INTERPRETATION NOTE: NO. 80

DATE: 5 November 2014

ACT : INCOME TAX ACT NO. 58 OF 1962
SECTION : SECTION 11(*a*), (*c*), 23(*c*) AND (*g*) AND SECTION 1(1), DEFINITION OF "GROSS INCOME"
SUBJECT : THE INCOME TAX TREATMENT OF STOLEN MONEY

CONTENTS

PAGE

Preamble

In this Note unless the context indicates otherwise –

- **"embezzlement"** means the misappropriation of funds entrusted to a person (for example, an employee or trustee) for care or management;
- **"fraud"** is the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another;[1]
- **"section"** means a section of the Act;
- **"stolen money"** means money obtained from embezzlement, fraud or theft;
- **"TA Act"** means the Tax Administration Act No. 28 of 2011;
- **"the Act"** means the Income Tax Act No. 58 of 1962;
- **"theft"** means the act or crime of stealing money;
- **"thief"** refers to the person perpetrating the embezzlement, fraud or theft; and
- any word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides guidance on –

- the deductibility of expenditure and losses incurred in a taxpayer's trade when money is stolen through embezzlement, fraud or theft, including expenditure incurred on legal and forensic services to investigate such losses;
- the inclusion in income of amounts recovered or recouped in respect of such expenditure and losses previously allowed as a deduction; and
- the taxation of stolen money in the hands of the thief and the non-deductibility of such amounts when repaid.

2. Background

Taxpayers may incur expenditure and losses during the course of their business activities as a result of money stolen through embezzlement, fraud or theft by, for example, employees, directors, independent contractors, shareholders, partners, burglars or armed robbers. As a consequence, these taxpayers may also incur expenditure pertaining to legal and forensic services to investigate such losses.

The manner in which the embezzlement, fraud or theft is perpetrated will vary from case to case, for example, it could result from a physical break-in to the taxpayer's premises, cheques could be manually altered or there could be an unauthorised use of electronic systems to make payments. The identity of the person perpetrating the embezzlement, fraud or theft may be known or unknown to the taxpayer.

The stealing of money through embezzlement, fraud or theft has income tax implications for both the victim and the thief.

---

[1] *W A Joubert, J A Faris & A Kanjan "Fraud/Definition" 6 (Second edition Replacement Volume) LAWSA [online]* (My LexisNexis: 31 August 2010) in paragraph 306.

3. The law

The relevant sections of the Act are quoted in the **Annexure**.

4. The victim

4.1 Deduction for stolen money

4.1.1 The positive test [section 11(*a*)]

The general deduction formula consists of a positive test [section 11(*a*)] and a negative test [section 23(*g*)]. These two sections must be read together in order to determine whether a taxpayer will be entitled to a general deduction.

In determining a person's taxable income derived from carrying on any trade, section 11(*a*) provides a deduction for –

- expenditure and losses,
- actually incurred,
- in the production of the income,
- which are not of a capital nature.

In accordance with the opening words of section 11, any expenditure and losses from embezzlement, fraud or theft must also have been incurred in carrying on a trade. This trade requirement is also addressed by section 23(*g*) – see **4.1.2**.

In addition, expenditure and losses must be claimed during the year of assessment in which they are actually incurred.

The facts and circumstances of each case must be considered when applying the principles discussed in this Note.

(a) Expenditure and losses

The words "expenditure" and "losses" referred to in section 11(*a*) are not defined in the Act.[2] In *Joffe & Co (Pty) Ltd v CIR* Watermeyer CJ explained the distinction between the words "loss" and "expenditure" as follows:[3]

> "In relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money."

A similar distinction was drawn between "disbursements" or "expenses" on the one hand and "losses" on the other in the English case of *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co,* in which Findlay J explained that the word "disbursements" –[4]

> "means something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; it is something which comes out of his pocket. A loss is something different. That is not a thing which he expends or disburses. That is a thing which, so to speak, comes upon him *ab extra*".

---

2 *Collins Essential English Dictionary* (1988) William Collins Sons & Co Ltd defines "expenditure" as "the total amount of money that is spent on something" and "loss" as "the fact of no longer having something or of having less of it than you had before".

3 1946 AD 157, 13 SATC 354 at 360.

4 17 TC 59 at 64.

In *COT v Rendle* Beadle CJ distinguished designed and fortuitous expenditure as follows:[5]

> "For the purposes of this case, expenditure incurred for the purpose of trade may be grouped broadly under two heads. First, money voluntarily and designedly spent by the taxpayer for the purpose of his trade; and second, money which is what I might call involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer. For the sake of convenience, I will refer to the first type of expenditure as 'designed expenditure', and to the second as 'fortuitous expenditure'."

Other court cases have expressed similar views on the meaning of expenditure.[6]

Applying these principles to stolen money, the term "loss" would cover the embezzlement, fraud or theft of a taxpayer's own money, while the term "expenditure" would be more appropriate in describing a reimbursement of trust monies which have been stolen.

(b) Actually incurred

For an expense or a loss to be deductible, it must be actually incurred. "Actually incurred" means that the taxpayer must have a definite and absolute liability to pay an amount[7] or must have suffered the loss. Anticipated expenditure and losses are not actually incurred. A liability that is conditional or contingent in any way will not be deductible.[8]

(c) In the production of the income

Expenditure and losses must have been incurred in the production of income in order to be deductible. The meaning of the words "in the production of the income" was considered by Watermeyer AJP (as he then was) in *Port Elizabeth Electric Tramway Company v CIR* in which he stated the following:[9]

> "The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

Although this case dealt with expenses, the same principle applies to losses. This test was, with slight alteration in the wording, subsequently approved and applied by the Supreme Court of Appeal in a number of cases.[10]

In *COT v Rendle*[11] the taxpayer was a partner in a firm of Chartered Accountants which had collected certain monies from the sale of some properties on behalf of its clients. One of the clerks employed by the firm had embezzled the clients' funds, and the taxpayer had incurred expenditure in reimbursing the clients as well as in

---

5 1965 (1) SA 59 (SRAD), 26 SATC 326 at 329.

6 ITC 1783 (2004) 66 SATC 373 (G); *C: SARS v Labat Africa Ltd* 2013 (2) SA 33 (SCA), 74 SATC 1; *Ackermans Ltd v C: SARS* 2011 (1) SA 1 (SCA), 73 SATC 1.

7 ITC 1545 (1992) 54 SATC 464 (C) at 466.

8 *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55.

9 1936 CPD 241, 8 SATC 13 at 17.

10 *CIR v Genn & Co* 1955 (3) SA 293 (A), 20 SATC 113*, CIR v African Oxygen Ltd* 1963 (1) SA 681 (A), 25 SATC 67and *CIR v Allied Building Society* 1963 (4) SA 1 (A), 25 SATC 343.

11 Above.

investigating the embezzlement and in obtaining legal advice. The taxpayer sought to claim a deduction for the expenditure. It was held that the amounts were allowable as they were part of the cost of performing the taxpayer's business operations. The court re-confirmed that the test established in the *Port Elizabeth Electric Tramway Co* case[12] was the appropriate test to apply when determining whether the expenditure and losses arising from the embezzlement, fraud or theft of money was incurred by the taxpayer in the production of the income and noted the following:[13]

> "All expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation."

In deciding whether the fortuitous expenditure was deductible, the court in the *Rendle* case was of the opinion that the inquiry must be whether the "chance" of such expenditure or loss being incurred is sufficiently closely connected with the business operation. The focus is thus on the risk of the expenditure or loss being incurred and not on the actual expenditure or loss itself. The court summarised the legal position as follows:[14]

> "Before fortuitous expenditure can be deducted, the taxpayer must show that the risk of the mishap which gives rise to the expenditure happening, must be inseparable from or a necessary incident of the carrying on of the particular business."

The test as formulated above has been confirmed and applied in various other court cases.[15]

In ITC 952[16] the appellant, a practising attorney, had carried on business in partnership. The appellant's partner had stolen money from the partnership trust account which the appellant had made good. At issue was whether the amount paid by the appellant was an allowable deduction for income tax purposes. In finding that the amount was not allowable, Fieldsend P stated that –[17]

> "the essential factor to be determined is whether the dishonest removal of funds was a reasonably incidental risk to the production of assessable income in the locality at the time".

Although the language used in the *Rendle* case ("inseparable from" and "necessary incident of") differs from that used in ITC 952 ("reasonably incidental risk"), they are in substance the same test. The assessment which needs to be made is whether in the particular taxpayer's business the risk of embezzlement, fraud or theft is such a familiar and recognizable hazard so as to be considered inseparable from and inherent in the business.[18] In other words, when carrying on that type of business the taxpayer inevitably has to undertake the risk that embezzlement, fraud or theft could occur.

---

12 As subsequently modified by various Appellate Division decisions.
13 At SATC 330.
14 At SATC 333.
15 ITC 1221 (1974) 36 SATC 233 (R); ITC 1242 (1975) 37 SATC 306 (C); ITC 1268 (1977) 40 SATC 57 (T); ITC 1383 (1978) 46 SATC 90 (T) and ITC 1710 (1999) 63 SATC 403 (C).
16 (1961) 24 SATC 547 (F).
17 At 551.
18 See the *Rendle* case above at SATC 333.

In ITC 1383[19] the appellant, a commercial bank, had claimed a deduction for a loss incurred as a result of theft by an employee. The "fairly senior" employee ranked sixth amongst the bank's senior officials at its head office but only had control over three employees. In allowing the loss as a deduction Hill AJ found that the risk of loss to a bank as a result of theft was an ever-present factor, stating the following:[20]

> "The appellant in the present case is a commercial bank which in the ordinary course of its business must necessarily allow the employees to handle large sums of money and however careful it could be expected to be in the selection and supervision of its staff, the risk of theft is an ever-present factor in the administration of its business and must be regarded as inseparable from it."

Burglary and robbery are likewise inherent risks attached to conducting a business and losses arising therefrom are connected with the trade.[21]

The removal of the proceeds from cash sales from a business by a sole proprietor is not theft but rather represents an omission of income.

The application of the risk test in the context of embezzlement, fraud or theft committed by senior employees or officials can be more difficult. The court cases have tended to find that such expenditure and losses are not deductible.

In *Lockie Bros Ltd v CIR*[22] a manager of the South African branch of a United Kingdom company had stolen a large sum of money from the company and the appellant sought to claim the loss as a deduction for income tax purposes. Mason J found that the loss was not incurred in the production of income because the embezzlement of the funds was not an operation undertaken for the purposes of the business.

In ITC 952 above, the court stated that a sound reason for the decision in the Lockie Bros case was –[23]

> "that one does not reasonably expect a senior manager or managing director to make away with his employer's funds, and that such a risk is not reasonably incidental to the trade, as the petty larcenies of servants and the leakages through carelessness or dishonesty to which the revenues of most profit-earning organizations are exposed".

Turning to the facts of ITC 952 (that is theft by a partner of the appellant), Fieldsend J held as follows:[24]

> "Applying the law to the facts of the appellant's case I do not think that it can be said that the defalcations of a partner in an attorney's firm can be said to be the kind of casualty, mischance or misfortune which is a natural and recognized incident of the business. If a distinction is to be drawn between ordinary servants, and managers or managing directors, for which there appears to be authority, it seems to me that, *a fortiori*,[25] a partner is in quite a different position to an ordinary servant. For this reason alone it seems to me that the appeal in this case cannot be allowed."

---

19 (1978) 46 SATC 90 (T).
20 At 94/95.
21 ITC 1268 (1977) 40 SATC 57 (T).
22 1922 TPD 42, 32 SATC 150.
23 At SATC 551.
24 At 552.
25 For a still stronger reason.

In ITC 1383, the commercial bank case referred to above, Hill AJ, referred to overseas court cases and authors when discussing the proposition that if a loss is occasioned by a theft committed by an employee it may be deductible, but if it is committed by a proprietor (including a partner, managing director or someone with the powers to represent his employer at that level) a deduction would not be permitted. He noted that in his view the position would be the same in South Africa under the Act. The loss was held to be deductible. On the facts of the case it was clear that the employee's "fairly senior position" was not similar to that of proprietorship.

SARS recognises that times have changed since the *Lockie Bros* and *ITC 952* cases and that embezzlement, fraud and theft by senior managers has become more prevalent. A loss arising as a result of embezzlement, fraud or theft by a senior employee will therefore not automatically be denied as a deduction. However, there may still be circumstances in which the risk of embezzlement, fraud or theft by a senior manager is not inherent in the particular business, for example, the theft of a company's cash by a director who is also the sole shareholder of the company. Each case must be considered on its merits having regard to its particular facts. Facts which will be relevant in most cases include, for example, the nature of the business, who perpetrated or is suspected to have perpetrated the embezzlement, fraud or theft, the perpetrator's relationship to the taxpayer and the method used to perpetrate the embezzlement, fraud or theft.

In ITC 1661[26] the appellants were two dentists who practised in partnership. They appointed a firm of auditors to perform certain management and accounting functions which included the making out of and signing of cheques on behalf of the partnership. One of the auditors' employees and possibly one of the auditors had stolen money and falsified signatures on cheques or used cheques for their own purposes. At issue was whether the losses could be claimed as a deduction under section 11(*a*). The court appeared to hold the view that in order to be 'in the production of income' the expenditure or loss had to either be 1) a pre-requisite to earning the income (that is, without the expenditure or loss the income could not have arisen) or 2) if it was not a pre-requisite to earning the income, then the activity giving rise to the expenditure or loss had to be an inherent risk in the taxpayer's business which gave rise to income. Based on the facts of the case it was held that the losses were not allowable because, first, the theft by the independent contractor occurred after the income was earned and could not therefore have been a pre-requisite to earning it and secondly, there was no evidence to prove that theft by an independent contractor was an inherent risk of the practice of dentistry.

[26] (1998) 61 SATC 353 (G).

In relation to the first basis, with respect, in the context of embezzlement, fraud and theft, the stealing of money can never be a prerequisite to earning income, the stealing of money will nearly always occur after the income has been earned and a pre-requisite test is therefore inappropriate.[27] As stated earlier, the relevant test is whether in the taxpayer's business, assuming it is a business which gives rise to income, the risk of embezzlement, fraud or theft that occurred is such a familiar and recognizable hazard so as to be considered inseparable from and inherent in the business. The fact that the income was earned before the loss occurred is not a bar to the deduction of the loss.

In relation to the second basis, it is unclear whether the court was saying that a deduction was simply not available because the theft was perpetrated by an independent contractor. It is submitted that this would be an incorrect approach to follow[28] and that the correct test, which is in line with case authorities discussed earlier in this Note and ITC 1661 itself, is to consider whether on the facts the risk of the loss was an inherent risk in the taxpayer's business. This test must be applied on a case-by-case basis and, depending on the facts, could lead to the conclusion that the theft by an independent contractor was incurred in the production of income. In a number of instances it will not matter whether the theft was perpetrated by an employee or independent contractor. For example, if an employee or independent contractor, who is also the sole shareholder of the company, perpetrated a theft, the loss is unlikely to be considered an inherent risk in the business. However, if an unrelated employee or independent contractor perpetrated the embezzlement, fraud or theft, the loss is more likely to be considered an inherent risk in the business.

In ITC 1661 the court said there was no evidence to support the submission that in that particular case the theft by an independent contractor was an inherent risk of the practice of dentistry. The outcome of ITC 1661 may have been different if the taxpayer had succeeded in adducing evidence to show that the risk of loss was inherent in the business, for example, by presenting appropriate crime or insurance statistics which supported the case.

In considering whether the loss is a risk which is inherent in a taxpayer's business it is necessary to consider the general business environment as well as the industry and type of business in which the taxpayer operates. Taking a wider look than just the taxpayer's business allows one to assess whether what occurred was an inherent risk or something in the nature of gross negligence[29] which is unlikely to be an inherent risk.

---

27 In other contexts it is submitted that the pre-requisite test is also inappropriate. The relevant enquiry is whether the expenditure was incurred for the purpose of earning income (see, for example, *Port Elizabeth Electric Tramway Co. v CIR* 1936 CPD 241, 8 SATC 13*; Sub-Nigel Ltd v CIR* 1948 (4) SA 588 (A), 15 SATC 381; *CIR v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475 (A), 23 SATC 251; and *CIR v Allied Building Society* 1963 (4) SA 1 (A), 25 SATC 343).

28 Support for the view that losses arising as a result of the actions of an independent contractor can qualify for a deduction if all the other requirements of section 11(*a*) read with section 23 are met, can be found in other court cases, for example, see *X v COT* 1960 (2) SA 682 (SR), 23 SATC 297 and *COT v Rendle* 1965 (1) SA 59 (SRAD), 26 SATC 326 (*obiter*).

29 See *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354. In that case damages arising out of negligence were held not to be deductible as based on the facts there was nothing to suggest that the negligence which had occurred was a necessary concomitant of the taxpayer's trading operations or that the expenditure was bona fide occurred for the purposes of trade.

(d) Not of a capital nature

In order for an expense or loss to be deductible it must not be of a capital nature. The capital or revenue nature of an expense or loss will be determined by the facts of the particular case. The courts have developed a number of tests for distinguishing between capital and revenue expenditure. A useful test for distinguishing capital and revenue expenditure is the distinction between fixed and floating capital. In *CIR v George Forest Timber Co Ltd* Innes CJ stated the following:[30]

> "Capital, it should be remembered, might be either fixed or floating. The substantial difference was that floating capital was consumed and disappeared in the very process of production, while fixed capital did not; though it produced fresh wealth it remained intact. The distinction was relative, for even fixed capital, such as machinery, did gradually wear away and required to be renewed."

In *New State Areas Ltd v CIR*[31] Watermeyer CJ stated the following:

> "When the capital employed in a business is frequently changing its form from money to goods and vice versa (e.g. the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a manufactured article) and this is done for the purpose of making a profit, then the capital so employed is floating capital."

In the *Lockie Bros* case cited earlier Mason J did not find it necessary to decide whether the loss resulting from embezzlement by a manager was of a capital nature, although he stated that there was much to be said for that view. De Waal J held that the loss was of a capital nature on the basis that once the company's assets are converted into money it becomes portion of its capital for reinvestment, if so desired. De Waal J's view, that the loss was of a capital nature, is not regarded as correctly reflecting the law as it is not in line with the fixed versus floating capital distinction drawn in the *George Forest Timber* case.

The theft of cash from a banking institution will usually result in a loss of a revenue nature because it is likely to represent a loss of the bank's floating capital.[32] Likewise, the theft of money from a current or similar transactional account with a bank, petty cash, safe or payroll in a non-banking business is also likely to represent a loss of floating capital and if such will give rise to a loss of a revenue nature.[33] However, the facts of each case must be considered in determining whether the theft of cash from a bank account represents a loss of fixed or floating capital. For example, the theft of a fixed deposit would likely represent a loss of fixed capital and give rise to a capital loss because of its non-circulating nature.

A deduction will not be available under section 11(*a*) if the expense or loss is of a capital nature. A capital loss may be available – see **4.2**.

---

30 1924 AD 516, 1 SATC 20 at 23.

31 1946 AD 610, 14 SATC 155 at 163.

32 In ITC 1383 (1978) 46 SATC 90 at 93 the court accepted the uncontested evidence of a bank manager that funds stolen from the bank by an employee formed part of the bank's floating capital.

33 See ITC 1242 (1975) 37 SATC 306 (C); ITC 1221 (1974) 36 SATC 233 (R) and ITC 1268 (1977) 40 SATC 57 (T).

(e) During the year of assessment

Expenditure and losses must be claimed in the year of assessment in which they were incurred.[34]

A revenue loss as a result of embezzlement, fraud or theft must be claimed in the year of assessment in which the embezzlement, fraud or theft occurs and not in the year of assessment in which it is discovered. Any amount so claimed under section 11(*a*) which is subsequently recovered from the thief must be brought to account as a recoupment under section 8(4)(*a*) in the year of recovery.

Under section 99 of the TA Act a reduced assessment may not be issued after the elapse of three years from the date of the assessment. Thus it will not be possible to claim an expense or loss omitted from a return of income for a year of assessment once the original assessment for that year has become final.

4.1.2 The negative test [section 23(*g*)]

Section 23(*g*) denies a deduction for moneys claimed as a deduction from income derived from trade to the extent that the moneys are not laid out or expended for the purposes of trade. A taxpayer that meets the requirements of section 11(*a*) is likely to also meet the trade requirement. However, losses as a result of embezzlement, fraud or theft which are of a domestic or private nature will be denied as a deduction under section 23(*g*).

4.2 Losses of a capital nature

A deduction will not be available under section 11(*a*) if the expense or loss is of a capital nature. However, the loss of an asset as a result of an act of embezzlement, fraud or theft may give rise to a capital loss under the Eighth Schedule.

The theft of notes and coins in current circulation cannot give rise to a capital loss because the definition of an “asset” in paragraph 1 of the Eighth Schedule excludes currency other than any coin made mainly from gold or platinum.

In contrast, a bank account is an asset for CGT purposes, being a debt claim against the bank. It follows that embezzlement, fraud or theft involving a bank account may give rise to a capital loss assuming that it does not represent a loss of floating capital allowable under section 11(*a*). To the extent that the expenditure on the bank account is allowable under section 11(*a*) it will result in the reduction in the base cost of the bank account under paragraph 20(3)(*a*) of the Eighth Schedule. Similarly, the expenditure on the bank account must be reduced under paragraph 20(3)(*b*) of the Eighth Schedule by any portion of that expenditure that has been recovered or has become recoverable from any other person (for example, the thief or an insurer).

Any amount recovered in a year of assessment subsequent to the year of disposal must be treated as a capital gain under paragraph 3(*b*)(ii) of the Eighth Schedule.

While capital gains and losses on the disposal of personal-use assets must be disregarded under paragraph 53 of the Eighth Schedule, funds on deposit with a financial institution are not a personal-use asset and can accordingly give rise to a

---

[34] *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381 at 390 and ITC 1545 (1992) 54 SATC 464 (C) at 471.

capital loss.[35] Similarly, a claim against an insurer for the loss of funds on deposit with a financial institution is also not a personal-use asset and can give rise to a capital gain or loss.[36]

A victim of a thief acquires an independent delictual claim for damages against the thief known as the *condictio furtiva*.[37] Being an independent action, its base cost will not be derived from the stolen money but could include legal fees in bringing the recovery action.

The timing of the disposal under the Eighth Schedule needs to be considered in relation to the stolen money and to the right of recovery which the taxpayer has against the thief and possibly an insurer. Paragraph 13(1)(*b*) and (*c*) of the Eighth Schedule are relevant in this regard.

Thus, for example, under paragraph 13(1)(*b*) the time of disposal of a claim against –

- a thief is on the date on which it is extinguished through recovery, abandonment or expiry; and
- an insurer is when it is settled or repudiated and the repudiation is not contested.

See sections 11 and 12 of the Prescription Act No. 68 of 1969 regarding the date on which debts prescribe. Prescription of a victim's claim against a thief only begins to run from the date on which the victim becomes aware that the monies were stolen.

4.3 Expenditure on legal and forensic services

The cost of forensic services incurred to investigate embezzlement, fraud or theft will be deductible under section 11(*a*) if the expenditure and losses resulting from the embezzlement, fraud or theft are deductible under section 11(*a*). See *COT v Rendle*[38] in which the court held that the costs of investigation and legal advice were inextricably related to the embezzlements and were allowable as deductions on the same grounds.

Any claim for legal expenses in investigating the embezzlement, fraud or theft must be made under section 11(*c*), which requires that the legal expenses must –

- be actually incurred during the year of assessment;
- be in respect of any claim, dispute or action of law which arises in the course of or by reason of the ordinary operations undertaken by the taxpayer in the carrying on of the trade;
- not be of a capital nature;
- not relate to a claim against the taxpayer for damages or compensation which, if payable, would not qualify as a deduction under section 11(*a*);

---

35 Paragraph 53(3)(*e*) of the Eighth Schedule excludes from a personal-use asset a financial instrument as defined in section 1(1) and paragraph (*a*) of that definition includes a deposit with a financial institution.

36 Under paragraph 53(3)(*h*) a short-term policy under the Short-Term Insurance Act, 1998, is not a personal-use asset to the extent that it relates to any asset which is not a personal-use asset

37 J C van der walt and J R Midgley *Principles of Delict* 3 ed (2005) LexisNexis Butterworths, Durban in 34.

38 Above at SATC 336.

- not relate to a claim by the taxpayer for an amount which would not comprise income of the taxpayer (assuming that the claim were successful); and
- not be incurred in respect of any dispute or action at law relating to any claim referred to in the preceding two bullet points (that is, which relates to non-deductible amounts or amounts not comprising income as the case may be).

Thus, for example, if an employee steals trust funds which the taxpayer is required to make good, any legal expenses incurred in relation to the theft of the funds would qualify as a deduction provided that the amount made good by the taxpayer qualifies as a deduction under section 11(*a*).[39]

4.4 Amounts recoverable under a contract of insurance [section 23(*c*)]

Under section 23(*c*) expenditure and losses that would otherwise be allowed as deductions, for example under section 11(*a*), will not be allowed to the extent that they are recoverable under a contract of insurance, guarantee, security or indemnity.

4.5 Inclusion in income of amounts recovered or recouped

Amounts which have previously been allowed as a deduction under section 11(*a*)[40] for losses of stolen money and expenditure on forensic and legal costs to investigate the loss must be included in the taxpayer's income under section 8(4)(*a*) if subsequently recovered or recouped. For example, if a taxpayer recovers all or part of the stolen money from the thief, the amount recovered must be included in the taxpayer's income in the year in which it is recovered.

4.6 Proof of embezzlement, fraud and theft of money

A taxpayer claiming a deduction for expenditure and losses owing to the embezzlement, fraud and theft of money and for expenditure pertaining to legal and forensic services to investigate such expenditure and losses bears the onus of proving such expenditure and losses under section 102 of the TA Act.

Without limiting the manner in which the expenditure and losses can be proven, the following will be considered as *prima facie* proof that such expenditure and losses occurred:

- A police case docket reference number;
- A report by an accredited private investigator;
- A report by a forensic auditor; or
- A charge sheet issued by a court.

A taxpayer will also need to prove the *quantum* of the expenditure and losses.

---

[39] In ITC 1710 (1999) 63 SATC 403 (C) the court allowed legal expenses as a deduction under section 11(*c*) because the damages to which they related qualified as a deduction under section 11(*a*).

[40] Read with section 23.

5. The thief

5.1 Taxation of stolen money

A thief will be taxed on stolen money if it falls within the thief's gross income.

The opening words of the definition of "gross income" in section 1(1) contain two key requirements relevant in the context of this Note for an amount to be included in gross income. They are that an amount must –

- be received by or accrued to a taxpayer, and
- not be of a capital nature.

5.1.1 Received by or accrued to

The terms "received by" and "accrued to" are not defined in the Act, but they have been the subject of judicial interpretation.

In *Geldenhuys v CIR* Steyn J stated that the words "received by" as used in the definition of "gross income" –[41]

> "must mean 'received by the taxpayer on his own behalf for his own benefit' ".

The words "accrued to" were held by Watermeyer J (as he then was) in *WH Lategan v CIR* to mean –[42]

> "to which he has become entitled".

In the context of stolen money there can be no accrual because a thief is not unconditionally entitled to the money. There can, however, be a receipt – see below.

In 1918 the Transvaal Provincial Division confirmed in *CIR v Delagoa Bay Cigarette Co, Ltd* that income was taxable even if derived from an illegal source. In that case, which involved the sale of illegal lottery tickets together with packets of cigarettes, Bristowe J stated the following:[43]

> "I do not think it is material for the purpose of this case whether the business carried on by the company was legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum, and after making the prescribed calculations and deducting the exemptions, abatement and deductions enumerated in the statute. The source of the income is immaterial. This was so held in *Partridge v Mallandaine* (18 Q.B.D. 276), where the profits of a betting business was held to be taxable to income tax; Denman J. saying that 'even the fact of a vocation being unlawful could not be set up against the demand for income tax'."

In *COT v G*[44] it was held that money stolen by a thief was not 'received' by him within the meaning of the Zimbabwean Tax Act as a thief "takes" rather than "receives" the money. Following the decision of the Supreme Court of Appeal in the *MP Finance case* discussed below, this decision is not regarded as correctly reflecting the position under South African law.

---

41 1947 (3) SA 256 (C),14 SATC 419 at 430.

42 1926 CPD 203, 2 SATC 16 at 20. The correctness of the interpretation of "accrued to" in *Lategan's* case was subsequently confirmed by Hefer JA in *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 24.

43 1918 TPD 391, 32 SATC 47 at 49.

44 1981 (4) SA 167 (ZA), 43 SATC 159.

In ITC 1545[45] the appellant had been taxed on the proceeds from the sale of stolen diamonds and the receipts from the growing and sale of dried "milk cultures". The latter activity was described by the court as a money-making racket similar to a chain-letter scheme and was accepted as amounting to an illegal lottery. The court held that the amounts were received by the taxpayer for the purposes of the definition of "gross income" notwithstanding that they were in pursuance of a void transaction. It distinguished the facts of the case from *G's* case above, noting that the instant case was not one in which there had been no receipt but merely a "taking" by a thief.

In ITC 1624[46] the appellant, acting as agent, fraudulently overcharged its principal for wharfage fees which it claimed it had paid to Portnet on the principal's behalf. The fraud was discovered in a later year of assessment and the appellant had refunded the overcharged amounts to its principal. The appellant argued that the amounts were not received by it as it was under an immediate obligation to repay them. Alternatively, the appellant argued that it was entitled to a deduction in the same year of assessment for the liability it had incurred to repay the amounts. The court rejected these arguments holding that the amounts were received by the appellant as part of its business receipts and that the amount was not an expenditure or loss incurred during the year of assessment in question. The court considered *G's* case above but declined to follow the *ratio* in that case.

In ITC 1792[47] the appellant, a stockbroker, had acted as agent for a principal on behalf of whom he bought and sold shares. The appellant, together with others, had become aware of the shares that his principal would be acquiring. He acquired those shares in a separate company and later sold them at a profit to his principal. The issue was whether the appellant was liable to tax on these illegal secret profits. The court found, based on the law of agency, that an agent is not entitled to make secret profits and that those profits belong to the principal. It accordingly held that the amounts had not been received by the appellant on his own behalf for his own benefit. Based on the outcome of the *MP Finance* case below, it is considered that this case was not correctly decided. The issue is not the legal relationship between principal and agent but between the agent and the *fiscus*.

The Supreme Court of Appeal case of *MP Finance Group CC (in liquidation) v C: SARS*[48] considered the question of whether deposits taken in an illegal and fraudulent pyramid scheme constituted amounts "received" within the meaning of "gross income". The taxpayer argued that because the scheme was liable in law to return the deposits there was no basis on which it could be said that they were "received" within the meaning of the Act. The court rejected this argument, stating the following:[49]

> "An illegal contract is not without all legal consequences; it can, indeed, have fiscal consequences. The sole question as between scheme and *fiscus* is whether the amounts paid to the scheme in the tax years in issue came within the literal meaning of the Act. Unquestionably they did. They were accepted by the operators of the scheme with the intention of retaining them for their own benefit. Notwithstanding that in law they were immediately repayable, they constituted receipts within the meaning of the Act."

---

45 (1992) 54 SATC 464 (C).
46 (1996) 59 SATC 373 (T).
47 (2005) 67 SATC 236 (G).
48 2007 (5) SA 521 (SCA), 69 SATC 141.
49 At SATC 145. Footnotes have been suppressed.

The principle to be drawn from the above cases is that the receipt of stolen money comprises gross income and is thus taxable. While the *MP Finance* case dealt with money fraudulently received under an illegal contract, its principles are considered to apply equally to the theft of money through robbery, burglary or other criminal means. The key issue is whether the thief intended to benefit from the stolen funds. If so, the requisite ingredients for a receipt have been met and there is no justification for the view taken in *G's* case above that a thief "takes" rather than "receives". The issue is not whether the victim intended to part with the money but rather whether the thief intended to benefit from it.

5.1.2 Not of a capital nature

The question has been raised whether stolen monies derived from a one-off opportunistic and fortuitous theft could be of a capital nature, as opposed to a considered and well-planned illegal business operation which is of a revenue nature.[50]

The case of *CIR v Pick 'n Pay Employee Share Purchase Trust*[51] is authority for the principle that the receipts or accruals bear the imprint of revenue if they are not fortuitous but designedly sought for and worked for. An opportunistic theft can hardly be described as "fortuitous". It is designedly sought and requires intent, planning and execution. It is therefore considered improbable that an amount derived from a once-off theft can be of a capital nature.

5.1.3 Timing and determination of the amount received

Stolen moneys must be included in gross income in the year of receipt.[52] Generally speaking, when a person has perpetrated an act of embezzlement, theft or fraud there is likely to be fraud, misrepresentation or non-disclosure from an income tax perspective meaning that there is no limitation on the period in which SARS may issue an assessment.[53] SARS is not obliged to wait for a criminal conviction before an assessment of stolen money can be raised on a thief. However, it is necessary for SARS to determine an "amount" for the purposes of the definition of "gross income".[54] The method applied to determine the amount will depend on the facts of the particular case but could include reconciling the growth in the taxpayer's net assets with the taxpayer's declared income and expenses or, more directly, tracing the stolen money to the taxpayer's bank account.

5.2 Deductibility of repayments of stolen money

In the event that a thief refunds all or a portion of the stolen money, the question which arises is whether having been taxed on the receipt the thief will be entitled to a deduction for the stolen money refunded. The relevant sections for consideration are section 11(*a*) read with section 23(*g*).

Both sections require the taxpayer to conduct a trade and any deduction is limited to the extent an amount is expended for the purposes of that trade. The stealing of

---

50 George Goldswain "Illegal Activities" (2008) 22 *Tax Planning* 143.

51 1992 (4) SA 39 (A), 54 SATC 271 at 280.

52 Amounts must be included in gross income on the earlier of receipt or accrual. However, stolen moneys do not accrue to a thief and therefore the date of receipt is relevant.

53 Section 99(2) of the TA Act.

54 In *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301, 13 SATC 21 at 39 Feetham JA stated that it was essential for the Commissioner in order to support his assessment to show that some amount had been received by or accrued to the taxpayer.

money cannot be described as a trade and accordingly the thief will not qualify for a deduction under section 11(*a*) read with section 23(*g*). In *Griffiths (Inspector of Taxes) v J P Harrison(Watford) Ltd* Lord Denning made the following *obiter* remarks:[55]

> "[T]ake a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade. You cannot point to any detail that it lacks. But still it is not a trade, nor an adventure in the nature of trade. And how does it help to ask the question: If it is not a trade, what is it? It is burglary and that is all there is to say about it."

Certain elements of a trade, for example, the intention to make a profit, repeated activities, planning and organisation, may be present but the thief's activities lack the key commercial character of a trade when it comes to sourcing the relevant goods (in this case, the stolen funds). The stolen moneys are not obtained through normal commercial means and are not received as a reward for the provision of any goods or services. The act of embezzlement, fraud or theft is not a trade.

Under section 23(*o*) a thief will also not be able to secure a deduction for any fines or penalties incurred as a result of an illegal activity or for any corrupt payments.[56]

6. Conclusion

Expenditure and losses incurred by a taxpayer in carrying on a trade as a result of embezzlement, fraud or theft of money and any legal and forensic expenditure incurred in investigating the crime will qualify as a deduction in determining taxable income provided it meets the requirements of section 11(*a*) or in the case of legal expenses, section 11(*c*). An important factor in determining the deductibility of the expense or loss will be whether the risk of its incurral was a necessary incident of the taxpayer's trade. Any amounts allowed as a deduction which are recovered or recouped must be included in the taxpayer's income.

A person who derives funds illegally, whether by embezzlement, fraud or theft, is regarded as having "received" those funds for the purposes of the definition of "gross income" in section 1(1) and will be subject to income tax on those funds. No deduction will, however, be permitted for the repayment of those funds.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

---

55 1963 AC 1 at 20.

56 See Interpretation Note No. 54 dated 26 February 2010 "Deductions – Corrupt Activities, Fines and Penalties".

Annexure – The law

Section 1(1) – Definition of "gross income"

"gross income", in relation to any year or period of assessment, means—

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

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely—

. . .

Section 11(*a*)

11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

(*a*) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

. . .

(*c*) any legal expenses (being fees for the services of legal practitioners, expenses incurred in procuring evidence or expert advice, court fees, witness fees and expenses, taxing fees, the fees and expenses of sheriffs or messengers of court and other expenses of litigation which are of an essentially similar nature to any of the said fees or expenses) actually incurred by the taxpayer during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade: Provided that the amount to be allowed under this paragraph in respect of any such expenses shall be limited to so much thereof as—

(i) is not of a capital nature; and

(ii) is not incurred in respect of any claim made against the taxpayer for the payment of damages or compensation if by reason of the nature of the claim or the circumstances any payment which is or might be made in satisfaction or settlement of the claim does not or would not rank for deduction from his income under paragraph (*a*); and

(iii) is not incurred in respect of any claim made by the taxpayer for the payment to him of any amount which does not or would not constitute income of the taxpayer; and

(iv) is not incurred in respect of any dispute or action at law relating to any such claim as is referred to in paragraph (ii) or (iii) of this proviso;

Section 23(*c*) and (*g*)

23. Deductions not allowed in determination of taxable income.—No deductions shall in any case be made in respect of the following matters, namely—

. . .

(*c*) any loss or expense, the deduction of which would otherwise be allowable, to the extent to which it is recoverable under any contract of insurance, guarantee, security or indemnity;

. . .

(*g*) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;

Paragraph 13(1)(*b*) and (*c*) of the Eighth Schedule

13. Time of disposal.—(1) The time of disposal of an asset by means of—

(*a*) . . .

(*b*) the extinction of an asset including by way of forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment, the date of the extinction of the asset;

(*c*) the scrapping, loss or destruction of an asset is the date—

(i) when the full compensation in respect of that scrapping, loss or destruction is received; or

(ii) if no compensation is payable, the later of the date when the scrapping, loss or destruction is discovered or the date on which it is established that no compensation will be payable;