

INTERPRETATION NOTE 54 (Issue 2)

DATE: 25 January 2017

ACT : INCOME TAX ACT 58 OF 1962

SECTION : SECTION 23(o)(i) AND (ii)

SUBJECT : DEDUCTIONS – CORRUPT ACTIVITIES, FINES AND PENALTIES

Preamble

In this Note unless the context indicates otherwise –

- “**section**” means a section of the Act;
- “**PCCA Act**” means the Prevention and Combating of Corrupt Activities Act 12 of 2004;
- “**TA Act**” means the Tax Administration Act 28 of 2011;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Purpose

Section 23(o) prohibits the deduction for income tax purposes of expenditure incurred in respect of –

- corruption or a corrupt activity; or
- a fine or penalty imposed as a result of an unlawful activity.

This Note examines the meaning and scope of section 23(o).

2. Background

Corruption and corrupt activities hamper democratic processes, good governance, sustainable development and fair business practices. According to its long title, the PCCA Act provides, amongst others, for –

“the strengthening of measures to prevent and combat corruption and corrupt activities; ... [and] for the offence of corruption and offences relating to corrupt activities.”

Its preamble notes, amongst others, the following:

- The Constitution enshrines the rights of all people in the Republic and affirms the democratic values of human dignity, equality and freedom.
- The Constitution places a duty on the State to respect, protect, promote and fulfil all the rights as enshrined in the Bill of Rights.
- Corruption and related corrupt activities undermine those rights, endanger the stability and security of societies, undermine the institutions and values of democracy and ethical values and morality, jeopardise sustainable

development, the rule of law and the credibility of governments, and provide a breeding ground for organised crime.

- The illicit acquisition of personal wealth can be particularly damaging to democratic institutions, national economies, ethical values and the rule of law.
- There are links between corrupt activities and other forms of crime, in particular organised crime and economic crime, including money-laundering.
- Corruption is a transnational phenomenon that crosses national borders and affects all societies and economies, and is equally destructive and reprehensible within both the public and private spheres of life, so that regional and international cooperation is essential to prevent and control corruption and related corrupt activities.
- A comprehensive, integrated and multidisciplinary approach is required to prevent and combat corruption and related corrupt activities efficiently and effectively.
- It is the responsibility of all States to prevent and combat corruption and related corrupt activities, and this requires mutual cooperation.
- The United Nations has adopted various resolutions condemning all corrupt practices, and urged member states to take effective and concrete action to combat all forms of corruption and related corrupt practices.
- The Southern African Development Community Protocol against Corruption, adopted on 14 August 2001 in Malawi, reaffirmed the need to eliminate the scourges of corruption through the adoption of effective preventive and deterrent measures and by strictly enforcing legislation against all types of corruption.
- The Republic of South Africa desires to be in compliance with and to become Party to the United Nations Convention against Corruption adopted by the General Assembly of the United Nations on 31 October 2003.¹
- It is desirable to unbundle the crime of corruption in terms of which, in addition to the creation of a general, broad and all-encompassing offence of corruption, various specific corrupt activities are criminalised.

The Organisation for Economic Co-operation and Development (OECD) 1996 Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials² sought to put an end to the claiming of bribes paid to foreign public officials as tax-deductible expenses. Many countries (including South Africa) have gone one step further and have prohibited the deductibility of all bribes, irrespective of the identity or status of the recipient.

Section 23(o) was introduced into the Act by section 28(1)(e) of the Revenue Laws Amendment Act 31 of 2005 with effect from 1 January 2006. It applies to any year of assessment commencing on or after that date.

Before the introduction of section 23(o), the Act did not specifically address the non-deductibility of expenses incurred on bribes or fines resulting from unlawful activities,

¹ South Africa ratified the convention on 22 November 2004 and it became part of South African law (as contemplated in section 239 of the Constitution) on 14 December 2005.

² [www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=c\(96\)27/final](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=c(96)27/final) [Accessed 24 January 2017].

and the matter had to be considered under the general deduction formula [section 11(a) taking into account section 23(g)]. A notable exception is section 23(d) that prohibits the deduction of –

“any tax imposed under this Act or interest or penalty imposed under any other Act administered by the Commissioner;”.

Some commentators argued that bribes, fines and penalties actually incurred in the course of carrying on a trade were deductible for income tax purposes if they were an inevitable concomitant of the trade of the taxpayer. On that basis the nature of the payment itself was relevant only to the question whether, in the circumstances, the expense could be said to have been actually incurred in the course of a trade and in the production of the taxpayer's income. The issue as to whether the amount is prohibited as a deduction under section 23(o) does not arise if an expense does not pass the positive test in section 11(a).

In ITC 1490³ a cartage contractor sought to claim a deduction for traffic fines under section 11(a). The court held that to allow the fines as a deduction would be contrary to public policy, frustrating the legislative intent and allow a punishment imposed to be diminished or lightened. The court added that the fines did not play any actual part in the earning of the income and were not an inevitable concomitant of the business of a cartage contractor.

Although the court in the above case and in a number of others⁴ found in favour of the *fiscus*, it was considered desirable to introduce a specific legislative provision barring the deduction of fines and penalties as a matter of good governance and to reinforce South Africa's anti-corruption drive. From a policy perspective the deduction for income tax purposes of fines and penalties relating to unlawful activities cannot be justified. The granting of a deduction for fines and penalties would reduce the burden of the penalty or fine and be contrary to the rationale of the law under which it is imposed.

Section 23(o) is solely concerned with expenditure. It is not concerned with whether income has been derived by a taxpayer through legal or illegal means.

3. The law

Section 23(o)

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

- (a) – (n).
- (o) any expenditure incurred—
 - (i) where the payment of that expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act No.12 of 2004); or
 - (ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic;

³ 1990 (53) SATC 108 (T).

⁴ ITC 1199 (1973) 36 SATC 16 (T); ITC 1212 (1974) 36 SATC 108 (R).

4. Application of the law

4.1 Corrupt activities [section 23(o)(i)]

Chapter 2 of the PCCA Act addresses the general offence of corruption and offences in respect of corrupt activities relating to specific persons. It further provides for offences in respect of corrupt activities relating to both the receiving and the offering of unauthorised gratification as well as for offences in respect of corrupt activities relating to specific matters.

“Specific persons” under the PCCA Act provides for corrupt activities relating to –

- public officers;
- foreign public officials;
- agents;
- members of the legislative authority;
- judicial officers; and
- members of the prosecuting authority.

The reference in the PCCA Act to “offences of receiving or of the offering of an unauthorised gratification” concerns, in particular, parties to employment relationships.

Specific matters identified for special consideration are corrupt activities relating to witnesses or evidential material in certain proceedings, contracts, the procuring and withdrawal of tenders, corrupt activities relating to auctions, sporting events, gambling games and games of chance.

Chapter 2 of the PCCA Act also provides for miscellaneous offences relating to possible conflicts of interest and other unacceptable conduct. It provides for –

- the acquisition of a private interest in a contract, agreement or in an investment of a public body;
- unacceptable conduct relating to witnesses; and
- the intentional interference with, hindering or obstruction of an investigation of an offence.

The Chapter finally provides for the position of an accessory to or an attempt, a conspiracy or for inducing another person to commit one of the offences listed in the chapter.

Under section 23(o)(i) a payment will not be deductible for income tax purposes if such payment, agreement, or offer to make that payment constitutes an activity contemplated in Chapter 2 of the PCCA Act. It is beyond the scope of this Note to provide a comprehensive analysis of all of those activities. A few general observations are nevertheless made about the general offence of corruption. They are to a large extent also applicable to the other specified offences.

Section 3 of the PCCA Act

3. General offence of corruption.—Any person who, directly or indirectly—

- (a) accepts or agrees or offers to accept any gratification from any other person, whether for the benefit of himself or herself or for the benefit of another person; or
 - (b) gives or agrees or offers to give to any other person any gratification, whether for the benefit of that other person or for the benefit of another person,
in order to act, personally or by influencing another person so to act, in a manner—
 - (i) that amounts to the —
 - (aa) illegal, dishonest, unauthorised, incomplete, or biased; or
 - (bb) misuse or selling of information or material acquired in the course of the, exercise, carrying out or performance of any powers, duties or functions arising out of a constitutional, statutory, contractual or any other legal obligation;
 - (ii) that amounts to—
 - (aa) the abuse of a position of authority;
 - (bb) a breach of trust; or
 - (cc) the violation of a legal duty or a set of rules;
 - (iii) designed to achieve an unjustified result; or
 - (iv) that amounts to any other unauthorised or improper inducement to do or not to do anything,
- is guilty of the offence of corruption.

The word “gratification” is central in the context of corruption in the PCCA Act. “Gratification” is defined in section 1 of the PCCA Act. It is a broad concept and includes, amongst other things, any donation, gift, contract of employment, or services, and the avoidance of punishment or loss.

Definition of “gratification” in section 1 of the PCCA Act

“gratification”, includes—

- (a) money, whether in cash or otherwise;
- (b) any donation, gift, loan, fee, reward, valuable security, property or interest in property of any description, whether movable or immovable, or any other similar advantage;
- (c) the avoidance of a loss, liability, penalty, forfeiture, punishment or other disadvantage;
- (d) any office, status, honour, employment, contract of employment or services, any agreement to give employment or render services in any capacity and residential or holiday accommodation;
- (e) any payment, release, discharge or liquidation of any loan, obligation or other liability, whether in whole or in part;
- (f) any forbearance to demand any money or money’s worth or valuable thing;

- (g) any other service or favour or advantage of any description, including protection from any penalty or disability incurred or apprehended or from any action or proceedings of a disciplinary, civil or criminal nature, whether or not already instituted, and includes the exercise or the forbearance from the exercise of any right or any official power or duty;
- (h) any right or privilege;
- (i) any real or pretended aid, vote, consent, influence or abstention from voting; or
- (j) any valuable consideration or benefit of any kind, including any discount, commission, rebate, bonus, deduction or percentage;

The general offence of corruption is very widely defined as is the concept of gratification. The inclusion of an extensive list of specific offences serves to make it plain that the purpose of the PCCA Act (and its statutory predecessors) is to expand the already widely formulated common law offence of bribery. Bribery was an offence committed by and in respect of state officials only, but the same moral considerations apply to the private commercial sector in its relationship with the state and between private persons and other entities. Broadly speaking, corruption under section 3 of the PCCA Act amounts to –

- an agreement to give, or an offer to give or the giving of a benefit that is not due;
- to a person vested with a duty;
- by virtue of his or her office, employment or status;
- intending to influence the receiver or offerree to do something or to refrain from doing something at variance with his or her duty, or
- intending to reward the offerree or recipient for having done it or for having refrained from doing it.

The crime is highly dependent on moral and ethical considerations. Consider, for example, the following words and phrases in section 3 of the PCCA Act:

- Illegal, dishonest, unauthorised, incomplete, or biased
- Misuse
- Abuse
- Breach of trust
- Violation of a legal duty or a set of rules
- An unjustified result
- Any other unauthorised or improper inducement

Many of those considerations, especially those emphasised, depend on value judgements. Courts and prosecuting authorities are used to determining what does and does not accord with the legal convictions of the community. In addition, before any person can be convicted of an offence, proof must be provided of the elements of that offence and of the fact that it was committed, conscious of its unlawfulness or at the very least recklessly as to whether or not it was a crime. In other words, the strictures of criminal law and the law of evidence, as well as the experience and vigilance of the courts, serve to protect the citizen against the potentially unlimited

reach of the PCCA Act. Importantly, however, section 23(o)(i) does not require that there must be a conviction for the section to apply. Any payment that constitutes an activity contemplated in Chapter 2 of the PCCA Act will be denied as a deduction for income tax purposes.

Not every form of promotional gift or free lunch comprises a criminal offence under section 3 of the PCCA Act. Gifts of no significant, lasting or commercial value will normally not fall within its ambit, but factors such as the taxpayer's intention, the size and regularity of the gift, the position of the recipient, amongst others, will be considered. In the course of doing so the Commissioner will take account of the following *dictum* in *Gates v Gates*:⁵

"It is true that in certain cases more especially in those in which charges of criminal or immoral conduct are made, it has repeatedly been said that such charges must be proved by the 'clearest' evidence or 'clear and satisfactory' evidence or 'clear and convincing' evidence, or some similar phrase. There is not, however, in truth any variation in the standard of proof required in such cases. The requirement is still proof sufficient to carry conviction to a reasonable mind, and the reasonable mind is not so easily convinced in such cases because there are moral and legal sanctions against immoral and criminal conduct and consequently probabilities against such conduct are stronger than they are against conduct which is not immoral or criminal."

Despite section 23(o) denying a deduction to the payer, illegal contracts can in principle have fiscal consequences for the recipient. The only question as between the taxpayer and the *fiscus* is whether amounts received by or accruing to a taxpayer fall under the literal meaning of "gross income".⁶

4.2 Fines and penalties

4.2.1 Payments of fines and penalties as a result of an unlawful act [section 23(o)(ii)]

Section 23(o)(ii) prohibits the deduction of a fine charged or penalty imposed as a result of an unlawful activity carried out –

- in the Republic; or
- in any other country if that activity would be unlawful had it been carried out in the Republic.

Claassen⁷ describes a fine as –

"a financial penalty imposed for a crime committed".

In *Rex v Laughton*⁸ Matthews J described a penalty as follows:

" 'Penalty', when used in a statute – though it may not always import a punishment for a criminal offence – does at least imply some form of sanction declared or operating by order of a court of law."

*Black's Law Dictionary*⁹ defines "unlawful act" as –

"[c]onduct that is not authorized by law; a violation of a civil or criminal law".

⁵ 1939 AD 150 at 155.

⁶ *MP Finance Group CC v C: SARS* 2007 (5) SA 521 (SCA), 69 SATC 141.

⁷ RD Claassen *Dictionary of Legal Words and Phrases* [online] (My LexisNexis: June 2016).

⁸ 1930 NPD 47 at 53.

⁹ 8 ed 2004.

Statutory offences

Most statutes create offences and corresponding penalties in order to enforce compliance with their provisions. The Act also contains various penalty provisions, such as –

- paragraph 5(5) of the Fourth Schedule to the Act which applies to an employer that fails to deduct or withhold the correct amount of employees' tax;
- sections 234 and 235 of the TA Act lists offences for which the courts could impose criminal penalties; and
- section 76 of the Act imposed "additional tax", which in essence was a penalty (*Israelsohn v CIR*)¹⁰ and was not considered to be tax on income (*CIR v McNeil*),¹¹ although it was collected via the machinery of assessment (see *Israelsohn's* case above).¹² Chapter 15¹³ and Chapter 16¹⁴ of the TA Act replaced section 76 and provides for non-compliance and administrative penalties. The main purpose of such additional charges is to ensure the accuracy of returns upon which the whole income tax system is based, and to thus avoid the loss of revenue to the *fiscus*.

Section 23(d) prohibits the deduction of such fiscal penalties (see 2). On the other hand, fines imposed for tax offences will be denied as a deduction under section 23(o)(ii).

Other examples of an unlawful act may include the following:

- Practices prohibited by the Competition Act, 89 of 1998 – Under sections 4 to 9 of this Act certain restrictive practices, as well as the abuse of a dominant position, are prohibited. Restrictive practices include –
 - horizontal or vertical relationships between parties which prevent or lessen competition;
 - restrictive horizontal practices, including price-fixing, market division between firms and collusive tendering; and
 - minimum resale price maintenance.
- Unfair marketing – The Consumer Protection Act, 68 of 2008, which came into operation on 24 October 2010, protects a number of fundamental consumer rights, including the right to fair and responsible marketing and the right to restrict unwanted direct marketing. A consumer's rights under that Act may be enforced through referral of a matter to the National Consumer Tribunal, an ombudsman with jurisdiction, or a court with competent jurisdiction. Contravention of the Consumer Protection Act, 2008 may result in civil or criminal liability as well as the possible imposition of an administrative penalty.
- Unfair discrimination, harassment, hate speech – This is dealt with by the equality courts. Equality courts are courts designed to deal with matters

¹⁰ 1952 (3) SA 529 (A) at 539–540, 18 SATC 247.

¹¹ 1959 (1) SA 481 (A) at 487F, 22 SATC 374.

¹² At 539G.

¹³ Section 208-220 of the Tax Administration Act 28 of 2011.

¹⁴ Section 221-233 of the Tax Administration Act 28 of 2011.

covered by the Promotion of Equality and Prevention of Unfair Discrimination Act, 4 of 2000, also known as the Equality Act.

- Violation of traffic laws.
- Contravention of municipal by-laws.

Common law

Companies are capable of being prosecuted and sentenced, for crimes committed on their behalf, such as culpable homicide. In the Rhodesian case of *S v Joseph Mtshumayeli (Pvt) Ltd*,¹⁵ a charge arose from the negligent driving of a bus in the course of the company's business. The appellant, a limited liability company operating an omnibus company, was convicted in a magistrate's court of culpable homicide and sentenced to a fine of \$200. Under equivalent circumstances in South Africa today, the company would not be allowed a tax deduction for the fine under section 23(o).

A fine or penalty imposed by a foreign country will also be denied as a deduction under section 23(o)(ii) if that activity would be unlawful had it been carried out in the Republic. A fine or penalty imposed by a foreign country for an offence that would not be unlawful in South Africa will not be debarred as a deduction by section 23(o)(ii), but will still have to pass the requirements for deductibility of section 11(a) read with section 23(g).

4.2.2 Penalties falling outside section 23(o)

Not all penalties payable result from an "unlawful act" and will thus not be barred as a deduction by section 23(o)(ii). Nevertheless such commercial penalties still need to meet the requirements of sections 11(a) and 23(g) in order to be deductible.

A typical example is found in the building industry. In concluding building contracts, the owner and the contractor would normally agree on the completion of work on or before a certain date. A penalty clause is added under which the contractor must pay the owner a certain sum of money for each day the operations continue after the date of completion as agreed upon. The clause becomes operative and the contractor must pay the sum of money stipulated if the contractor breaches the contract by failing to complete the work in time. Such a penalty is not unlawful and will likely meet the requirements for deductibility of section 11(a). It is beyond the scope of this Note to examine the requirements of the general deduction formula in detail. It suffices to say that the facts and circumstances of each case will have to be considered in deciding whether a particular penalty is deductible under section 11(a) read with section 23(g).

4.2.3 Compensation and damages

Fines and penalties must be distinguished from amounts payable as compensation or damages. Amounts payable as compensation or damages may qualify for a deduction under section 11(a) and will not be denied under section 23(o). The principles laid down in *Port Elizabeth Electric Tramway Co. Ltd v CIR*¹⁶ will apply to the payment of compensation or damages.

¹⁵ 1971 (1) SA 33 (RA).

¹⁶ 1936 CPD 241, 8 SATC 13.

5. Conclusion

Section 23(o) has put it beyond doubt that corrupt payments such as bribes, fines and penalties for unlawful activities are not deductible for income tax purposes. However, the deductibility of bona fide commercial penalties remains unaffected by the provision. Such commercial penalties are subject to the normal tests for deductibility under the general deduction formula.

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