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1 Introduction

Moneymaking schemes such as prostitution, drug dealing, pyramid schemes and the sale of counterfeit goods have been around for years. Taxing and moreover the application of Value Added Tax on these transactions/schemes has become a contentious issue. In the case of *MP Finance Group CC (In Liquidation) v CSARS,*[1] the High Court of Appeal ruled that income 'received by' a taxpayer from illegal gains will be taxable in the hands of the taxpayer. The question arises, however, whether the decision in the *MP Finance* case (and other preceding cases on illegal receipts) can also be applied to determine the output VAT liability of VAT vendors. Furthermore, does the decision in *MP Finance* have the far-reaching consequence that "enterprises" conducting their business by illegal means should register as VAT vendors? Ultimately, should a prostitute[2] or a dealer in counterfeit goods[3] register as a VAT vendor and subsequently account for output VAT and if so, can the prostitute or dealer in counterfeit goods claim input VAT on his/her trading expenses? In order to understand the question better, some background information is needed.

2 Background

Generally, any person (natural or juristic) who carries on an enterprise or business within the Republic and who generates taxable supplies in excess of R1 million per annum should register as a VAT vendor and should ultimately levy VAT at 14%[4] (or at 0% in terms of section 11) on the supply of goods or services within the Republic or on the importation of goods or services to the Republic by that person.[5] However,

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1 *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.

2 Prostitution is a criminal offence in terms of s 20(1)(a), (c) *Sexual Offences Act* 23 of 1957.

3 Dealing in, export or import of, manufacture of, and, or the disposal of counterfeit goods is illegal in terms of s 2(1) *Counterfeit Goods Act* 37 of 1997.

4 Section 7(1) *Value Added Tax Act* 89 of 1991.

5 Section 23(1) read together with s 7(1) *Value Added Tax Act* 89 of 1991. Also see Beneke and Silver *VAT Handbook* 19-24, 157; De Koker and Kruger *Value Added Tax* para 2.1, para 12.1;

a VAT vendor is only required to account for output VAT on goods or services rendered "in the course or furtherance of any enterprise carried on by him."[6] This excludes a once off or private domestic deal. As the end user is the ultimate bearer of the tax burden under a VAT system,[7] a vendor may, subject to exclusions and limitations, deduct input VAT from his output VAT liability[8] on any goods or services acquired or imported (goods only) by that vendor where the goods and services are intended to be used in the course of making taxable supplies.[9] In order to determine whether a person who renders illegal services or who supplies illegal goods should register as a VAT vendor and ultimately levy VAT on the service or goods supplied, it is paramount that the definition of 'enterprise' should be discussed.

3 'Enterprise'

In terms of section 1 the term 'enterprise' means:

> (a) in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club;

In order to establish whether or not a person is carrying on an enterprise the following elements should be present:

i) a continuous or regular activity

ii) carried on within the Republic

Clegg *Practical Guide* 1-8; Morris, Huxham and Haupt *Getting to Know VAT* 9; Ferguson and Rubin *Handy Guide* 1-4, 6-12; Huxham and Haupt *South African VAT* A7-A9; James *VAT Demystified* 3-4, 8-9; Stiglingh *et al South African Income Tax 2011* 942-943.

6 *Metcash Trading Ltd v Commissioner South African Revenue Services* 2001 1 SA 1109 (CC) 1120 [12]-[13]; *Shell's Annandale Farm (Pty) Ltd v Commissioner, South African Revenue Services* 2000 3 564 (C) 573.

7 Beneke and Silver *VAT Handbook* 3; Stiglingh *et al South African Income Tax 2011* 943.

8 Section 16(3) *Value Added Tax Act* 89 of 1991. Also see James *VAT Demystified* 27; Ferguson and Rubin *Handy Guide* 53; Morris, Huxham and Haupt *Getting to Know VAT* 28; Huxham and Haupt *South African VAT* A65; Clegg *Practical Guide* 47; De Koker and Kruger *Value Added Tax* para 2.3; Beneke and Silver *VAT Handbook* 119-121.

9 Also see the interpretation of s 16(3) in *Metcash Trading Ltd v Commissioner South African Revenue Services* 2001 1 SA 1109 (CC) 1122 [15]; *Price Waterhouse Meyernel v Thoroughbred Breeders' Association of South Africa* 2003 3 SA 54 (SCA) 62 [21]; *Milner Street Properties (Pty) Ltd v Eckstein Properties (Pty) Ltd* 2001 4 SA 1315 (SCA) 1320 [2].

iii) the supply of goods or services to any other person

iv) for consideration.

Each of these elements will now be discussed to determine whether a prostitute or dealer in counterfeit goods is carrying on an enterprise for the purposes of registration as a VAT vendor, and the subsequent output VAT liability of such vendor.

3.1 Continuous or regular activity

It is clear from the professions listed in the definition of an enterprise that an enterprise is limited to the genus of a commercial activity of some kind, or to an active continuous business, in contrast to a once-off supply of goods or services. A continuous activity is an activity that is prolonged over a period of time without any interruption.[10] A regular activity is an activity that is carried on at periodical or frequent intervals or - to put it differently - a usual activity.[11] Ostensibly a once off activity or irregular activity, that is to say an activity that is carried on by chance instead of frequently, does not constitute a trade. For example, where a person trades in his vehicle every five years to enable him/her to purchase a new vehicle, the trading in of the vehicle will not constitute a regular activity and the person is not carrying on an enterprise for VAT purposes. A once-off disposal of counterfeit goods at a flea market would probably not constitute an enterprise for VAT registration purposes (see the full discussion under paragraph 5).

3.2 Carried on within the Republic

Although goods and services that are exported from the Republic attract VAT at 0%[12] (and can be construed in layman's terms as VAT-less supplies), exporters operating from the Republic (or partly from the Republic) should still register as VAT vendors if their taxable supplies (a zero rated supply is a taxable supply)[13] exceed

10 Collins *English Dictionary*; Soanes and Stevenson *Concise Oxford English Dictionary.*

11 Collins *English Dictionary*; Soanes and Stevenson *Concise Oxford English Dictionary.*

12 Section 11(1)(*a*) *Value Added Tax Act* 89 of 1991.

13 Section 11(1)(*a*) *Value Added Tax Act* 89 of 1991; Beneke and Silver *VAT Handbook* 16, 75; De Koker and Kruger *Value Added Tax* para 5.1.

R1 million per annum. The requirement is that the enterprise or business should be conducted in the Republic. The place of supply of the goods or services is irrelevant for purposes of determining whether an activity constitutes an enterprise. It is furthermore irrelevant whether the person (who should or wishes to register as a VAT vendor) is resident in South Africa as long as the enterprise is conducted in South Africa.[14] It should, however, be noted that vendor registration is dependent on the fact that the applicant has a fixed abode or business and has a South African bank account.[15] Therefore, where a seller of counterfeit goods or a prostitute operates his/her business from South Africa, irrespective of whether the goods or services are exported, he or she complies with the requirement of "carried on within the Republic" of the definition of "enterprise."

3.3 The supply of goods or services to any other person

As a consumer tax, VAT is primarily levied on the consumption of goods and services.[16] Goods are defined in section 1 as "corporeal movable things, fixed property, and any real right in any such thing or fixed property, and electricity …" Excluded from the definition are money, rights under a mortgage bond and stamps.[17] The goods supplied to a person need not be consumed (opgebruik in Afrikaans); a mere use (gebruik) of the item should suffice to attract VAT. The word 'or' in the definition of enterprise indicates that if a person delivers goods and/or renders services to another person this may constitute an enterprise. An enterprise is therefore not restricted to either goods or services. It is important to note that more than one person (or one person acting in more than one capacity) should be involved in order to make a supply.[18] In other words, a supplier and recipient should exist. "Person" is defined in section 1 as including any public authority, company, body of persons, or the estate of any deceased or insolvent person. Goods and services rendered to or by juristic persons would also constitute a supply. In the absence of legislation, case law or a practice (interpretation) note to the contrary, the supply of illegal goods, or the supply of goods by illegal means, satisfies the requirement of

14 De Koker and Kruger *Value Added Tax* para 12.4; Beneke and Silver *VAT Handbook* 25.
15 Section 23(7) *Value Added Tax Act* 89 of 1991.
16 Beneke and Silver *VAT Handbook* 3.
17 Section 1 *Value Added Tax Act* 89 of 1991.
18 Beneke and Silver *VAT Handbook* 20; Stiglingh *et al South African Income Tax 2011* 944.

supply for the purposes of the definition of enterprise and section 7(1)(*a*) if the goods are supplied to a person (or juristic person) to be used and enjoyed.

"Services" is defined in section 1 as:

> anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (c) of the definition of "goods";

Ostensibly services can be seen as all other "things" that can be either consumed or used by a person but that fall outside the scope of the definition of goods. Where something is done or is to be done to another person (either by an illegal act or with an illegal result) this satisfies the requirement of rendering a service for the purposes of the definition of "enterprise" and section 7(1)(a).

3.4 For consideration

Consideration is defined in section 1 as meaning:

> in relation to the supply of goods or services to any person, includes any payment made or to be made (including any deposit on any returnable container and tax), whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain: Provided that a deposit (other than a deposit on a returnable container), whether refundable or not, given in respect of a supply of goods or services shall not be considered as payment made for the supply unless and until the supplier applies the deposit as consideration for the supply or such deposit is forfeited;

From the definition of consideration read together with the definition of enterprise it is clear that there should be some sort of *quid pro quo* when the goods are delivered or when the services are rendered. It is irrelevant whether a profit is made or a loss is suffered. The consideration can be provided on either a voluntary or an involuntary basis.[19] The supplier of the goods or services need not intend to make a profit or

[19] Beneke and Silver *VAT Handbook* 20; see however the *dicta* in *Shell's Annandale Farm (Pty) Ltd v Commissioner, South African Revenue Services* 2000 3 564 (C) 241-242 before the amendment of the Act in 1999, where Davis J ruled that 'supply' means that the taxpayer should have actively taken part in the disposal of the goods and that the taxpayer did not act in the case

"earn income" from the proceeds. The recipient of the consideration need not be the supplier of the goods or services.[20] A mere causal link between the goods supplied or services rendered and the consideration is sufficient to attract VAT.[21] In the absence of any indication to the contrary, the consideration received for illegal goods or services or the question whether the transaction took place by means of illegal tender will not negatively affect the fact that such a transaction will *prima facie* attract VAT. Therefore, in principle, where a prostitute regularly delivers goods or renders services in the Republic to another person for consideration (in money or in kind), the prostitute's business will constitute an enterprise. In the absence of any case law specifically dealing with the VAT-ability of the supply of illegal goods or the rendering of illegal services for consideration, case law on the income tax liability of a taxpayer on illegal receipts might prove to shed some light on the question whether a prostitute or dealer in counterfeit goods should register as a VAT vendor and subsequently levy VAT on his or her supplies.

4 Income tax liability on illegal receipts

4.1 The court's interpretation of "received by" or "accrued to"

In short, it can be said that in terms of the definition of gross income a taxpayer will have to account for income tax on "actual receipts" or "accrual" or "receipts in favour of the taxpayer" of money or payment in kind.[22] The words "received by" and "accrued to" are not defined in the Act and case law is clear that "received by" can only be interpreted as such where a taxpayer received an amount or otherwise for his or her own benefit.[23] Further, in case law the meaning attached to "accrued to" is

of expropriation and can thus not be construed to be a supply for taxable purposes. Also see *Metcash Trading Ltd v Commissioner South African Revenue Services* 2001 1 SA 1109 (CC) 1122 [17].

20 Beneke and Silver *VAT Handbook* 30; Stiglingh *et al South African Income Tax 2011* 949.

21 Beneke and Silver *VAT Handbook* 30; Stiglingh *et al South African Income Tax 2011* 949.

22 Section 1 *Income Tax Act* 58 of 1962; Stiglingh *et al South African Income Tax 2010* 13-25; Stiglingh *et al South African Income Tax 2011* 13-24; Meyerowitz *Meyerowitz on Income Tax* para 5.7-5.14; Huxham and Haupt *Notes on South African Income Tax* 18-23.

23 *Geldenhuys v CIR* 1947 3 SA 265 (C) 266-267; *Brooks Lemos Ltd v CIR* 1947 2 SA 976 (A) 983-984; *Ochberg v CIR* 1933 CPD 256 263-264.

"to be unconditionally entitled to" the amount in question.[24] Various cases have hinged on the question whether or not receipts or accruals from illegal means are indeed taxable.[25] The issue confronting the courts was the maxim *ex turpi causa non oritur actio* in terms of which no consequence can arise from illegal contracts.[26] For this reason there has been a great deal of uncertainty as to whether the taxpayer who received an amount from illegal means received it for his or her own benefit,[27] or whether the taxpayer was unconditionally entitled to the amount.[28] Where legislation does not expressly state that a contract that contravenes the provisions of the act shall be void it is often difficult to determine the enforceability of the agreement unless the legislator's intention can be imputed.[29] It can be said that where a penalty is imposed on persons contravening the act, the natural conclusion is that the contract is also void and unenforceable.[30] However in *Rooiberg Minerals Development Co Ltd v Du Toit*[31] Blackwell J ruled that the mere fact that a dealer in vehicles did not correctly complete the statutory forms (and thus committing a criminal offence) does not render the whole agreement void. It should be determined

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24 *Lategan v CIR* 1926 CPD 203 209. Also see the judgements by Wessels CJ and Curlewis JA in *CIR v Delfos* 1933 AD 242 251 onwards; *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 2 SA 353 (A) 367 C-D.

25 In *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391 394 the court expressed the opinion that the source of income - legal or illegal - is irrelevant for purposes of determining taxable income. Bristowe J, in following the earlier English case of *Partridge v Mallandaine* 1886 2 TC 179-180, opined that it is common sense that if illegal profits are taxable they should be subject to the same deductions as if they were legal. In *ITC 11282* 2005 ZATC 5 (18 March 2005), Malan J ruled that illegal income is only taxable in the hands of the taxpayer if the income was received for the benefit of that taxpayer. In *ITC 1545* 54 SATC 464, Scott J ruled that where the taxpayer was aware of the illegality of the transaction (in this case the sale of stolen diamonds) the proceeds 'received' by the taxpayer amounted to 'gross income'. This should be distinguished from a mere 'taking' by a thief, which is no receipt at all.

26 Christie *Law of Contract* 337-402; Kerr *Principles* 181-203; Maasdorp *Institutes* 22-23; Van der Merwe *et al Kontraktereg* 211.

27 *Geldenhuys v CIR* 1947 3 SA 265 (C) 266-267. In *ITC 1624* 59 SATC 373, the court did not deal with the issue of mutual intention but merely ruled that the taxpayer had 'received' the proceeds from fraudulently overcharging clients as he intended to receive the amounts for his own benefit; see also Webber Wentzel Attorneys 2005 www.webberwentzel.com.

28 *Lategan v CIR* 1926 CPD 203 209; Olivier 2008 *TSAR* 814; Muller 2007 *Obiter* 166; Classen 2007 *SA Merc LJ* 534-553; Pugsley 2001 *Tax Planning* 89, 90; Vanek 2008 www.moneywebtax.co.za: In *ITC 1792* 67 SATC 236, the court steered away from the taxpayer's intention and followed an objective approach to determine whether the taxpayer was 'entitled' to the amount received. The fact that the taxpayer returned the proceeds of his illegal ventures to his principal convinced the court that the taxpayer had never been entitled to the earnings and the court therefore ruled that the amount was not taxable in the taxpayer's hands.

29 Christie *Law of Contract* 338; Kerr *Principles* 181.

30 Kerr *Principles* 181-203; Maasdorp *Institutes* 22-23; Van der Merwe *et al Kontraktereg* 211; *Hamilton-Browning v Dennis Barker Trust* 2001 4 SA 1131 (N) 1135; *Henry v Branfield* 1996 1 SA 244 (D) 250; *Swart v Smuts* 1971 1 SA 819 (A) 829-831; *Barclays National Bank v Brownlee* 1981 3 SA 579 (D) 582-584.

31 *Rooiberg Minerals Development Co Ltd v Du Toit* 1953 2 SA 505 (T) 509.

if the void part of the agreement is severable from the rest of the agreement. Smith J ruled that the indications for invalidity and validity must be weighed against each other. It is submitted that the reasonable person in South Africa knows that prostitution is illegal and should consequently know that a prostitution contract is void *ab initio* and that restitution (on whatever basis) cannot be claimed (*in pari delicto potior est conditio defendentis).*[32] Can the same principles apply to the unsuspecting buyer of counterfeit goods? For example, where the purchaser thought, as a result of contractual mistake or misrepresentation by the seller, that the goods were genuine, it could be argued that the contract will not only be void because of the illegality of the agreement (*Ex turpi causa non oritur actio*)[33] but it may also be void or voidable for another reason such as mistake[34] or misrepresentation.[35] In the case of misrepresentation, the seller will not be entitled to the proceeds as the purchaser has a legal right to restitution based on unjustified enrichment or he can claim his money back with the *rei vindicatio.*[36] It should however be noted that the agreement remains illegal and unenforceable irrespective if one party was induced to believing that the agreement was legal.[37] The *in pari delictio potior est conditio defendentis* principle may under certain circumstances be departed from to prevent an injustice for example where one party was completely innocent or has less guilt than the other party.[38] The plaintiff, however, cannot enforce the contract. Where both parties are equally at fault the seller would not be entitled to keep the performance already received or claim the outstanding performance nor would the purchaser be entitled to claim restitution or delivery of the *merx.*[39] Does this mean that the seller is "entitled" to the performance already received where restitution is not allowed? If the "entitlement" approach is followed to determine the VAT-ability of a transaction the intention of both the seller and the purchaser of goods or services should be determined objectively. It is submitted that this approach should not be followed as it

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32 Christie *Law of Contract* 392; Kerr *Principles* 195.
33 Christie *Law of Contract* 392; Kerr *Principles* 196.
34 Christie *Law of Contract* 314; Kerr *Principles* 264.
35 Christie *Law of Contract* 286-293; Kerr *Principles* 285-287; Van der Merwe *et al Kontraktereg* 123-124.
36 Christie *Law of Contract* 286-293; Kerr *Principles* 196; Van der Merwe *et al Kontraktereg* 21; Hutchison and Pretorius *Kontraktereg* 199-201.
37 Christie *Law of Contract* 393.
38 *Jajbhay v Cassim* 1939 AD 537; *Klokow v Sullivan* 2006 1 SA 259 (SCA) 264-265; *First National Bank of Southern Africa Ltd v Perry* 2001 3 SA 960 (SCA) 969; *Warren and De Ville v Cacouris* 1951 2 SA 574 (T) 577; *Mamoojee v Akoo* 1947 4 SA 733 (N) 738-739; Vos 2006 www.deneysreitz.co.za.
39 *Jajbhay v Cassim* 1939 AD 537; *Klokow v Sullivan* 2006 1 SA 259 (SCA) 264-265.

would be virtually impossible to determine the seller's entitlement to the proceeds in the absence of a purchaser's evidence. Some of these transactions are completely anonymous and the staggering number of customers would ultimately lead to chaos in the witness stand.

In the *MP Finance*-case,[40] the Supreme Court of Appeal has finally closed the book on the issue of the taxation of illegal income and has hopefully eliminated any possible biases. *In casu* the taxpayer initially received cash from investors with the intention of returning the initial investment and possible interest or dividends to the investors. Upon liquidation of the consolidated entity the commissioner assessed the entity on the amounts received from the investors. The liquidators contended that the amounts were not "received" within the meaning of the definition of gross income because the taxpayer had the intention of returning the initial investments to the investors, possibly with interest or dividends. Howie P ruled that, for the years of assessment in question, the perpetrators (taxpayer) of the scheme were aware of its illegality but they continued to fraudulently "receive" money from investors.[41] Furthermore, they knew that it would be impossible to return the money to the initial investors.[42] With these facts in mind, Howie P ruled that whatever the original intention may have been, it changed to an intention to make money by swindling innocent investors.[43] The court ruled that the amounts were "received" by the taxpayer irrespective of whether there was any obligation to repay the amounts. Olivier[44] states that it can be concluded that even unilateral takings are taxable and that the intention of the recipients is irrelevant. It is submitted, however, that Howie P did not explicitly rule that the recipient's intention is irrelevant but only that the question whether the amounts are or are not repayable in law is irrelevant. A swindler will take money for his or her own benefit in any event, even if he or she is aware of an underlying duty to repay or return the amount. It is submitted that it cannot be said, by implication, that the recipient's intention subsequently becomes irrelevant.

40 *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141.
41 *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141 523 H-I.
42 *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141 523 I.
43 *MP Finance Group CC (In Liquidation) v CSARS* 69 SATC 141 524 A-B.
44 Olivier 2008 *TSAR* 819.

In conclusion the requirement of "received by" as construed by the courts can be said to amount to something that was received by the taxpayer for his or her own benefit. The question arises whether the interpretation by the courts of "received by" for purposes of illegal income can be extended to mean "for consideration" for VAT purposes. For this reason a comparison should be drawn between the charging provision of the *Income Tax Act* and the *VAT Act*.

4.2 "For consideration" vs "received by or accrued to or in favour of"

It has been established above that the charging provision in terms of the definition of "gross income" in section 1 of the *Income Tax Act* is concerned with the intention of the taxpayer when an amount was received by (or accrued to) the taxpayer. For an amount to be taxable, the taxpayer should have intended to receive the amount in question for his or her own benefit. The charging provision in terms of section 7(1) of the *VAT Act* is, however, not concerned with a beneficial intention on the part of the recipient of the consideration. To invoke VAT, section 7(1) only requires goods to have been supplied or services rendered for consideration in the course or furtherance of an enterprise (A mere *quid pro quo is* required.). From the definition of "consideration"[45] it is clear that the intention of the recipient to receive the amount for his or her benefit is irrelevant, for the following reasons: (i) The consideration should have been made as a counter performance for goods supplied of services rendered;[46] (ii) it is irrelevant whether consideration was voluntarily or involuntarily provided;[47] and, (iii) it is irrelevant whether the consideration was paid to the supplier of the goods or to the person who rendered the services or to any other person, such as an assistant or debt collector.[48] In *National Educare Forum v C:SARS*[49] Van Zyl J ruled that the charging provision in terms of section 7(1) requires a) a supply of goods and services and b) that the supply should take place in the course or furtherance of an enterprise.[50] It is submitted that Van Zyl erred in his judgment by omitting a third requirement, namely that the supply should be made for consideration (irrespective of the value of the consideration or the method of

45 Section 1 *Value Added Tax Act* 89 of 1991.
46 Beneke and Silver *VAT Handbook* 29.
47 Beneke and Silver *VAT Handbook* 30; Stiglingh *et al South African Income Tax 2011* 946.
48 Beneke and Silver *VAT Handbook* 30; Stiglingh *et al South African Income Tax 2011* 946.
49 *National Educare Forum v CSARS* 2002 3 SA 111 (TkHC).
50 *National Educare Forum v CSARS* 2002 3 SA 111 (TkHC)129-130.

payment). It is, however, evident that no beneficial intention is required from the vendor in terms of section 7(1). In *Metcash Trading ltd v Commissioner, South African Revenue Services* [51] Kriegler J mentioned that VAT vendors are involuntary tax collectors on behalf of the Receiver of Revenue. For these reasons it is submitted that, strictly speaking, no analogy can be drawn between the interpretations of "received by" for purposes of income tax and "for consideration" for purposes of VAT. That said, the question arises whether there is any need to determine the intention of the VAT vendor in cases of illegal transactions. Although this cannot be objectively established, it can be assumed that the reasonable businessman will operate his or her business with the intention of making a profit. Moreover, the intention of making a profit will probably be coupled with the intention of making a profit for his or her own benefit. But in the light of the absence of the intention or benefit requirement in the charging provision in section 7(1) read with the definition of "consideration" in section 1, any inquiry into the intention of the vendor in cases of illegal transactions will prove to be a futile exercise. It is therefore suggested that the case law interpretation of "received by" for illegal income serves no purpose in determining the VAT-ability of illegal transactions. That said, it is clear from the case law on the income taxability of illegal income that the courts are in agreement that the illegality of the underlying agreement (and the subsequent unenforceability thereof in applying the *ex turpi*-rule) has no effect on the taxability of the proceeds. The courts merely test whether the proceeds of the illegal agreement comply with the definition of gross income (moreover the interpretation of "received by"), and if so, it is taxable. Conversely, in applying the principles of tax neutrality, it is clear that taxation is not concerned with the legality or illegality of a transaction. It is merely required that the transaction in question must comply with the taxing requirements for it to be taxed. It is submitted that the same argument can be followed to determine if VAT should be levied on an illegal transaction. The mere fact that the prostitution agreement or the sale-of-counterfeit-goods-agreement is void *inter partes* should not affect the VAT-ability of the agreement or proceeds of the agreement. However, where the illegal contract was induced by the misrepresentation by the seller, the agreement remains invalid but the seller may be obliged to return the purchase price and VAT (provided that a credit note was issued

51 *Metcash Trading Ltd v Commissioner, South African Revenue Services* 2001 1 SA 1109 (CC).

in terms of section 21(1)) to the purchaser since the parties are not *in pari delicto.* Under normal circumstances (legal and enforceable contracts) VAT is levied on the supply of goods irrespective if the supplier becomes conditionally or unconditionally entitled to the amount. Where an amount is received conditionally and the supplier must at some stage return the amount, the supplier must account for output VAT when the invoice was issued (or payment received),[52] and may claim input VAT when the amount is returned (wholly or in part) to the customer.[53] It is therefore submitted that the charging provision in terms of section 7(1) is clear that any supply of goods or services in the furtherance of an enterprise for consideration will attract VAT irrespective of whether the supply or consideration is illegal or was obtained illegally. The question now arises whether or not a prostitute or dealer in counterfeit goods should register as a VAT vendor in terms of section 23(1) and whether such person would be entitled to claim input VAT on goods or services acquired to make taxable supplies.

5 Duty to register?

In terms of section 23(1)(*a*), a person who carries on an enterprise becomes liable to register as a VAT vendor if the total annual value of the taxable supplies (standard and zero rated supplies) exceeds or (in terms of subparagraph (*b*)) is likely to exceed R1 million. A person operating a continuous or regular activity (enterprise) in the Republic, which activity is likely to yield annual taxable supplies exceeding R50 000 may apply at the Commissioner for voluntary vendor registration.[54] If the Commissioner is not satisfied that the voluntary applicant has a fixed place of business, proper accounting system or bank account, the Commissioner may refuse to register the applicant as a VAT vendor.[55] The onus is on the applicant VAT vendor to satisfy the Commissioner by submitting proof of identification, copies of at least 3 month's bank statements, proof of appointment of an accountant and proof of place of business. Neither section 23 nor section 24 (or any other provision in the Act) prohibits vendor registration if the enterprise is solely or partially operated by illegal

52 Section 9(1) *Value Added Tax Act* 89 of 1991.
53 Section 21(1) *Value Added Tax Act* 89 of 1991.
54 Section 23(3)(*d*) *Value Added Tax Act* 89 of 1991.
55 Section 23(7) *Value Added Tax Act* 89 of 1991. The Commissioner may also refuse voluntary registration if the vendor has previously registered as an enterprise under the *Sales Tax Act* 103 of 1978 and it was found that it failed to perform its duties under the act.

means. In the absence of any provision to the contrary, a person who carries on an enterprise by illegal means - either by rendering illegal services such as prostitution or by supplying illegal goods such as counterfeit goods or where the enterprise itself is illegal (for example the sale of liquor without a licence) - where the total annual taxable supplies exceed or are likely to exceed R1 million should register as a VAT vendor. Similarly, illegal enterprises may, in the absence of any provision to the contrary, register as VAT vendors if the enterprises' taxable supplies exceed R50 000 per annum.[56] The question is, however, when such registration should take place? It is trite that once it has been determined that the activities are illegal, the national prosecuting authority will (in all probabilities) charge the person operating the illegal enterprise with the applicable offence and if the person is found guilty, the activities will have to cease. After it has been established that the enterprise should have registered as a VAT vendor and should account for VAT, but once the enterprise has ceased all activities owing to criminal charges, can the Commissioner claim output VAT retrospectively on the goods or services illegally supplied before the activities stopped? For this purpose it is important to note that a vendor's liabilities in terms of the act are not affected by the fact that the person ceased to be a vendor.[57] But what happens where the enterprise failed to register as a VAT vendor and the duty to register as such only became evident after the activities had ceased as a result of criminal charges having been brought against the person? The Commissioner may assess and recover any unpaid output VAT for a period of five years from the date of supply.[58] This right may only be invoked after expiration of the 5-year period and only if it has been shown that the underpayment or failure to pay was due to bad faith on the part of the person responsible for such payment.[59] Section 41(*d*) will not apply to cases where the Commissioner has issued a written decision or general written ruling before 1 January 2007 that is binding on supplies or imports made after 1 January 2007.[60] Conversely, the Commissioner may, once it becomes evident that a person has made illegal taxable supplies and should have

56 Provided that the applicant taxpayer has satisfied the commissioner of the additional requirements in s 23(7).

57 Section 26 *Value Added Tax Act* 89 of 1991.

58 Section 41(d) *Value Added Tax Act* 89 of 1991. See also Beneke and Silver *VAT Handbook* 206; De Koker and Kruger *Value Added Tax* para 18.4

59 Section 41(d) *Value Added Tax Act* 89 of 1991. See also Beneke and Silver *VAT Handbook* 206; De Koker and Kruger *Value Added Tax* para 18.4

60 Section 41(*d*)(i), (ii) *Value Added Tax Act* 89 of 1991; Beneke and Silver *VAT Handbook* 207.

registered as a VAT vendor, at the end of a five-year period, claim output VAT retrospectively for the previous five years on the illegal taxable supplies. It is doubtful, however, whether the Commissioner will be successful in claiming past output VAT if the activities in question ceased after a once-off event. The following is an example: A person sold counterfeit goods at a flea market but got caught during his first day of business. Criminal charges were brought against the person and all activities ceased immediately. Clearly the activities did not take place frequently and would therefore not constitute an enterprise as defined. Hypothetically, the vendor would have continued with his business if he had not been caught. If it can be argued that, based on the sales of the day, the vendor would have made taxable supplies in excess of R1 million per annum if he had continued with his activities, the Commissioner should be successful in claiming past output VAT on the day's taxable supplies as if it had been a regular activity. It should be noted that for these purposes the onus of proof is on the person liable for output VAT to show that the supplies in question are/were not taxable and not on the Commissioner to prove that the amount is taxable.[61] Once registered (or once the Commissioner has invoked his right to claim unrecovered output VAT on past supplies in terms or section 41(d)), the question arises whether an illegal vendor may claim input VAT before accounting for output VAT (and if input VAT may be claimed retrospectively on past supplies).

6 Input VAT

The tax burden of VAT is carried by the final consumer and is collected on behalf of the Commissioner by vendors.[62] In order to prevent double taxation or tax on tax, vendors may deduct, from their output VAT liability on taxable supplies, input VAT paid on goods and services acquired to enable the vendor to make taxable supplies.[63] From the definition of input VAT in section 1 it can be deduced that a

61 Section 37 *Value Added Tax Act* 89 of 1991.

62 Beneke and Silver *VAT Handbook* 3, 13.

63 Section 16 read together with s 17 *Value Added Tax Act* 89 of 1991. See also Beneke and Silver *VAT Handbook* 119-120; De Koker and Kruger *Value Added Tax* para 2.3; *Price Waterhouse Meyernel v Thoroughbred Breeders' Association of South Africa* 2003 3 SA 54 (SCA) 171; *Weare v Commissioner, South African Revenue Services* 2005 4 SA 488 (SCA) 495; *Metcash Trading Ltd v Commissioner, South African Revenue Services* 2001 1 SA 1109 (CC) 1121; *Milner Street Properties (Pty) Ltd v Eckstein Properties (Pty) Ltd* 2001 4 SA 1315 (SCA) 1365.

vendor will be entitled to deduct input VAT on goods or services acquired by the vendor wholly or partly to make taxable supplies.

It is not necessary for the vendor to have acquired the goods or services personally. Where an employee of the vendor's acquired the goods or services on behalf of the vendor the vendor will be entitled to claim the input tax provided that a tax invoice was issued and the employee was reimbursed.[64]

The definition envisages a pro rata allocation where the goods acquired are partially used to make standard or zero rated supplies and partly to make exempt supplies. In this case, a vendor may be required to claim an adjusted input calculated as a *pro rata* percentage of the taxable supplies it represents.[65] An apportionment is only required if the intended use to make taxable supplies is less than 95% of the total use.[66]

It is not required that the goods or services acquired by the vendor should in turn be supplied to another person.[67] The vendor may consume the goods and services as part of his trade; examples here would be cleaning materials, telecommunication services and electricity. The purpose of the acquisition must, however, be to make taxable (standard rated or zero rated) supplies. Goods or services acquired for private domestic consumption will not qualify for an input tax deduction as the vendor will then be the last consumer who bears the tax burden.[68]

In terms of section 23(o) of the *Income Tax Act*[69] a taxpayer will not be allowed a deduction where the expenditure incurred contemplates an activity in terms of Chapter 2 of the *Prevention and Combating of Corrupt Activities Act*[70] or if it constitutes a fine or penalty for unlawful activities. No similar provision can be found

64 Section 16(2)(a) *Value Added Tax Act* 89 of 1991; see also De Koker and Kruger *Value Added Tax* para 2.3.

65 Section 17(1) *Value Added Tax Act* 89 of 1991; see also De Koker and Kruger *Value Added Tax* para 2.3.

66 Section 17(1)(i) *Value Added Tax Act* 89 of 1991; see also Beneke and Silver *VAT Handbook* 125.

67 Section 17(1)(i) *Value Added Tax Act* 89 of 1991; see also Beneke and Silver *VAT Handbook* 125.

68 Beneke and Silver *VAT Handbook* 3.

69 *Income Tax Act* 58 of 1962.

70 *Prevention and Combating of Corrupt Activities Act* 12 of 2004.

in the *VAT Act*. Therefore, in the absence of any provision, case law or practice/ interpretation note to the contrary, it is evident that a vendor - acting as a mere debt collector on behalf of SARS - should be entitled to claim input tax on its taxable supplies irrespective of whether the taxable supplies are illegal or are supplied illegally. Bristow J in the *Delagoa*-case (*supra*) expressed the opinion that it is common sense that if an amount, which was received illegally or by illegal means, is taxable, that amount should be subject to the same allowable deductions as if the amount had been acquired legally.[71] In the USA case of *Commissioner of Internal Revenue v Doyle*[72] the court said that the court's aversion to the illegality of the transaction should not hinder the court's neutral application of the law. Conversely, if the expense complies with the requirements of the general deduction formula or the requirements for that specific type of deduction sought, it should be deductible. Similarly, a vendor who should account for output VAT on supplies should be entitled to an input VAT deduction on the same supplies.

It is almost certain, however, that illegal activities or enterprises will only be exposed after criminal charges have been laid. A person conducting an illegal enterprise is unlikely to disclose his or her illegal activities to the Commissioner. It is therefore trite that the output VAT liability of such enterprises will only be determined after the Commissioner has become aware of the activities and after the Commissioner has invoked his right to claim output VAT on past supplies in terms of section 41(d). The question therefore arises whether the said enterprise would be entitled to claim input VAT on goods or services acquired to make the past supplies. In the light of the Commissioner's rights in terms of section 41(d), the *dicta* in *Delagoa Bay* (*supra*) and the "vendor's" right to object to an assessment (in terms of section 32), a person should be able to claim input VAT on goods or services acquired to make past supplies provided that the person can prove (submit documentary proof) that the said goods and services were acquired by that person to make the past taxable supplies.[73]

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71 *CIR v Delagoa Bay Cigarette Co* 1918 TPD 391 394.
72 *Commissioner of Internal Revenue v Doyle* 231 F2d 635 (11 April 1956).
73 *Metcash Trading Ltd v Commissioner South African Revenue Services* 2001 1 SA 1109 (CC) 1124 [22].

For the current discussion it is important to note that section 17(2)(a) prohibits an input VAT deduction on goods or services acquired for the purposes of entertainment unless such goods or services are acquired to make taxable entertainment supplies in the ordinary course of business.[74] In *CIR v Namsov Fishing Enterprise (Pty) Ltd*[75] Strydom AJA ruled that section 19 of the *VAT Act* 10 of 2000 (NM)[76] is not aimed at denying an entertainment input to all vendors, but it is aimed at denying an entertainment input to any vendor whose enterprise or business is not involved in entertainment at all but who uses entertainment as a marketing or promotional strategy.[77] As is the case under the Namibian *VAT Act*, entertainment under the South African *VAT Act* is defined in the broadest terms to include the supply of food, beverages, amusement and recreation.[78] Neither section 17(2)(a) nor section 19 (NM) requires a vendor who wishes to claim entertainment input VAT to exclusively make entertainment taxable supplies.[79] All that is required is that it should be the vendor's regular business to supply taxable entertainment, for example cinemas, hotels, theatres and casinos.[80] The question arises whether the services rendered by a prostitute constitute a supply of entertainment in the ordinary course of business. Would the prostitute be entitled to claim input tax on entertainment goods and services acquired (such as food, beverages, pornographic films, sex toys and lubrication) to render taxable supplies to his/her clients? The *Concise Oxford Dictionary*[81] defines entertainment as "to provide amusement or enjoyment". It is submitted that a prostitute mainly supplies goods and services for the amusement or enjoyment of his/her clients. It can therefore be said that a prostitute makes taxable entertainment supplies in the ordinary course of business. Consequently, the entertainment input tax prohibition in terms of section 17(2)(a) will not apply to prostitutes.

74 Beneke and Silver *VAT Handbook* 128; De Koker and Kruger *Value Added Tax* para 2.4; Stiglingh *et al South African Income Tax 2011* 985.
75 *CIR v NAMSOV Fishing Enterprise (Pty) Ltd* 2009 2 SA 567 (NmS).
76 The Namibian equivalent of s 17(2)(*a*).
77 *CIR v NAMSOV Fishing Enterprise (Pty) Ltd* 2009 2 SA 567 (NmS) 572.
78 Section 1 *Vaule Added Tax Act* 89 of 1991.
79 *CIR v NAMSOV Fishing Enterprise (Pty) Ltd* 2009 2 SA 567 (NmS) 574.
80 *CIR v NAMSOV Fishing Enterprise (Pty) Ltd* 2009 2 SA 567 (NmS) 574.
81 Soanes and Stevenson *Concise Oxford English Dictionary.*

8 Charging VAT on illegal transactions in the European Union

In terms of the article 2 read together with articles 4 and 5 of the Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes,[82] VAT, in member states, is levied on the supply of goods or services by a taxable person who carries out an economical activity. In *Vereniging Happy Family Rustenburgerstraa Inspecteur der Omzetbelasting*[83] the Court of Justice of the European Communities ruled that, in interpreting article 2(1) and 4(1) of the Sixth Council Directive (77/338 EEC), a member state cannot levy VAT on the supply of goods or services if the supply of the goods or services is illegal. *In casu* the taxpayer sold small quantities of Hemp, an illegal substance in the Netherlands as well as the rest of the European Community. The Inspecteur[84] sought to claim turnover tax (VAT) based on the taxpayer's sales. The court ruled that the sale (movement) of narcotic drugs can only give rise to penalties under criminal law and is alien to the objectives of the Sixth Directive. VAT or General Sales Tax cannot be levied on the supply of goods where such supply (activity) is subject to possible criminal prosecution.[85] The court further ruled that the fact that the Netherland's Prosecuting Authority does not prosecute small dealers such as the taxpayer *in casu* does not legalise the transaction, it remains illegal in principle and therefore not taxable.[86] The only exception, when the sale of narcotic drugs can be taxable, is when the narcotic drugs are sold legally for medical or scientific purposes. Thus, illegal transactions can only give rise to criminal prosecution and penalties and has no tax consequences.

Article 5 of the Sixth Directive, to which the court did not refer, states that the supply of goods shall mean the transfer of the *right to dispose*[87] of ownership.[88] It is clear

82 *Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment* (77/388/EEC); see also Boomsma *et al VAT in Europe* 7-13.

83 *Vereniging Happy Family Rustenburgerstraa Inspecteur der Omzetbelasting* Case 289/86 ECJ.

84 Commissioner of Revenue in the Netherlands.

85 *Vereniging Happy Family Rustenburgerstraa Inspecteur der Omzetbelasting* Case 289/86 ECJ par 23, also see Dale and Nieuwenhuizen *VAT Yearbook* 134.

86 *Vereniging Happy Family Rustenburgerstraa Inspecteur der Omzetbelasting* Case 289/86 ECJ par 29, also see Dale and Nieuwenhuizen *VAT Yearbook* 134; Terra and Wattel *European Tax Law* 138.

87 Author's emphasis.

88 Buckett *VAT in the European Community* 38; Coopers and Lybrand *Guide to VAT* 13.

that where the possession of goods are in principle illegal the owner/possessor does not have the right to dispose of the ownership of the goods and the disposal does not fall under the requirements for the supply of goods. Similarly where a country's laws prohibits the sale of certain goods or prohibits the type of transaction the owner or possessor does not have the right to dispose of the goods. This argument, however, cannot be applied in the case of the supply of services (article 6 does not refer to the right to supply services).[89]

In the case of *R v Goodwin and Unstead*,[90] Mr. Goodwin and Mr. Unstead were charged with the fraudulent evasion of VAT in respect of sales of counterfeit perfumes. Goodwin and Unstead contended that the sale of counterfeit goods are precluded from the application of article 2 of the Sixth Directive not only because the sale agreements would be void and illegal but also because it infringe on a wide variety of intellectual property and it seriously undermine the functioning of the common market just like the sale of narcotics.[91] The court however distinguished the sale of counterfeit perfumes from the sale of narcotics in the *Happy Family*-case.[92] According to the court narcotics are in its nature, products that can never be incorporated in the market.[93] The sale of counterfeit goods is not prohibited because of the nature of the products but because of the detrimental effect that it has on the rights of third parties.[94] The prohibition of the sale of counterfeit goods is not absolute as is the case with narcotics.[95] The possibility of competition between lawful and unlawful products cannot be ruled out.[96] Counterfeit goods, unlike narcotics, cannot be regarded as *extra commercium*[97] and the sale thereof, however illegal, is subject to VAT.[98]

89 Buckett *VAT in the European Comminty* 39.
90 *R v Goodwin and Unstead* Case C-3/97 ECJ.
91 *R v Goodwin and Unstead* Case C-3/97 ECJ para 10; also see Dale and Nieuwenhuizen *VAT Yearbook* 138.
92 *R v Goodwin and Unstead* Case C-3/97 ECJ para 12; see also Dale and Nieuwenhuizen *VAT Yearbook* 139.
93 *R v Goodwin and Unstead* Case C-3/97 ECJ para 12.
94 *R v Goodwin and Unstead* Case C-3/97 ECJ para 14.
95 *R v Goodwin and Unstead* Case C-3/97 ECJ para 14.
96 *R v Goodwin and Unstead* Case C-3/97 ECJ para 15.
97 *R v Goodwin and Unstead* Case C-3/97 ECJ para 15.
98 *R v Goodwin and Unstead* Case C-3/97 ECJ para 16; see also Dale and Nieuwenhuizen *VAT Yearbook* 139.

In *Town and County Factors Ltd v Commissioners of Customs and Excise*[99] the court ruled that an agreement "binding in honour only" complies with the requirements to constitute an agreement "for consideration" and should therefore be subject to VAT.[100]

In *Staatssecretaris van Financiën v Coffeeshop "Siberië" vof*[101] (case C158/98) the taxpayer rented out a table in a coffee shop to a third party to conduct business in the form of the sale of soft drugs. When charged with VAT on the rental income, the taxpayer contended that the sale of soft drugs is prohibited by law and, in following the judgment in *Happy-Family*-case, VAT cannot be levied on the transaction. The commissioner contended that prosecuting authorities never prosecuted the taxpayer and that the transaction *in casu* should therefore be distinguished from transactions that are banned and prosecuted. It further contended that in failure to outright ban the current transaction it rendered the supply subject to VAT. The court said that the principle of tax neutrality prevents it from distinguishing between lawful and unlawful transactions.[102] That however is not the case with narcotics where there is an outright ban in all member states on the use, sale and manufacture thereof.[103] In this case however the activity in question is the renting out of a table to enable a third party to sell narcotics. Unlike the sale of narcotics, the renting out of a table can compete with a legal market and strictly speaking falls within the spectrum of commercial activities as contemplated in the sixth directive and should be subject to VAT.[104]

In *Karlheinz Fischer v Finanzamt Donaueschingen*[105] (case C-283/95) the court ruled that unlawful gaming like roulette falls within the scope of the sixth directive as gaming as such (legal or illegal) is not completely banned in member states.[106] Illegal gaming therefore can compete with a legal market of gaming. The court

99 *Town and County Factors Ltd v Commissioners of Customs and Excise* Case C-498/99 ECJ.
100 *Town and County Factors Ltd v Commissioners of Customs and Excise* Case C-498/99 ECJ para 23-24.
101 *Staatssecretaris van Financiën v Coffeeshop "Siberië" vof* Case C158/98 ECJ.
102 *Staatssecretaris van Financiën v Coffeeshop "Siberië" vof* Case C158/98 ECJ para 14.
103 *Staatssecretaris van Financiën v Coffeeshop "Siberië" vof* Case C158/98 ECJ para 14.
104 *Staatssecretaris van Financiën v Coffeeshop "Siberië" vof* Case C158/98 ECJ para 22.
105 *Karlheinz Fischer v Finanzamt Donaueschingen* Case C-283/95 ECJ.
106 *Karlheinz Fischer v Finanzamt Donaueschingen* Case C-283/95 ECJ para 29.

further ruled that where legal gaming is exempt from VAT in terms of article 13(B)(f) of the directive, unlawful gaming should also be exempt from VAT.[107]

Generally it can be deduced, that in the European Union, the principles of tax neutrality should strictly be applied except in those cases where a uniform ban on products exist due to the detrimental intrinsic nature of the goods. This interpretation of the principles of tax neutrality negates the very core of the principle of "neutrality" and can strictly speaking not be followed.

7 Applying the principles of tax neutrality creating a moral dilemma?

In applying the principles of tax neutrality to determine the VAT-ability of illegal transactions a moral dilemma is created where the layman could construe the taxation of illegal contracts as government's approval of illegal transactions. Olivier[108] quite rightly opines that government benefits from crime if amounts illegally received are taxed, and that this is a matter that calls for social outcry. Is it right and just to condemn an agreement that is morally wrong or illegal (for purposes of the law of obligations) but at the same time tax the agreement (or the proceeds resulting from the agreement) as if the agreement was legally and morally sound? This creates a moral dilemma where, on the one hand illegal and immoral agreements are punished by law, and on the other hand it is "acknowledged and enforced" by law to benefit government coffins. It can furthermore not be argued that the taxation of illegal transactions should be seen in a punitive light as the taxation of illegal transactions is not a sanction for illegal activities.[109] That said, the Commissioner may, in addition to the outstanding output VAT, claim interest and penalties[110] and in cases of evasion or input VAT fraud, claim double the amount of tax as a penalty.[111] Such penalties are however directed at the nonpayment of tax or the evasion thereof and it is not aimed (nor should it be construed as such) to impose a penalty on the underlying illegality of the agreement. It is clear from the judgments on the income taxability of illegal proceeds that the courts, in applying the principles of tax neutrality, are not

107 *Karlheinz Fischer v Finanzamt Donaueschingen* Case C-283/95 ECJ para 31.
108 Olivier 2008 *TSAR* 816.
109 Olivier 2008 *TSAR* 816*;* Onoue-Oliveira 2010 www.articlesbase.com.
110 Section 39 *Value Added Tax Act* 89 of 1991; also see *Metcash Trading Ltd v Commissioner South African Revenue Services* 2001 1 SA 1109 (CC) 1125 [23].
111 Section 59(3), 60(1) *Value Added Tax Act* 89 of 1991.

concerned with the moral desirability thereof.[112] This approach should also be followed to determine the VAT-ability of illegal transactions. Taxing a transaction (either for VAT or Income Tax purposes) is one of many methods to contribute to the cost of government.[113] Taxing a transaction does not put the government at partnership with the taxpayer in any way whatsoever.[114] Furthermore what is lawful and unlawful differ not only from countries but also from provinces or even the time of day. For example the sale of liquor in Gauteng can be legal at 15h00 but illegal at 17h10 depending on the type of license.[115] If the levying of VAT is subject to the legality or illegality of a transaction, the vendor in the example above must levy VAT on the sale of liquor at 15h00 but may not levy VAT on the sale of liquor at 17h10. Furthermore by not charging VAT on illegal transactions the non VAT paying vendor is put at an unfair economic advantage to the VAT paying vendor. The legitimate goods are effectively sold at 14% higher than the illegitimate goods. This creates an untenable situation where the seller of legitimate goods needs to compete with the seller of illegitimate goods.

The misconception that taxing illegal transactions attaches a *quassi* validity to the transaction and that the government ultimately approves of such activities might stem from the administration of punitive measures in the prosecution of gangsters in the United States of America like Al Capone.[116] Typically prosecuting authorities could not argue a solid case against the illegal activities.[117] These activities were then taxed (as if legal) and the taxpayer would then be prosecuted, and in most cases jailed for tax evasion.[118] This is strictly speaking an abuse of the punitive measures built in tax legislation and should not be taken as the norm but should rather be seen as the prosecutor's last resort. It is therefore submitted that the taxation of an illegal transaction (moreover to charge VAT on illegal supplies) will not create the impression in the reasonable person/taxpayer's mind that the transaction is valid and that it conveys government's approval of illegal activities.

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112 Olivier 2008 *TSAR* 816; Vanek 2008 www.moneywebtax.co.za.

113 Keesling 1958 *UCLA Law Review* 30; *Metcash Trading Ltd v Commissioner South African Revenue Services* 2001 1 SA 1109 (CC) 1122 [19].

114 Keesling 1958 *UCLA Law Review* 30.

115 Sections 51-96 *Gauteng Liquor Act* 2 of 2003.

116 Keesling 1958 *UCLA Law Review* 31; MSN Money Staff 2009 www.msn.com; Háború [date unknown] taxwar.net.

117 Háború [date unknown] taxwar.net.

118 Keesling 1958 *UCLA Law Review* 31.

Another ethical dilemma might arise when the illegal vendor is allowed to claim input VAT. Keesling[119] opines that the notion that the allowance of a deduction of illegal items will frustrate public policy fails to distinguish between interfering, assisting and remaining neutral. The core of the principle of tax neutrality is not to assist taxpayers (i.e. illegal activities) nor to interfere in business or the prosecution of criminals but to remain neutral in applying tax laws. Taxing an illegal transaction in the same way as a legal transaction (and thus allowing the same deductions) reflects an attitude of neutrality which neither hinders nor encourages.[120] The disallowance of a deduction or input VAT on illegal transactions will most certainly discourage these transactions. It should however be noted that the primary purpose of tax legislation is to tax the taxpayer. Tax legislation should not be interpreted as such to serve as a penalty for illegal transactions, either as an additional penalty, or where common law or legislation fails to penalise it adequately.

9 Conclusion

From the discussions above three arguments can be deduced to determine the VAT-ability of illegal transactions.

First argument: It was found that the charging provisions for taxing income and to levy VAT are irreconcilable with each other and that the case law on the taxability of illegal income can, strictly speaking, not be applied to determine the VAT-ability of illegal transactions. That said, the basic principles or arguments laid down in these cases are that the illegality and unenforceability of the agreement only affects the parties *inter partes*. The principles of tax neutrality is not concerned with the lawful or unlawfulness of an agreement. If the income (proceeds) complies with the requirements of definition of gross income (section 1 of the *Income Tax Act*) it will be taxable. This principle can also be applied to determine if VAT should be levied on an illegal transaction. If the transaction complies with the requirements of the supply of goods and or services for consideration in terms of section 7(1) of the *VAT Act*, then it is taxable. In following the *dicta* in the *Delagoa Bay*-case (*supra*) the invert

119 Keesling 1958 *UCLA Law Review* 36.
120 Keesling 1958 *UCLA Law Review* 37.

should also apply namely, that if the expense complies with the requirements of the general deduction formula or special deduction in terms of the act (in the case of income tax) it should be deductible and if it complies with the requirements of input VAT (for VAT purposes) in terms of section 16 of the *VAT Act*, the taxpayer should be entitled to claim input VAT. This argument is preferred.

The second argument, in following the judgment of the European Court of Justice in *Vereniging Happy Family Rustenburgerstraa Inspecteur der Omzetbelasting*, is that criminal charges or penalties can be the only result following an illegal transaction. This is also clear from the *ex turpi* rule that there can be no consequence resulting from an illegal contract but criminal charges (if sanctioned by a penalty of some sort). The mere fact that the taxpayer is/was not prosecuted does not render the contract valid. Taxing the transaction would lead to a false sense of validity attached to the agreement. This quasi validity indirectly decriminalises the parties' actions and could be construed as government's approval of illegal activities. This argument would however create an untenable situation where legitimate products (which are sold at market value + VAT) unfairly competes with illegitimate products (which are sold at market value). This could also be construed as government's approval of illegal transactions whereby government indirectly subsidizes illegal activities by not taxing them. Conversely, where counterfeit goods are not subject to VAT, because they are illegal, government effectively grants the consumer who buys counterfeit goods a discount of 14%. Obviously this will encourage the trade in illegal goods.

The third argument is that the intrinsic nature of the goods or services should be established to determine the VAT-ability of the transaction regardless of the illegal nature of the agreement. If the transaction or agreement is illegal because of the intrinsic characteristics of the goods or services concerned (because of the negative impact of the goods or services on society or morals), the supply is not subject to VAT. If the agreement or transaction is illegal because it infringes on the rights of third parties (such as intellectual property rights), the supply is subject to VAT. Conversely where the goods or services in question compete with a legal market, the goods are not *extra commercium* because of its unlawfulness and should be subject to VAT. In following this argument the sale of drugs would not be subject to VAT because the intrinsic nature of the goods is immoral or has a negative effect on

society. The sale of counterfeit T-shirts would however be subject to VAT because the mere possession or sale of a counterfeit T-shirt does not negatively affect morality but only infringes on the intellectual property of a third party. This argument cannot be followed as it differentiates between types of goods and services and negates the very core of the principle of tax neutrality.

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List of abbreviations

ECJ	European Court of Justice
ITC	Income Tax Case
SA MercLJ	South African Mercantile Law Journal
TSAR	Tyskrif vir die Suid Afrikaanse Reg
UCLA Law Review	University of California, Los Angeles Law Review