of persons other than a tax debtor envisaged in the section are subject to a lien, detention and sale. The constitutional court held that section 114 amounted to an arbitrary deprivation and was for that reason inconsistent with the Constitution and invalid.<sup>255</sup>

## **6.2 Recommendations for change in South Africa**

The problem is one of conflicting interests, the first being the interest of SARS to fulfil its mandate of collecting taxes, and the second being the interests of the individual in having his constitutional right not to give self-incriminating evidence protected. This problem needs a compromise solution that will balance the two conflicting interests.<sup>256</sup> It is submitted that the required solution should not involve the declaration, by the Constitutional Court, of the relevant statutory disclosure provisions as invalid. This is because such a declaration would defeat the tax-collection mandate of SARS as mentioned above. An appropriate solution should balance the conflicting interests, rather than defeat one of them. Such a solution would, however, need to take into consideration a third important and intervening interest, being the investigative and prosecutorial interests of law enforcement

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<sup>252</sup> Croome & Olivier op cit note 78 at 119.

<sup>253</sup> 2002 (4) SA 768 (CC). This decision is referred to by Van der Walt op cit note 24 at 190 as ‘... the most important South African decision on constitutional property’.

<sup>254</sup> Act 91 of 1964.

<sup>255</sup> Van der Walt op cit note 24 at 191.

<sup>256</sup> Stone op cit note 67 at 1137.

authorities. This is due to the ‘level of crime in South Africa and the need to reduce that’.<sup>257</sup> One would assume that the legislator had this interest at heart when the provisions of section 4(1B) of the Income Tax Act and section 6(2A) of the VAT Act were enacted.

There are two possible solutions to this problem.<sup>258</sup> The first solution would be the introduction into the system of ‘some kind of statutory immunity’.<sup>259</sup> The second would be for the judiciary to provide clear judicial decisions which provide for immunity in the income tax regulatory scheme, to enable a taxpayer to invoke his constitutional right against self-incrimination when filing tax returns.

With regard to the first solution, there are two kinds of immunity that can be considered: ‘immunity from prosecution’ and ‘use immunity’.<sup>260</sup> Both kinds of immunity would satisfy the interests of the fiscus as well as that of the taxpayer in that the information needed by SARS regarding taxable income would have been provided, and the possibly self-incriminating information disclosed can not be used against the taxpayer in a subsequent prosecution. However, the intervening interests of law enforcement may suffer in the case of ‘immunity from prosecution’ in that this kind of immunity indemnifies the taxpayer from any prosecution whatsoever resulting from his declared illegal dealings.<sup>261</sup> As has been pointed out, this would allow individuals to escape the consequences of their criminal activities. On the other hand ‘use immunity’ ‘prohibits the use of the information disclosed in a subsequent prosecution’.<sup>262</sup> This means that the taxpayer can still be prosecuted, provided the State is able to prove that the evidence used in that prosecution has been obtained independently of the tax return disclosures, and therefore is not self-incriminatory. At worst the disclosures in the tax return in the case of ‘use immunity’ can motivate law

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<sup>257</sup> Croome op cit note 7 at 163.

<sup>258</sup> Stone op cit note 67 at 1148.

<sup>259</sup> Ibid.

<sup>260</sup> Ibid.

<sup>261</sup> Ibid at 1149.

<sup>262</sup> Ibid.

enforcement to initiate a criminal investigation,<sup>263</sup> but will not be directly used in the prosecution, hence it is also known as ‘use restriction’.<sup>264</sup>

The second possible solution would lead in most instances to taxpayers that have derived income unlawfully declaring that income but refusing, on the strength of their constitutional right against self-incrimination, to answer questions relating to the means of deriving that income. The authorities would then most probably become suspicious and initiate a criminal investigation, leading to a situation similar to the ‘use immunity’ solution where the information in the tax return would provide motivation for initiation of criminal investigations, but would not be directly used in any subsequent prosecution of the taxpayer. The only difference would be that, unlike with ‘use immunity’, there would be no information of illegal activities but only a suspicion arising from the taxpayer’s refusal to state how his income is derived.<sup>265</sup>

It is recommended that both a use immunity and a right to invoke the constitutional right against self incrimination be worked into the South African system. These safeguards would balance the conflicting interests of the individual’s constitutional right against self-incrimination, the interest of SARS to collect information regarding taxable income, as well as the law enforcement authorities’ interests in combating crime. By adopting use restriction we will also save the disclosure provisions from being declared unconstitutional and therefore invalid.<sup>266</sup>

It is also recommended that in cases such as the UK Collins case (discussed above),<sup>267</sup> where the taxpayer has been induced with promises by persons in authority to make self-incriminatory disclosures, our courts should follow that decision and disallow use of the incriminating evidence during the non-tax trial.<sup>268</sup>

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<sup>263</sup> Ibid at 1149.

<sup>264</sup> Ibid.

<sup>265</sup> Ibid.

<sup>266</sup> Hanzel op cit note 199 at 193.

<sup>267</sup> Op cit note 17.

<sup>268</sup> Hanzel op cit note 199 at 193.

Implementing these recommendations will undoubtedly involve a measure of compromise of one principle or the other. However, such compromise would be worth the resulting benefit to all the conflicting interests if a balance is to be struck between the duty to disclose income derived from illegal activities and the constitutional right against self-incrimination. Furthermore, both our legislature and our judiciary would do well to keep in mind the purpose of taxation statutes as reiterated in the Tellier case above,<sup>269</sup> 'to tax net income, not to punish unlawful behaviour'.

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<sup>269</sup> *Commissioner v Tellier* op cit note 160.

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