

# REPORTABLE

IN THE TAX COURT OF PORT ELIZABETH

Case No.: 11483

Date delivered: 31 March 2006

In the matter of:

Appellant

And

**THE COMMISSIONER FOR THE  
SOUTH AFRICAN REVENUE SERVICES**

Respondent

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## JUDGMENT

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**JANSEN, J:**

This is an appeal against the Commissioner's revised assessment in respect of the appellant's 2000/2001 tax period. The appeal involves only a matter of law. I, therefore, sat alone as stipulated by section 83(4)(c) of the Income Tax Act No. 58 of 1962.

It is common cause that the appellant from 2 November 1999 to 4 August 2000 on six occasions invested various amounts of money totalling R865 963 with one A. When making these investments the appellant concluded an acknowledgement of debt with A. Paragraph 1 of this acknowledgement of debt provides that A as debtor acknowledged his indebtedness to and in favour of the appellant as creditor. Paragraph 2 thereof provides for interest to be paid in respect of monies lent and advanced by the creditor to the debtor. Paragraph 3 provides that all payments to the

creditor in terms of the acknowledgement of debt shall be appropriated firstly in reduction of interest and thereafter capital. It is common cause that the appellant withdrew three amounts of R50 000 each. It is further common cause that no interest was paid by A to the appellant.

A was sequestrated by an order of the High Court of South Africa, Eastern Cape Division, on 16 November 2000. On 31 January 2001 the appellant submitted a claim to the trustees of the insolvent estate of A. The amount of the claim was R1 166 000. It is common cause that the appellant in submitting his claim against the insolvent estate stipulated an amount of R449 036 as a claim for interest due to him. The assessments which formed the basis of this dispute were based on the claims submitted by the appellant against the insolvent estate.

It is common cause that A was operating a scheme which is known as a pyramid scheme. It was agreed by the parties that a pyramid scheme can be defined as a scheme “whereby the operator borrows money from one investor using the proceeds to pay the other investors and for personal benefit”.

The only issue to be determined at this stage, as agreed by the parties, is whether interest accrued to the appellant as a result of the investments he made with A in terms of the definition of gross income in section 1 of the Income Tax Act read with the provisions of section 5. “Gross income” is defined as the total amount in cash or otherwise received by or accrued to or in favour of a resident. Section 5(1)(c) provides that subject to the provisions

of the Fourth Schedule there shall be paid annually income tax in respect of the taxable income received by or accrued to in favour of a person during the year of assessment ended the last day of February each year.

It was not submitted on behalf of the Commissioner that the pyramid scheme in which the appellant invested the various amounts was not an illegal activity. It was correctly submitted on behalf of the Commissioner that in levelling income tax the Income Tax Act does not distinguish between income from legal activities and income from illegal activities. Counsel referred me to various decisions to support her submission in that regard. This argument, however, does not go to the root of the matter.

The word “accrued”, used in the definition of gross income, is not defined in the Act. In the well-known case of **Lategan v Commissioner for Inland Revenue** 1926 CPD 203 Watermeyer J held that the word “accrued” as used in the gross income definition means “that to which a person had become entitled to”. At page 209 Watermeyer J states: “... he has acquired a right to claim payment of the debt in future. This right has vested in him, has accrued to him in the year of assessment, and is a valuable right which he could turn into money if he wished to do so.” This definition was approved by Hefer JA in **Commissioner for Inland Revenue v People’s Stores (Walvis Bay) (Pty) Ltd** 1990 (2) SA 353 (AD). In **Cactus Investments (Pty) Ltd v Commissioner for Inland Revenue** 1999 (1) All SA 345 (SCA) Hefer JA had again occasion to consider the meaning of “accrual” in the Income Tax Act. The learned Judge confirmed the interpretation of the expression “accrued to”

in section 5(1) and in the definition of “gross income” by the court in the **People’s Stores** case to mean “has become entitled to the right in question”. Applying the interpretation, the learned Judge, at page 348e, said the following:

“What we are trying to ascertain, is whether, after making the funds available to the borrower, the lender has an unconditional right to receive the interest on due date.” (My underlining)

It was submitted on behalf of the appellant that he never had the unconditional right to claim interest from A. I agree with this submission.

A was sequestrated one year and fourteen days after the appellant had made his first investment with A. Section 26(1)(b) of the Insolvency Act No. 24 of 1936 provides that every disposition of property not made for value may be set aside by the court if such disposition was made by an insolvent within two years of the sequestration of his estate, and a person claiming or benefited by the disposition is unable to prove that immediately after the disposition was made the assets of the insolvent exceeded his liabilities. It must be accepted that A’s scheme was from its inception insolvent, and that the appellant would not succeed to discharge the onus placed on him by the said section. The very nature of the pyramid scheme dictates its insolvency. The proceeds of the loan received by A from one investor was used to pay other investors and for A’s personal benefit. Any disposition made by A in terms of an agreement in terms of which monies were invested in the pyramid scheme would not be a

disposition for value. In **Visser en 'n ander v Rousseau en andere NNO** 1990 (1) SA 139 (AD) where the operators of a pyramid scheme paid participants for a useless product, such payments were found to be dispositions without value. Had any interest been paid by A to the appellant those payments of interest would have been dispositions without value. Such disposition may be set aside by a court on application. It was held by Conradie JA in **Fourie N.O and Others v Edeling NO and Others** 2005 (4) All SA 393 (SCA) at 401a that a promise to reward investors with returns paid by a pyramid scheme is a mere nullity and any payment of a profit or interest would be a disposition not made for value. Thus, in my view, the appellant never had an unconditional right to claim interest from A.

In considering the issue, I take into account the following dictum of Hefer JA in the **Cactus** case on p 349g-j:

“I am aware of the fact that an application of the concept of accrual which does not take account of commercial realities may operate harshly inasmuch as it requires that tax be levied on income which may be received only in the very distant future (cf 44 (1995) *The Taxpayer* (62). However, it is often said (cf ITC 268 7 SATC 157 at 163) that there is no equity in tax legislation (nor, I would add, complete rationality). The inequity of levying tax on income which will only be received in future is inherent in the system of receipts and accruals, which has been with us for many years. As long as the system prevails inequitable results cannot always be avoided. Of course, the Act must

be interpreted and applied in the least onerous manner which its wording allows. But, if the wording is clear, it must be applied however harsh the result might be. The taxpayer's remedy is to arrange his affairs, so far as he is able, so as not to attract these results."

I can, however, not come to a conclusion that it could ever have been the intention of the legislature to have a person taxed on income that he never got, or, if he gets it, would lose it in terms of other legislation.

In the result, I find that the interest claimed by the appellant from the insolvent estate of A had not accrued to him as required by section 5(1) of the Income Tax Act.

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**J C H JANSEN**

**PRESIDENT**