Corruption and Financial Mismanagement in State-Owned Entities – The role of Fiscal Legislation in deterring corruption and fruitless and wasteful expenditure in State-Owned Entities

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Abstract

Corruption has been around for thousands of years, but in recent years, it has been increasing and has attracted world-wide attention. South Africa as a developing country, has also been affected by corruption and also financial mismanagement in its State-Owned Entities. South African tax law, like most tax law across different jurisdictions, generally provides for tax reforms that promote the anti-corruption drive in government entities and tax reforms that manage fruitless and wasteful expenditure. As corruption and fruitless and wasteful expenditure continuously increase in government entities, concerns about the impact on liquidity of these entities due to the misappropriation of public funds also increase. The evidence of this paper aims to address the following question: Have the promulgated tax laws been effective (proxied by perceived corruption) in deterring corruption and fruitless and wasteful expenditure in South African State-Owned Entities? The tax regulations against which an analysis was performed are:

1. Provisions of section 23*(o)* of the Income Tax Act, 58 of 1962 which regulate the deductibility of illegal expenses and fruitless and wasteful expenditure.
2. Application of the definition of gross income on illegal receipts.

Specifically, it has been found that the increase in corruption, increases tax non-compliance which means it is most likely that those who are party to corruption, are likely not to comply with the laws promulgated to reduce corruption. It has also been found that fruitless and wasteful expenditure is high, and it mainly relates to interest and penalties levied by creditors and South African Revenue Services. The higher the fruitless and wasteful expenditure, the higher the amount subjected to non-deductibility for State-Owned Entities.

Key words: State-Owned Entities, Corruption, Illegal Activities, Fruitless and Wasteful Expenditure.

Declaration

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Zola Elsie Mkhwanazi

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Abbreviations

The abbreviations bear the meaning as set out below:

Abbreviation	Description
ITA	Income Tax Act, 58 of 1962
TAA	Tax Administration Act, 28 of 2011
OECD	Organisation for Economic Co-operation and Development
PFMA	Public Finance Management Act of 1999
PCCA Act	Prevention and Combating of Corrupt Activities Act, 12 of 2004
IN54	Interpretation Note 54 (Issue 2)
SOE	State-Owned Entity
SARS	South African Revenue Service
Competition Act	Competition Act, 89 of 1998
Constitution	Constitution of the Republic of South Africa, 1996
AGSA	Auditor General South Africa
MFMA	Municipal Finance Management Act, 56 of 2003
PPPFA	Preferential Procurement Policy Framework Act, 5 of 2000

Chapter 1: Introduction

1.1 Background and motivation

Without tax revenue, the government cannot do its job and cannot fulfil its responsibilities. All South Africans meeting the requirements of registering to pay taxes must pay the required taxes to finance social and economic programmes. The government also uses the funds collected through taxes to provide goods and services to the population, such as schools, universities, hospitals, clinics, roads, national defence, and security.[1] Since the government largely depends on taxes, the moment that the amounts that need to be collected by the government are tampered with, then the objectives of the taxes collected by government are impacted.[2]

Corruption and financial mismanagement in State-owned Entities (SOEs) have become major setbacks in government's mandates, being the promotion of economic development, good governance, social progress, and a rising standard of living for all South Africans.[3] According to the World Bank (2007), the global concerns about corruption have intensified in recent years. If anything, there is increasing proof that corruption undermines the development of any country.[4] Corruption also affects the effectiveness with which domestic savings and external aid are used in many countries that are developing.[5]

The mandate of SOEs play a significant role in the economy across the globe, particularly as it affects the natural resources, public utilities, and public finance sectors. Although these entities provide essential services to the public, corruption and corrupt activities affect equitable distribution of resources across the country's population. It negatively impacts the investment climate and hinders democratic processes, good governance, sustainable development, and fair business practices.[6]

[1] SARS, '*What kinds of tax do we pay*?', viewed 07 May 2022, from: https://www.sars.gov.za/about/sas-tax-and-customs-system/what-kinds-of-tax-do-we-pay%E2%80%8B/
[2] The World Bank, '*Taxes & Government Revenue*' viewed 07 May 2022, from: https://www.worldbank.org/en/topic/taxes-and-government-revenue#1, par 1.
[3] National Treasury, '*The Role of the National Treasury*', viewed 10 May 2022, from http://www.treasury.gov.za/nt/info.aspx, par 1
[4] The World Bank, 2007, '*Countries Combat Corruption: The Role of the World Bank*', at page 1.
[5] The World Bank, 2007, '*Countries Combat Corruption: The Role of the World Bank*', at page 1
[6] SARS Interpretation Note 54 (Issue 2), at page 1

In 2004, South Africa adopted the Prevention and Combating of Corrupt Activities Act 12 of 2004, the mandate of which may be summarised as follows:

- *"*to provide for the strengthening of measures to prevent and combat corruption and corrupt activities;
- to provide for the offence of corruption and offences relating to corrupt activities;
- to provide for investigative measures in respect of corruption and related corrupt activities;
- to provide for the establishment and endorsement of a Register in order to place certain restrictions on persons and enterprises convicted of corrupt activities relating to tenders and contracts;
- to place a duty on certain persons holding a position of authority to report certain corrupt transactions;
- to provide for extraterritorial jurisdiction in respect of the offence of corruption and offences relating to corrupt activities and
- to provide for matters connected therewith."

The SARS IN54 states that "the OECD Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials 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."[7]

Based on the OECD's recommendations, South Africa introduced section 23(*o*) into the ITA with effect from 1 January 2006. At the time of the introduction of section 23*(o)*, only two provisions were included, i.e., section 23*(o)*(i) and section 23*(o)*(ii). Prior to the date of enactment of this section, the non-deductibility of expenses incurred on bribes or fines was not specifically addressed by the ITA and the matter had to be considered under the general deduction formula in section 11*(a)* read with section 23*(g)*.

[7] SARS Interpretation Note 54 (Issue 2), at page 2

IN54 goes on to state that "some commentators had argued that bribes, fines, and penalties were deductible if they satisfied the criteria for deductibility laid down in the general deduction formula, in other words, if the expenditure was incurred for the purpose of producing income."[8]

For example, prior to the enactment of section 23*(o),* taxpayers could argue that in carrying on a business of transporting goods, one ought to be able to deduct traffic fines in connection with breaching the road traffic legislation in terms of section 11*(a)* read with section 23*(g)* as being expenditure incurred in the production of income since the expenditure is closely related to the trade of the taxpayer (*ITC 1490*).

In *ITC 1490,*[9] the court ruled that allowing fines to be deducted was against public order and morals, defeating the legislature's intentions, and allowing the decision to be relaxed or mitigated. The court added that fines have no real role in generating revenue and are not an integral part of the trucking company's activities.

The SARS IN54 further states that "although the court in the above case, and in several others, found in favour of the fiscus, it was considered desirable to introduce a specific legislative provision barring the deduction of fines and penalties. This would be a matter of good governance and would 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."[10]

In the 2018 Budget Review, it was frankly pointed out that poorly governed and managed SOEs are burdening the fiscus and budgets because of significant costs associated with managing operational inefficiencies and financial distress. Media coverage of the past few years has repeatedly emphasized this, especially noting that government agencies are suffering from fruitless and wasteful spending. To maintain

[8] SARS Interpretation Note 54 (Issue 2), at page 3
[9] *ITC 1490 (1990) 53 SATC 108 (T) at 113-114*
[10] Ibid (note 8)

a stable tax base, the ITA was further amended to introduce section 23*(o)*(iii) which prohibits the deduction of fruitless and wasteful expenditure by government entities.

It should however be highlighted that, although the ITA has a role to play in deterring or eradicating corruption, there are still legal and institutional frameworks that are responsible for investigating and prosecuting crime. If it is found that the provisions of the ITA that have a role in re-enforcing South Africa's anti-corruption drive are not effective, that does not in itself mean the ITA is ineffective in achieving its objective, which is to collect revenue.

1.2 Research problem

1.2.1 The statement of the problem

This research investigates whether the promulgated tax regulations have been effective in combating corruption and fruitless and wasteful expenditure caused by financial mismanagement in South African SOEs. In addressing this problem, the sub-problems below are addressed in detail.

<u>The research problem is made up of the following sub-problems:</u>

- What are the tax laws imposed by the South African Government in deterring or eradicating corrupt behaviour and fruitless and wasteful expenditure caused by financial mismanagement?
- What are some of the common corrupt behaviour and financial mismanagement traits in South African SOEs?
- Have the tax laws imposed by the South African government to promote an anti-corruption drive and eliminating fruitless and wasteful expenditure caused by financial mismanagement in SOEs been effective?

A purely quantitative analysis of the effectiveness of tax provisions is unachievable and undesirable. This report adopts a qualitative stance to determining the effectiveness of the non-deductibility of bribery and related expenses.

1.3 Research Methodology

The research conducted for this work is a literature review of the of South Africa's Income Tax Act 58 of 1962, Tax Administration Act 28 of 2011, relevant anti-corruption legislation, the Organisation for Economic Co-operation and Development material, journal articles and any other relevant case law.

The research study examines the effectiveness of disallowing the deductibility of expenses incurred because of corrupt activities and fruitless and wasteful expenditure as it pertains to State-Owned Entities in South Africa. This paper also analyses the role of taxing income derived from unlawful or illegal activities as a corruption deterrence mechanism in the South African SOEs. In determining the effectiveness of the tax provisions that assist the government of South Africa in reducing corruption and related expenses, the results of the Afrobarometer[11] surveys collected are studied to understand what it means in relation to the tax regulations implemented to promote the anti-corruption drive in South Africa. The Audit report by the Auditor General South Africa for the 2020-21 financial period has also been identified as a report that plays a pivotal role in understanding the effectiveness of those tax regulations.

1.4 Research Report Outline

This report is divided into five chapters. Chapter One provided background to the research question and sub-questions and introduced the issues that are studied.

Chapter Two examines the tax laws/fiscal legislation imposed by the South African government in attempting to combat corrupt behaviour and financial mismanagement in SOEs. For the purposes of this report, fiscal legislation refers to the tax laws that regulate the deductibility of expenses incurred because of corrupt or unlawful activities. Including the deductibility of fruitless and wasteful expenditure caused financial mismanagement of funds in South African State-Owned Entities. The fiscal legislation for the purpose of this paper also includes the discussion around the taxing of income derived from unlawful or illegal activities. An understanding of the reasons why these regulations were adopted is also addressed in this chapter.

[11] Afrobarometer Dispatch No. 476, Patel J. & and Govindasamy P., '*South Africans see corruption as worsening during President Ramaphosa's tenure'*, accessed 16 January 2022, from https://afrobarometer.org/sites/default/files/publications/Dispatches/ad476-south_africans_see_corruption_as_worsening_under_ramaphosa-afrobarometer_dispatch-15sept21.pdf

Chapter Three provides some examples of corrupt behaviours and financial mismanagement of funds in SOEs. The examples provided are the most common examples.

Chapter Four seeks to understand the effectiveness of how the fiscal legislation has played its role in helping to deter corrupt conduct in SOEs. In determining the effectiveness, the research study evaluates the intensity of the corrupt behaviour and fruitless and wasteful expenditure caused by financial mismanagement ever since section 23*(o)* was implemented, as well as other relevant regulations. In so far as there are tax laws put in place to combat corrupt behaviour and financial mismanagement in SOEs, the issue starts on whether there are sufficient and effective controls in place to prevent SOE funds from being looted. This chapter also focuses on the controls adopted in aiming to prevent any corrupt activities and financial misstatement from occurring.

Chapter Five is a concluding chapter of this dissertation. This chapter determines whether the analysis made in the preceding chapters is able to answer the research question. Any necessary recommendations in relation to the research answer, are made in this chapter.

Chapter 2: Tax laws imposed by the South African Government in attempting to deter corrupt conduct and financial mismanagement in SOEs.

This chapter examines the various tax regulations imposed by the South African government in attempting to combat corruption and financial mismanagement. The Prevention and Combating of Corrupt Activities Act 12 of 2004 and the Public Finance Management Act 1 of 1999 are analysed to determine the connection with the statutory provisions of the ITA dealing with the non-deductibility of expenses or losses arising from corruption and fruitless and wasteful expenditure. An understanding of the reasons why these regulations were adopted is also addressed in this chapter. In addition, the discussion around the taxing of income derived from unlawful or illegal activities, as meeting the definition of gross income, is analysed.

The discussion points are outlined as follows:

- Discussion of the deductibility of expenditure incurred because of unlawful activities under the provisions of section 11*(a)* of the ITA.
- Discussion of the deductibility of payment of expenditure where that payment constitutes an activity contemplated in Chapter 2 of the PCCA Act. Here the provisions of section 23*(o)*(i) of the ITA are analysed.
- Discussion of the deductibility of expenditure which constitutes a fine charged or penalty imposed as a result of an unlawful activity. Here the provisions of section 23*(o)*(ii) of the ITA are analysed.
- Discussion of the deductibility of expenditure incurred which constitutes fruitless and wasteful expenditure as defined in section 1 of the PFMA. Here the provisions of section 23*(o)*(iii) of the ITA are analysed.
- Discussion of the deductibility of penalties and interest imposed under ITA. Here the provisions of section 23*(d)* of the ITA are analysed.
- Discussion of whether the receipts that are derived from corrupt activities or illegal activities by the recipient meet the gross income definition which is included in section 1 of the ITA.

2.1 Section 11*(a)* – Also known as General deduction formula and related case law

Probably the best-known section of the Income Tax Act, 58 of 1962 is section 11*(a),* which is the general deduction formula. This section provides for general deductions in cases where a specific deduction section is not available in the ITA. As there was previously no specific section regulating the deduction for fines and penalties and any other expenses connected to illegal activities, one would therefore refer to section 11*(a).* To qualify for a deduction of expenses in this section, the following conditions must be met:

- Expenditure and losses must be actually incurred;
- In the production of income;
- Not of a capital nature; and
- Expended for the purposes of trade.

In addition to the section quoted above and as forming an integral part of the general deduction formula, are the provisions found in section 23 of the ITA. The provisions of section 23 prohibit deductions of certain kinds. The relevant subsection of section 23 for purposes of this chapter is section 23*(g).* Section 23*(g)* is a prohibitive section, and it reads as follows:

> *'23. No deduction shall in any case be made in respect of the following matters, namely –*
> *(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.'*

This research report now discusses each of the above criteria with reference to applicable case law before moving on to a discussion of public policy issues, requirements of section 23*(o)* and the taxing of income acquired from illegal activities.

To assist putting forth the discussion around the requirements of section 11*(a)*, a link to the fines and penalties arising from contravening the Competition Act is used as an example.

"Expenditure actually incurred"

According to case law, "actually occurred" in this context does not mean "actually paid" but there should be an existence of an absolute and unconditional payment obligation.[12] It is quite clear that if a penalty has been imposed by the courts within the meaning of competition law, there is an irrevocable and unconditional legal obligation to pay it, and for the purposes of this research part, this requirement is met, and no further discussion is required.

"In the production of income"

The requirement for the expenditure to be in the production of income requires a more censorious assessment. The 'income' referred to is that as defined in section 1 of the ITA, namely, the gross income less the exempt income.[13] The amount that a person spends does not necessarily translate into income. It is the series of acts and activities that generate income, and the question arises as to whether costs are closely related to this income.

"The meaning of the expression 'in the production of the income' was considered in the seminal decision of *Port Elizabeth Electric Tramway case of 1936*[14] and the interpretation accorded to it in the decision has never since been doubted."[15] The facts of this case involved the tramway company (i.e., the Taxpayer) which was involved in a transport business. The driver of one of its cars lost control of the vehicle, which collided with a building, after which, the driver suffered injuries and eventually died. The company was forced to pay compensation and the legal fees when it disputed the

[12] *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue (1936) CPD 241, 8 SATC 13 at 244*
[13] De Koker, A.P. & Williams, R.C. *Silke on South African Income Tax* 70th ed (Durban: LexisNexis 2021), page 799
[14] supra note 12
[15] De Koker, A.P. & Williams, R.C. *Silke on South African Income Tax* 70th ed (Durban: LexisNexis 2021), page 799

claim of the representatives of the deceased. The court took the view that the compensation paid served to generate income, but the legal fees were not associated with contesting the claim. Justice Watermeyer AJP, then delivering the judgment of the Cape Provincial Division of the Supreme Court, proceeded on the following principle:

> *"The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible."*

De Koker & William (2021), state in their book ,*Silke on South African Income Tax* that "Since the employment of drivers was necessary for the carrying on of the business of the company, and since the employment of drivers carried with it, as a necessary consequence, a potential liability to pay compensation if those drivers were injured in the course of their employment, the court considered that the compensation paid by the company had to be regarded as being so closely connected with the income earning act from which the expenditure arose as to form part of the cost of performing it. The compensation was therefore allowed as a deduction".[16]

Regarding the legal fees, their view is that "The court held that legal costs may be deducted if they are so intricately connected with the earning of the income as to be regarded as part of the cost of earning it. In this case, they were expended in resisting a demand for compensation, and since this was not an operation entered upon for the purpose of earning income, the legal costs were disallowed. (These restrictive criteria for the deductibility of legal expenses have since been relaxed by the enactment of s 11(c) which now governs the deductibility of legal costs)".[17] Section 11*(c)* is not part of the scope and therefore this research does not go into detail to address its requirements.

Penalties as a result of unlawful business practices must also be analysed to determine whether they are deductible or not. In *Alexander von Glehn,* a lawsuit on fines and penalties in the United Kingdom, the Court of Appeals ruled that the company was

[16] Ibid
[17] Ibid

fined for violating the law and therefore the cost of the penalty cannot be associated with the operations or trade of the business.[18]

In *Mann v Nash*, the court referred to *Alexander von Glehn,* and observed that:

> *"[T]he decision in the case was that payment of those penalties was nothing to do with the trade or business; it was not an expense for the earning of the profits, but it was an expense in the form of an inconvenience which supervened later when the profits were made, because illegality had been committed in the course of earning them."*[19]

The United Kingdom decision suggests that a deduction is denied on the basis that the required statutory connection or link between the fine/penalty and trading is absent.[20]

In the South African *Port Elizabeth Electric Tramway* case, Justice Watermeyer AJP states that:

> *"It follows that provided the act is bona fide done for the purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible."* And then qualifies his above statement to say *"It seems, however, that this statement may require qualification in one respect. If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible."*[21]

However, during 1918, there was also a court ruling in South Africa arguing that the costs of illegal activity could actually be deducted, in which case they would be classified as capital in nature rather than revenue in nature.[22] The case of *Delagoa Bay Cigarette Co Ltd* is the basis for the claim that expenses incurred to generate income

[18] *IRC v Alexander von Glehn and Co Ltd (1919) 12 TC 233*
[19] *(1932) 16 TC 523 at 529*
[20] Stansfield, E., 2010 '*The tax deductibility of penalties levied in terms of the Competitions Act 89 of 1998 and related expenditure, namely - interest expenditure and legal fee*s', at page 7
[21] *Port Elizabeth Electric Tramway* case at 17
[22] Goldswain, G., '*Illegal activities'* Tax Planning (2008) v 22 No 6 at page 143, see also SARS Draft Interpretation Note on *Deductibility of Expenditure and Losses Arising from Embezzlement or Theft of Money* at page 13

from immoral, illegal, or extreme activities may be deductible. In this case the court said:

> *"If the income itself is taxable it follows I think that if the [expenditure] would have been a legitimate deduction, had the business been legal, they would equally be a legitimate deduction if the business is illegal. The deductions permitted by our statute are not made to depend on any question of legality or illegality… Indeed it seems common sense that if illegal profits are taxable they must be subject to the same deductions as if they were legal*."[23]

When considering income-generating transactions that constitute illegal activities, it is necessary to distinguish between the business operation and illicit activity equivalent to the business operations. This is set out in *ITC 1199*, where the court said: '…*the nature and character of a fine as a punishment exacted by the State are such that it could not properly, naturally or reasonably be regarded as part of the cost of performing the business operation.'*[24]

The court cited in conjunction to the following extract from the Australian case of *Herald & Weekly Times Ltd*:

> *"The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character of trader."* [25]

Given the nature of competition and preventive penalties, it can be assumed that in most cases, companies can be reasonably expected to operate within the framework of the Competition Act rules. Penalties paid for violations of the Competitions Act are not part of the necessary costs of doing business, nor is negligence.[26]

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[23] *Commissioner for Inland Revenue v Delagoa Bay Cigarette Co Ltd (1918) TPD 32 SATC 47* at page 49
[24] *(1973) 36 SATC 16 (T)* at page 20-21
[25] *Herald & Weekly Times Ltd v Federal Commissioner of Taxation (1932) 2 ATD 169* at 172
[26] Stansfield, E., '*The tax deductibility of penalties levied in terms of the Competitions Act 89 of 1998 and related expenditure, namely - interest expenditure and legal fees'*, (2010) at page 9

The trade requirement:

Prior to the amendment of Section 23*(g)* in 1993,[27] its business requirements required that expenses be wholly and exclusively for business or trade purposes in order to be deductible.[28] In this modified section, expenses cannot be deducted if they are not for business or trade purposes, and therefore they can be apportioned if the expenses have both business and non-business purposes.[29] Primarily before this change, case law helped determine what constitutes a trade purpose.

In general, expenditure that is laid out for purposes of making a profit is always considered to be for purposes of trade. However, in *De Beers Holdings (Pty) Ltd v CIR*[30] it was stated that:

> *"It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade…Where, however, a trader normally carries on by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy section 23(g), be shown to have been so connected with the pursuit of the taxpayer's trade, e.g. on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively for the purposes of trade".*[31]

The paying of penalties as an expense does not in itself give rise to the production income, however the company has a legal obligation to pay the fine or penalty. Failure to do so could result in many unsuccessful transactions not conducive to a good trading situation. To avoid these situations, the business should avoid being involved in affairs that will result in fines and penalties. As stated in the *Warner Lambert* case,

[27] Paragraph (g) was substituted by section 20(b) of the Taxation Laws Amendment Act No 141 of 1992
[28] *1960 (2) SA 475 (A) at 479H–480A, 23 SATC 251* at 257
[29] De Koker, A.P. & Williams, R.C., *Silke on South African Income Tax* 70th ed (Durban: LexisNexis 2021), page 802
[30] *1986 (1) SA 8 (A), 47 SATC 229*
[31] *De Beers Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (A), 47 SATC 229* at 36 I-J

> *'To qualify as moneys expended in the course of trade, an outlay does not itself have to produce a profit.'*[32]

Similarly, to South Africa, the courts of New Zealand, Australia and the United Kingdom generally deny a deduction for the payment of a fine or penalty imposed under a statute or regulation. This is for one of two reasons:

> (a) The payment does not meet the statutory test for deductibility (the general permission, s DA 1(1) ITA 2007),[33] i.e., the fine is imposed for a violation of the law or to punish the offender, and therefore does not have the necessary connection with the generation of income or the conduct of a business activity, or (b) Because of overriding public policy grounds.

In Case *Z6 (2009) 24 NZTC 14,068* the TRA held that "a transport company which transported timber from forests for processing was unable to deduct fines incurred for overloading its trucks because the fines arising from the taxpayer's illegal activities (transporting too heavy a load) did not have a sufficient nexus with the taxpayer's income earning process. His Honour also disallowed the payment on public policy grounds".[34] The court stated that:

> *"[It seems] illogical to seek to deduct fines relating to a breach of the law as if they were a business expense, because they relate to activities which do not confirm to the law and so are not within the permitted scope of the business. I consider that a penalty/fine arising from a taxpayer's illegal activities…cannot have a sufficient nexus with the taxpayer's income earning process so as to create deductibility for that cost of the fine."*[35]

There are, however, some statements in case law (for example, *Case K62 (1988) 10 NZTC 504*) submitting that a deduction may be available if a sufficient and an

[32] *Warner Lambert SA (Pty) Ltd v Commissioner, SARS 2003 (5) SA 344 (SCA)* at page 16
[33] Section to the New Zealand Income Tax Act 2007
[34] Sevele, R., '*Lectures 5 and 6 Deductions - General permission, General limitations, Specific provisions*', viewed 20 March 2022, from https://www.studocu.com/en-nz/document/university-of-canterbury/taxation/acct254-2021-deductions/15857822
[35] *Case Z6 (2009) 24 NZTC 14,068*

appropriate relationship can be found between the derivation of income and the payment of the fine such as double-parking fines imposed on a courier driver required by an important customer to urgently deliver a package to a downtown city office.[36] The argument is that, since the fine for double-parking is closely linked to the production of income it would then qualify to be deductible in terms of section 11*(a)* of the ITA. However, with the implementation of section 23*(o)*(ii) of the ITA, which is discussed in detail in point 3.2 below, any fines or penalties imposed because of an unlawful activity would not be deductible for tax purposes. This means that there is no need to analyse the deductibility of such fines or penalties by applying case law because the ITA makes a provision for the treatment of fine and penalties imposed for contravening the law.

Is it of a capital nature?

Although the “capital nature” requirement is frequently left out when discussing the deductibility of penalties and fines imposed for contravening the law, as referred to the above case, *K62 (1988) 10 NZTC 504*, the double parking which led to the fines and penalties to arise might not be within the production of earnings themselves, however, alternatively are paid in protection of the environment conducive to the production of income. Therefore, as in the *Smith v Secretary for Inland Revenue* case, it can be argued that maintaining this income earning structure is essentially capital.[37] However, the Supreme Court of Appeal ruled that this was not the case. In the *Warner Lambert* case, the court ruled that just as insurance payments are revenue payments in nature, expenditures made to maintain, preserve, or avoid damage to the income earning structure are revenue payments. When considering the circumstances of this case, one can distinguish between payments that create a revenue earning structure (capital characteristics) and payments to maintain it (revenue characteristics). Any business could be closed[38] if the competition penalties are not paid. According to

[36] supra (note 35)
[37] *Smith v Secretary for Inland Revenue (1968) 30 SATC 35* at 37
[38] Examples of occasions that may lead to closure of the business:

a. Disqualification of directors of the company in terms of the Companies Act 61 of 1973. This may be a significant individual who has knowledge about the business.
b. Even if the business avoids the payment of the penalty, the customers could launch a civil claim for damages cases against the business, which may lead to bankruptcy of the business.

Emma Stansfield (2010), these payments are of the nature of revenue, as they protect the income earning structure.[39]

As mentioned in Chapter one above, that from a public policy perspective, the fines and penalties imposed as a result of contravening the law cannot be justified. The next subheading discusses the nexus of public policy to the deductibility of these payments.

Connection to Public Policy

> *"Public policy can be generally defined as a system of laws, regulatory measures, courses of action, and funding priorities concerning a given topic promulgated by a governmental entity or its representatives".* As stated by Dean G. Kilpatrick.[40]
>
> *"Public policy is based on the premise that the law should serve the public interest. It assists judges in the concurrent development of the common law and statutory interpretation".*[41]

This distinction is important because the rule of law is binding, but principles are guidelines only. If a law contains rules, those rules are binding for the purposes of the law. On the other hand, the principle is not binding, so there is room for more flexible application depending on the circumstances of the individual case. However, while there is flexibility in applying the judicial principles, judges are expected to respect the principles when relevant.[42]

It is also important to highlight that the principles can be binding and only if they have considerable authoritative support in a line of judgments. All that must be shown

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c. Business reputation can be damaged. Engaging in anti-competitive behaviour not only affects those directly involved, but it can also damage the entire business if customers decide they no longer want to get involved with the business. This may also lead to bankruptcy, which may lead to the business closure.

[39] Stansfield, E., (2010),'*The tax deductibility of penalties levied in terms of the Competitions Act 89 of 1998 and related expenditure, namely - interest expenditure and legal fees'.*

[40] Kilpatrick, D G., '*Definitions of Public Policy and the Law'*, viewed 06 June 2022, from https://mainweb-v.musc.edu/vawprevention/policy/definition.shtml#:~:text=Public%20policy%20can%20be%20generally,governmental%20entity%20or%20its%20representatives.

[41] Interpretation Statement IS 09/01, viewed 09 February 2022, from https://www.taxtechnical.ird.govt.nz//media/project/ir/tt/pdfs/interpretationstatements/is0901.pdf?modified=20200316220053&modified=20200316220053 at 11.

[42] note 41 at 12

is that they underlie a series of courts' decisions, that they were in fact a reason operating in a series of cases. [43]

In the *Mayne Nickless* case[44] in Australia, the taxpayer, that is a transportation company and operates armoured vehicles, had received several fines and penalties related to several traffic violations. Ormiston J. reviewed all the relevant authorities and concluded that no costs could be deducted for reasons best described as public policy reasons. He stated that:

> *"The critical feature of the fines and penalties are that they are imposed for purposes of the law in order to punish breaches thereof... This deterrent aspect makes it undesirable for a fine to be deductible, whether for serious or minor regulatory offences…To allow such deductions is seen as frustrating the legislative intent, as the punishment imposed will be seen to be diminished or lightened.*"[45]

In 1990, the South African Tax Courts concurred with the above judgment.[46]

Another public policy argument is that permitting tax deductions for these fines and penalties would allow violators of law to share these expenses with the public that the law was enacted to protect. This was mentioned in the case of *Lords in McKnight (Her Majesty's Inspector of Taxes) v Sheppard [1999] 3 All ER 491* where Lord Hoffman stated that (at page 486):

> *"[A fine or penalty's] purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden of the rest of the community by deduction for the purposes of tax. This, I think, is what Lord Sterndale MR meant when he said that the fine was imposed 'upon the company personally.'*[47]

[43] Braithwaite, J., 2002, '*Rules and Principles: A Theory of Legal Certainty*', page 51
[44] *Mayne Nickless Ltd v FCT (1984) 15 ATR 752*
[45] supra at 772-773
[46] *ITC 1490 (1990) 53 SATC 108 (T)* at 113-114
[47] Interpretation Statement IS 09/01, viewed 09 February 2022, from https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/interpretationstatements/is0901.pdf?modified=20200316220053&modified=20200316220053 at 3.

Thus, being able to deduct fines and penalties can also create inequalities among taxpayers. For New Zealand, the court stated that:

> *"[this practice would] prefer business lawbreakers over individuals as the business lawbreaker would obtain the benefit of deductibility of the amount of the fine or penalty whereas the individual would have to bear that particular expense personally. Additionally, it would tend to allow, and encourage, lawbreaking and in some instances, to even treat it as a legitimate business option resulting in deductibility.*"[48]

"Public policy is never static: it evolves over time. This evolution is due to the constant change in the wide range of interests that make up the public interest. For example, changes in society's economic needs, social costs, customs, and moral aspirations can affect the public interest. Although public policy can also additionally alternate in reaction to indicators from any part of society at any time, modifications normally arise incrementally. This intentional aspect separates public policy from legal norms."[49]

As noted by Ormiston J in the *Mayne Nickless* case,

> *"Many aspects of public policy have been and remain controversial largely because the courts have attempted to express and apply policies which did not derive directly from the common law or statute, but were derived from what were said to be accepted social or economic beliefs at the time. These beliefs have not always remained constant, so that difficulties arise in determining whether 'public policy' can change or expand."*[50]

It should be noted that Section 59*(2)* of the Competition Act sets a limit on the maximum penalty that may be imposed for offences or contravention of the

[48] *Nicholas Nathan Ltd v CIR (1989) 11 NZTC 6*, page 213 at 6, page 217 at 9
[49] Interpretation Statement IS 09/01, viewed 09 February 2022, from https://www.taxtechnical.ird.govt.nz//media/project/ir/tt/pdfs/interpretationstatements/is0901.pdf?modified=20200316220053&modified=20200316220053 at page 11-12,
[50] *Mayne Nickless Ltd v FCT (1984) 15 ATR 752* at page 772

Competitions Act. The said limit is set at 10% of the sales of the infringing company in the preceding fiscal year. The penalty imposed under Section 59 of the Competition Act shall not exceed 25% of the annual turnover of the enterprise in the Republic and its exports from the Republic in the preceding fiscal year, if the conduct is essentially a repetition of conduct by the same enterprise previously classified by the Competition Court as a prohibited practice. "The fact that it is set out in this way and not, as in section 74, which provides a set of maximum penalty for criminal offences, suggests that the legislature intended the penalty to be relative to the economic impact of the respondent in the market…This relative, as opposed to absolute cap, is more consistent with a deterrent than a punitive model, [as] it requires greater administrative penalties to be imposed on larger players."[51]

South African tax expert, Van Dorsten, properly states that the deterrent effect of the administrative penalty would be diminished or weakened if the penalty would be allowed as a deduction. This would defeat the legislative intent of Section 59*(1)* of the Competition Act.[52] It must therefore be concluded that it is against public policy to allow deductions of expenses incurred because of administrative sanctions under section 11*(a)* of the ITA.

Government policy plays a significant role when it comes to tax deductions for fines and penalties. From a public interest point of view, the overall goal of the public policy approach to fines and penalties is clear. Anti-competitive behaviour is often associated with income generation. You can expect this to be true, as this is actually the motive for such illegal activity. Because of this, and because most of the other requirements of section 11*(a)* can be shown to be generally met, it can be inferred that it is often easier for judges to invoke public policy when a judge prohibits such deductions.[53]

[51] Van Dorsten, J., (2009), 'The tax implications of competition penalties', *Taxpayer* v 58 No 8 at page 145 also see Stansfield, E., '*The tax deductibility of penalties levied in terms of the Competitions Act 89 of 1998 and related expenditure, namely - interest expenditure and legal fees*', (2010) at page 13-14
[52] Van Dorsten, J., (2009), 'The tax implications of competition penalties', *Taxpayer* v 58 No 8 at page 145 also see Stansfield, E., 'The tax deductibility of penalties levied in terms of the Competitions Act 89 of 1998 and related expenditure, namely - interest expenditure and legal fees', (2010) at page 14
[53] Stansfield, E., '*The tax deductibility of penalties levied in terms of the Competitions Act 89 of 1998 and related expenditure, namely - interest expenditure and legal fees'*, (2010) at page14

2.2 Section 23*(o)* considerations

Section 23(*o*) was introduced into the ITA by section 28*(1)(e)* of the Revenue Laws Amendment Act, No. 31 of 2005 with effect from 1 January 2006. It applies in respect of any year of assessment commencing on or after that date and reads as follows:

> *'**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 - (o)—*
> *(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.'*

Prior to the introduction of section 23*(o)*, the ITA did not specifically address the non-deductibility of costs incurred in connection with illegal activities, and such expenses were considered under the general deduction formula, section 11*(a)* read with section 23*(g)*. As explained earlier, it is often said that bribes, fines, and penalties incurred in conducting a trade can be deducted for income tax purposes as they would occur in the generation of income and in the conducting of the taxpayer's business operations. Section 23*(o)* was then introduced into the ITA, to resolve the debate around the eligibility of the deductibility of these expenses and to eliminate the reliance on the subjective application of the court's public policy.

The governmental basis for including Section 23*(o)* is explained in the Explanatory Memorandum to the 2005 Revenue Law Amendment Bill as follows:

> *"From a policy perspective the deduction of fines and penalties for tax purposes cannot be justified where those payments relate to unlawful*

> *activities. 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 in terms of which it is imposed."*[54]

The Taxation Laws Amendment Act, 23 of 2018 further introduced into the ITA section 23*(o)*(iii) which prohibits a deduction of any expenditure incurred constituting fruitless and wasteful expenditure, as defined in section 1 of the Public Finance Management Act, determined in accordance with that Act.

Section 23*(o)*(iii) came into operation on 1 April 2019 and applies in respect of years of assessment commencing on or after that date.

Firstly, Section 23*(o)*(i) is relevant to the scope of this paper as it focuses on corruption in SOEs which is what the provisions of section 23*(o)*(i) address. Secondly, the deductibility of penalties or fines imposed as a result of unlawful activities in terms of section 23*(o)*(ii) will be considered since they may be directly related to the financial mismanagement of SOEs. Thirdly, the provisions of section 23*(o)*(iii) address the deductibility of fruitless and wasteful expenditure incurred by SOEs.

To elaborate on the relevance of the provisions of section 23*(o)*, each subsection will be discussed in detail.

*2.2.1 Section 23(o)***(i)** *considerations*

The provisions of section 23*(o)*(i) prohibit the deductibility of any payment from income tax, "if such a payment, agreement, or offer to make a payment constitutes an activity contemplated in Chapter 2 of the PCCA Act".[55] Although there are several types of corrupt activities that fall under the ambit of Chapter 2 of the PCCA Act, this research report does not provide an analysis of all the corrupt activities identified in the PCCA Act. This research report focuses on corruption related to public procurement.

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[54] Explanatory Memorandum to the 2005 Revenue Law Amendment Bill at page 24
[55] Section 23*(o)*(i) of the ITA

As mentioned in the SARS Interpretation Note 54, chapter 2 of the PCCA Act deals with the general offence of corruption and offences related to corrupt acts in relation to specific individuals. The PCCA Act further addresses the offences in respect of corrupt activities relating to both the receiving and the offering of unauthorised gratification by or to party to an employment, 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".

"Specific matters" under the PCCA Act provides for corrupt activities relating to –

- "witnesses and evidential material during certain proceedings
- contracts
- procuring and withdrawal of tenders
- auctions
- sporting events
- gambling games or games of chance"

Chapter 2 of the PCCA Act also contains various criminal offences related to potential conflicts of interest and other unacceptable conduct. It provides for the following –

- "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".

Finally, the Chapter regulates the status of aiding, abetting, attempting, conspiring, or inducing another person to commit any of the offences listed in this Chapter

2.2.2 A definition of 'corruption'

Finding a comprehensive definition of the word "corruption" can be difficult. The term contains moral and ethical elements and in almost any society, it is a particularly diplomatic subject. If "corruption" is broadly defined, it definitely goes against its own and perhaps universal values, but nevertheless it is suggested that corruption can be culture specific. It can certainly be argued that there is a dichotomy between the concepts of corruption when viewed from the point of view of Western and non-Western interpretations of the term.[56] However, despite these challenges, there are no simple definitions which capture the quintessence of the concept.

Merriam Webster dictionary provides the essential meaning of "*corruption*" as follows:

> *"dishonest or illegal behaviour especially by powerful people (such as government officials or police officers)"*.[57]

In addressing this term, we may turn to the simpler definition provided by the World Bank, to say, corruption is the abuse of power for personal gain.[58] In the South African context, we may refer to two international instruments to which the country is a party, namely the African Union Convention on Preventing and Combating Corruption [59] and the United Nations Convention Against Corruption.[60] Both international documents recognize that corruption has become a cross-border phenomenon that affects all societies and economies. Therefore, international co-operation is essential to prevent and eradicate corruption. The instruments aim to

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[56] Williams, S. & Quinot G., '*Public Procurement and Corruption: The South African Response*' (2007) 124(2) South African Law Journal 339 at page 340.
[57] Merriam Webster Dictionary, since 1828, viewed 09 February 2022, from https://www.merriam-webster.com/dictionary/corruption.
[58] The World Bank, (1997), '*Corruption and Economic Development*' in Helping Countries Combat Corruption: The Role of the World Bank at page 8.
[59] African Union, The African Union Convention on Preventing and Combating Corruption (11 July 2003), viewed 20 March 2022 ,from https://au.int/sites/default/files/treaties/36382-treaty-0028_-_african_union_convention_on_preventing_and_combating_corruption_e.pdf
[60] United Nations. 2003. '*United Nations Convention Against Corruption*'. Treaty Series 2349 (October): 41, viewed 20 March 2022, from https://www.unodc.org/documents/brussels/UN_Convention_Against_Corruption.pdf

promote and strengthen measures in signatory countries that prevent, detect, combat, and punish corruption and further promote integrity, accountability and proper management of public affairs and public property.[61] The vital role of these instruments cannot be understated - it is globally recognised that public procurement, which is used as the subject matters of this part of the report, as a sphere of government activity is a major area in which corruption takes place and South Africa is no exception. This is because public procurement tends to be expensive, especially for large infrastructure projects. The contractors involved are often non-commercial in nature. Due to the inherent nature of the relationship between persons making decisions and government institutions, deviations from the public interest generally do not affect the personal finances of those people making decisions; a broad and often uncontrolled level of discretion given to decision makers; bureaucratic rules that provide insufficient regulation and guidance to governments and individuals.[62]

When it comes to domestic regulation and penalisation of corruption, the PCCA Act is South Africa's main legislation that enforces the country's international obligations on this issue. It is instructive to repeat its definition of corruption in section 3:

"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,*

[61]Article 1 of the United Nations Convention Against Corruption and Article 2 of the AU Convention on Preventing and Combating Corruption.
[62] Williams, S. & Quinot G., 2013, '*A perspective on corruption and public procurement in Africa'*, at page 341.

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 comprehensive definition of corruption in the PCCA Act is part of an effort to develop a consistent and comprehensive approach to combating corruption in the public sector in South Africa.[63] In addition to defining the term, the PAAC Act regulates certain crimes that may be committed by certain categories of people, such as civil servants, judicial and legislative officials.[64] It also provides for two offences in relation to procurement and further prohibits public officials from obtaining private interests in contracts involving public institutions in which they work.[65] These mechanisms are described in detail below.

2.2.3 Public Procurement Considerations

With the advent of democracy in 1994, the South African government realized that it needed to maintain and expand its electricity, water, transportation, and telecommunications infrastructure in order to sustain and promote the country's economic growth and social development. This is set out in the National Development Plan 2030 (NDP),[66] the South African Government's long-term policy strategy to eradicate poverty and reduce inequality by 2030. The NDP appreciates that the development of economic infrastructure is a necessity for the provision of basic services, and that South Africa has a "superior core network of national economic

[63] Caswell, G.S., (2016), *"Public Procurement Challenges and Reforms for Infrastructure Development in South Africa"*, Public Law Department", Degree LLM in Constitutional and Administrative Law, Faculty of Law, University of Cape Town at page 41.
[64] Ibid
[65] Ibid at page 346.
[66] The South African National Planning Commission, *The National Development Plan* (2013)

infrastructure". 'This infrastructure must be robust and comprehensive enough to support the needs of the country's industry, commerce, and housing.[67] Accordingly, the NDP recognises that government will need to make huge investments to propel economic activity and given government's limited finances, it further recognises that private funding is needed to achieve the developmental outcomes. The result is that given the scale and complex nature of investing in infrastructure, partnering with the private sector through procurement mechanisms, such as public-private partnerships, has become fundamental.[68][69]

Since public procurement has played a central role in democratic South Africa, it is not surprising that it is regulated not only at the constitutional level, but also through strong legal and political mechanisms at the national, provincial, and local levels. In addition, South African courts play a vital role in the field of South African procurement law, regularly interpreting and ruling controversial legal issues that are a natural consequence of roles and functions during the procurement process. As governments become more dependent on public procurement, the more the procurement laws evolve with time. As far as procurement is concerned, the court's involvement in public procurement and the development of administrative law is especially evident when procurement procedures relate to large infrastructure projects in areas such as transportation and energy. Procurement for the functions of the development of huge infrastructure has a tendency to contain a mess of administrative approaches and choices that are interrelated, and which call for increasing numbers of complicated and nuanced duties and considerations for government decision-makers to take into account. Owing to this increasingly complex structure of responsibilities and considerations, large-scale infrastructure procurement is often taking place over a long-term period. Despite strong laws governing government procurement, South Africa's procurement system continues to suffer from many problems. These issues include elements of unnecessary bidding, overcharging, false billing, poor demand

[67] Ibid at page 160.
[68] Ibid.
[69] Caswell, G.S., (2016), '*Public Procurement Challenges and Reforms for Infrastructure Development in South Africa*', Public Law Department", Degree LLM in Constitutional and Administrative Law, Faculty of Law, University of Cape Town at page 3.

management, scope creep, unreasonable escalation costs, and sadly ubiquitous corruption.[70]

The direct result of these growing issues is that the South African government is currently facing a considerable number of legal and other challenges to its procurement process. These challenges are created by a variety of stakeholders, including unsuccessful private sector bidders competing for the development of infrastructure projects, especially civil society organizations and communities affected by infrastructure procurement. The complex nature of the procurement process for massive infrastructure and the time it takes to complete the process suggest that the legal challenges are launched earlier than the overall gamut of administrative decisions has been made and the tender finally awarded. The meaning of these issues is clear. They create a tension between the need for governments to effectively provide essential infrastructure in South Africa on the one hand, and on the other hand, the need for an illegal, unsound, or procedurally unfair public procurement process to be diligently reviewed.

Public servants when entering into procurement contracts must act in the best interests of the public, act honestly in dealing with public money and report corruption.[71] In *Glenister v President of the Republic of South Africa*[72] the court stated that corruption "….has the potential to undermine the ability of the state to deliver on many of its obligations in the Bill of Rights, notably those relating to social and economic rights". It was found that the Constitution imposes an obligation on the state to establish and maintain an independent body to combat corruption and organised crime. A connection between public procurement and the constitution is discussed below.

2.2.4 Public procurement and what it means in the Constitution

The heart of South Africa's public procurement management regime is the guiding principles set forth in the Constitution.[73] In particular, the principles outlined in Section 217*(1)* provide that public bodies of national, provincial, or local

[70] Caswell, G.S., (2016), '*Public Procurement Challenges and Reforms for Infrastructure Development in South Africa'*, Public Law Department, Degree LLM in Constitutional and Administrative Law, Faculty of Law, University of Cape Town at page 4.
[71] Corruption watch, 2015, '*Corruption and The Law in South Africa- A quick Reference Guide'*, at page 18
[72] *Glenister v President of the Republic of South Africa and Others (CCT 48/10) [2011] ZACC 6* at page 83
[73] The Constitution of the Republic of South Africa, 1996 (the 'Constitution').

governments or other bodies as provided for in national law, when entering into contracts for goods or services, must: do so according to a system that is fair, equitable, transparent, competitive, and cost-effective. This constitutional requirement is again mentioned in section 51*(1)(a)* of the PFMA, which states that “an accounting authority for a national or provincial department or entity must ensure that the particular department or entity maintains an appropriate procurement and provisioning system which is fair, equitable, transparent, competitive, and cost effective”. That means, in addition to the PFMA, all the laws, relevant regulations, and government policies that make up South Africa's regulatory system must serve, protect, and promote these five principles outlined in the Constitution. These principles will each be considered in turn.[74]

Fairness and equity require that the procurement process be procedurally fair and refer to how the process is conducted. For example, all participants must receive the same information, deadlines, and opportunities.[75] In providing more clarity the “fairness” element of section 217*(1)* requires that the process be non-discriminatory, just, and appropriate in the circumstances, impartial in accordance with rules or standards, and free from corruption or prejudice. The principle of “equity” ensures that in order to achieve justice, there needs to be recognition of differences in resources, development, race, and environment and provide remedies that account for these differences. In the context of procurement, the principle of equity is most prominent in the context of affirmative action.

Transparency requires openness and accountability. This means that the process must be public and not behind closed doors. It means that information about procurement must be widely available, that procurement rules and practises should be standardised and publicised, and that information about public contracts and how they are awarded should be accessible.[76]

[74] Caswell, G.S., (2016), ‘*Public Procurement Challenges and Reforms for Infrastructure Development in South Africa"*, Public Law Department’, Degree LLM in Constitutional and Administrative Law, Faculty of Law, University of Cape Town at page 5.
[75] Turker, C., Grimwood, S., Mandlana, W., ‘Guide to Government Contracting and Public Procurement in South Africa’, at page 9
[76] Ibid

Competitiveness and cost-effectiveness are closely related, revolve around cost, and require that a government entity, taking into account the other principles, must seek to procure goods or services at the lowest possible cost and obtain value for money.[77] Bolton (2007) points out that the principle of "competitiveness" has several meanings. More formally, it is defined as "a process related to or determined by competition. Associated with or characterized by the aspiration to compete", whereas in a broader sense, it means a process that is "free to all" and "open to the public".[78] A clear benefit of incorporating the principles of competition and profitability into the Constitution is that it compels government through laws, policies, and procedures to ensure that factors such as price and quality are comparable when purchasing goods and services. It is also important to emphasize that achieving the lowest price should not be a decisive factor. Instead, when evaluating the cost effectiveness of a particular public procurement process, considerations such as the efficiency, reliability, and maintenance and operating costs of the goods or services that can be delivered should be considered.[79]

The fact that the aforementioned principles have been constitutionally enshrined, prima facie warrants that they should all be complied with whenever the state contracts for goods or services. However, the variable nature of state procurement processes (which very often turns on the nature of the goods or services being procured) means that the weight attached to each of the principles is similarly variable. The total effect must be that the principles in section 217*(1)* must permeate the entire procurement process and the individual elements must be balanced to ensure overall compliance.[80]

A further ramification of this is that any legislation which is directly aimed at procurement processes must be construed in accordance with the constitutional principles and, if it is found to be inconsistent, it may be declared invalid for its inconsistency with the principles. The legislation regulating state procurement processes largely stem from sections 217*(2)* and *(3)* of the Constitution. These

[77] Ibid
[78] Bolton, P., 2007, '*The Law of Government Procurement in South Africa*', page 40-41.
[79] Turpin, C., Government Procurement and Contracts (1989) at page 66.
[80] Caswell, G.S., (2016), '*Public Procurement Challenges and Reforms for Infrastructure Development in South Africa'*, Public Law Department, Degree LLM in Constitutional and Administrative Law, Faculty of Law, University of Cape Town at page 9.

sections allow organs of state to implement 'a procurement policy providing for (a) categories of preference in the allocation of contracts; and (b) the protection or advancement of persons, or categories of persons, disadvantaged by unfair discrimination' and that 'national legislation must prescribe a framework within which the policy referred to in subsection (2) must be implemented'. In addition, the sections establish a mechanism through which state procurement can be used as a policy tool to realise certain constitutional outcomes, such as the achievement of equality, through preferential or differential treatment of contractors in certain circumstances.[81]

Evidently, even though section 217*(1)* lists five principles, sections 217*(2)* and *(3)* create a mechanism through which justifiable limitations may be placed on the former section. For example, even though section 217*(1)* requires procurement processes to be 'fair' which would mean that contractors would have to be treated equally, sanctioning the use of preferential treatment of contractors in section 217*(2)* allows equity to prevail to ensure that the award of government contracts take levels of disadvantage into account and the related differing levels of resources and development of vulnerable groups in South Africa. The constitutional provisions in section 217 demonstrably ensure that state funds are spent efficiently, economically, and lawfully. The fact that South Africa has constitutionally regulated procurement processes provides a solid grounding of core principles which should, in theory, ensure a good procurement system.[82]

2.2.5 Conclusion on the deductibility of expenditure or payment constituting an activity contemplated in Chapter 2 of PCCA Act.

Sections 23*(o)*(i) does not require the existence of a conviction for the section to apply. Payments that make up the activities set out in Chapter 2 of the PCCA Act will be disallowed as a deduction for the income tax. Also, this is suggested by what the public policy believes in and the fact that the constitution specifically sets forth the principles which should be abided by to ensure a lawful and effective procurement process. If these principles are not complied with that would be contravention of the Constitution Act itself that underpins the PAAC Act. It is worth noting that under

[81] Ibid
[82] ibid

section 3 of the PCCA Act, not all forms of gifts constitute a criminal offence. Gifts of no substantive, permanent, or commercial value are usually not within that range, but factors such as taxpayer intent, gift size and regularity of the gift, and recipient position are taken into account. In determining if the gift falls under the ambit of criminal offence, the Commissioner will consider the *dictum* in the *Gates v Gates*[83] case:

> *"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."*

The impact of section 23*(o)*(i) has been discussed and it is clear that the said section denies a deduction of any expenses that comprise illegal activities, however the other question would now be whether the amounts received by the taxpayer or the amount accruing to the taxpayer from illegal activities are within the literal meaning of "gross income".[84] The gross income aspect of the corruption issues has been discussed below under the considerations of gross income definition. This aspect has been discussed because SARS in Interpretation Note 54 fails to acknowledge this issue and focuses only on one aspect, which is on the side of the payer and no discussion is undertaken on the side of the recipient.

[83] *1939 AD 150* at 155.
[84] *MP Finance Group CC v C: SARS 2007 (5) SA 521 (SCA), 69 SATC 141*.

2.3 Section 23*(o)*(ii) considerations

Consideration regarding the deduction of penalties imposed by the Competition Commission under Competition Law 89 of 1998 to address what is intended by the provisions of section 23*(o)*(ii) is discussed as an example, similar to the way in which it was used to discuss the provisions of section 11(a) above.

The provisions of section 23*(o)*(ii) of the ITA deal with the prohibition of the deductibility of a fine or penalty imposed as a result of an unlawful activity carried out in the Republic or in another country, if such that activity would have been unlawful if it had been carried out in the Republic.

The ITA does not provide a definition of a "penalty", "fine" or "unlawful activity". Therefore, it is judicious to apply the literal interpretation rules set out in the *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of the Sale of the MV Jade Transporter,*[85] case. This rule requires that words be given their ordinary grammatical meaning, unless to do so would cause a senseless result or would be contrary to the intention of the legislation. Furthermore, in respect of the interpretation rule, the Supreme Court of Appeal in *Natal Joint Municipal Pension Fund v Endumeni Municipality*[86] held as follows:

> *"The present state of the law can be expressed as follows. Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence…The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document…from the outset one considers the context and the language together, with neither predominating over the other. This is the approach that courts in South Africa should now follow…"*

[85] *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of the Sale of the MV Jade Transporter (1987) 2 SA 547 (A)* at 596
[86] *2012 (4) SA 593 (SCA)* at para 18

Definitions:

Black's Law Dictionary[87] defines a *penalty* and *unlawful act* as follows:

> "***Penalty***" – "a penalty is a sum of money which the law exacts payment of by way of punishment for doing some act which is prohibited or for not doing some act which is required to be done."

> "***Unlawful***" – "That which is contrary to, prohibited, or unauthorised by law. That which is not lawful. The acting contrary to, or in defiance of, the law; disobeying or disregarding the law. "

Merriam Webster Dictionary[88] defines a fine as follows:

> "***Fine***" – "a sum imposed as punishment for an offence"

Matthews J stated the following in *Rex v Laughton case*:

> *'" **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.'*[89]

From the dictionary definition of the word "penalty" and the judicial definition, it is clear that the administrative penalty is within the normal meaning of "penalty".

> Merriam Webster has defined "Law" as "*a binding custom or practice of a community: a rule of conduct or action prescribed or formally recognized as binding or enforced by a controlling authority*."[90]

[87] Garner, B.A., Black's Law Dictionary 8th ed (2004)
[88] "*Fine*" Merriam-Webster.com Dictionary, Merriam-Webster, viewed 12 Aug. 2021 from https://www.merriam-webster.com/dictionary/fine.
[89] *Laughton, Rex v 1930 NPD 47* at 53
[90] "*Law*" Merriam-Webster.com Dictionary, Merriam-Webster, viewed 10 February 2022, from https://www.merriam-webster.com/dictionary/law.

Whether or not the conduct giving rise to the penalty is "unlawful" or “illegal”, reference should be made to Section *59(1)* of the Competition Act, which lists the only offences for which a penalty may be imposed. Since the penalty can only be imposed on companies that violate or ignore certain provisions of the Competition Act or orders of the Competition Tribunal or the Competition Appeals Tribunal, and since this Act was enacted by Parliament and signed by the President, it is clear that such conduct is unlawful.[91] This is also confirmed in relation to price-fixing in *Civcon Construction (Pty) Ltd*[92] case, where *Civcon* agreed that it is liable to pay an administrative penalty of R798 385.98 (Seven Hundred Ninety Eight Thousand Three Hundred Eighty Five Rand and Ninety Eight Cents), such penalty being equal to 1% of Civcon's annual turnover for the year ending February 2013. This penalty was as a result of contravention of section 4*(1)(b)*(iii) of the Competition Act. There were sufficient grounds for *Civcon* to justify the act of contravening the law.

From the above discussion, it has been established that administrative sanctions are penalties imposed as a result of unlawful or illegal acts, as stipulated in section 23*(o)*(ii) of the ITA and as such, they are not eligible for deductions.

Although SARS Interpretation Note 54 makes mention, in paragraph 4.2.1, that SARS regards the practices prohibited by the Competition Act as unlawful acts for the purposes of section 23*(o)*(ii), it is noteworthy to state that interpretation notes are not legislation, and the views set out by SARS therein are merely SARS’ views on the interpretation of section 23*(o)* of the ITA.

2.3.1 Conclusion on the deductibility of Competition penalties

Over the years, courts have had to decide on the deductibility of fines and penalties arising from unlawful acts. The two approaches used would either be to focus on the requirement of "production of income" or to rely on public policy. There are arguments for and against fines and penalties being in the production of income and there are case studies that support both. However, public policy does not favour the deduction of these fines and penalties because it would defeat their purpose and moreover it would seem as if the law favoured the business law violators more than

[91] Van Dorsten, J., ‘The tax implications of competition penalties’ *Taxpayer* (2009) v 58 No 8 at 146
[92] *Competition Commission v Civcon Construction (Pty) Ltd, (2015) JOL 33847 (CT)*

the non-business law violators and encouraging breaking the law as a legitimate business option.

Since the application of public policy is a subjective approach rather than an accurate science, Section 23*(o)* was enacted to prohibit bribes, fines and fine deductions related to unlawful or illegal activities. When using literal rules of interpretation for the words "*penalty*" and "*unlawful*", it is clear that this prohibition section also refers to the fines and penalties for contravening the Competition Act.

2.4 Section 23*(o)*(iii) considerations

Section 23*(o)*(iii) provides provisions pertaining to the prohibition of the deduction of any expenditure incurred as constituting fruitless and wasteful expenditure as defined in section 1 of the PFMA.[93]

The PFMA defines fruitless and wasteful expenditure as expenditure which was made in vain and would have been avoided had reasonable care been exercised.

One of the proposals in the Budget Review 2018 ("Budget") to preserve a sustainable tax base was to disallow fruitless and wasteful expenditure by government entities.[94]

The Budget candidly noted that poorly governed and administered SOEs are a burden to the fiscus due to the substantial costs of operational inefficiencies and financial mismanagement. Media reports in the past few years have echoed this, and, increasingly, noted that public entities, in particular, are plagued by fruitless and wasteful expenditure.[95]

Prior to 1 April 2019, the ITA did not use the term "fruitless and wasteful expenditure" in any of its provisions. It also did not contain an adjusted or tailored tax mechanism to penalize SOEs for this particular mischief. The PFMA, on the other hand, defines fruitless and wasteful expenditure as "*expenditure which was made in vain and would have been avoided had reasonable care been exercised*." However,

[93] Public Finance Management Act of 1999
[94] The tax implications of fruitless and wasteful expenditure, viewed 10 February 2022, from https://www.webberwentzel.com/News/Pages/the-tax-implications-of-fruitless-and-wasteful-expenditure.aspx ,
[95] Supra

the applicable sanctions imposed by PFMA did not seem to be completely effective in combating this prevailing obstacle. As part of the stated efforts to undo the harmful effects of corruption on tax morality and to restore national trust in public institutions, the Budget proposed to deny income tax deductions available to public entities, in cases where losses and expenses are classified as fruitless and wasteful within the meaning of the PFMA.[96] Section 23*(o)*(iii) was then formally introduced in the ITA to make it official to disallow the deduction of losses or expenditure which fall under the definition of fruitless and wasteful in the PFMA. This provision came into effect from 1 April 2019 and applies in respect of years of assessment commencing on or after that date.

The PFMA requires a public organization to take effective and appropriate disciplinary action against any public entity employee who causes or permits fruitless and wasteful expenditures. According to National Treasury, “effective and appropriate action incorporates any actions by the public entity to recover such wasteful and fruitless expenditure from the offending employee. As a measure to ensure tax neutrality in the legislation, it is proposed that any amount of fruitless and wasteful expenditure that was not allowed as a deduction and was recovered by the public entity be deemed to be exempt from income tax during the year of assessment in which it is received or accrued”.[97][98]

2.4.1 Conclusion on the deductibility of fruitless and wasteful expenditure

The introduction of Section 23*(o)*(iii) in the ITA was and is an encouraging proposition that will hopefully be a clear and practical tax remedy to address the pervasive and detrimental impediment to normal operations and normal financial management, usually by many public entities.

2.5 Section 23*(d)* considerations

Section 23***(d)*** is a provision in the ITA that disallows interest and penalties paid to SARS. This section states that:

[96] Supra
[97] Section 10*(1) (zL)* of the Income Tax Act, 58 of 1962
[98] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018 (P. 23)

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

(d) any tax imposed under this Act or any interest or penalty imposed under any other Act administered by the Commissioner."

Section 23*(d)* is analysed as follows:

It is important to note that the interest and penalties paid to SARS are not deductible for tax purposes. It follows that any reckless completion of tax returns or failure to submit tax returns timeously as a result of mismanagement may give rise to interest and penalties which will ultimately, not be deductible for tax purposes.

The emphasis is that fines and penalties incurred as a result of prejudicing of the fiscus will fall under the ambit of section 23*(d)*, whereas fines and penalties imposed for tax offences will be disallowed as a deduction under section 23(*o*)(ii). The provisions of section 23*(o)* have been discussed in detail above.

2.6 Section 1 - Gross income definition considerations

In the above paragraphs, we have been discussing the tax laws imposed by the South African government in denying the deductibility of expenditure in respect of corrupt activities, fines and penalties, interest and penalties paid to SARS, as well as the expenditure that falls under the ambit of Fruitless and Wasteful expenditure as defined in the PFMA. In this section, we explore the impact of the receipts that are derived from corrupt activities or illegal activities by the recipient from the fiscus perspective and whether the receipts are taxable or not. Furthermore, this section determines if the role of taxing those illegal receipts, if at all, assists in discouraging any corrupt and illegal activities by government officials and other employees of SOEs that participate in unlawful activities.

2.6.1 Should income derived from illegal activities be taxed?

In South Africa and other jurisdictions, taxing income derived from illegal activities has always been highly controversial, as there is always the question of whether income tax should be levied on income from illegal activities. It should be noted that not taxing the income from illicit activities could have a profound impact on any country as it gives those who engage in criminal business activities a competitive advantage over those who engage in legitimate business practices. Illegal businesses produce goods at a discount and sell them at a lower price than businesses that pay taxes. Criminals get a higher income and expect that income to be exempted because it is derived from illegal activities.[99] One may then question that taxing income derived from illegal activities may appear to be normalising and condoning unlawful activities and that the government is benefiting from crime. This is however not the case according to Lord Browne-Wilkinson in *McGuckian v CIR* where he states that "liability to tax depends on statutory construction not moral disapproval."[100]

Furthermore, it has been argued that by taxing income receipts from illegal activities, SARS does not necessarily condone such activities. Because SARS was not involved in the participation of those illegal activities, it simply recognizes income derived from what appears to be trade and the tax law provides for taxation of income derived from the furtherance of trade. To support this claim, reference is made to the case of *Mann v Nash (HM Inspector of Taxes)* [101] in England. In this case, the court held that the government did not condone illegal activity by taxing income derived from illegal activities.

> *"The Revenue, representing the State, is merely looking at an accomplished fact. It is not condoning it; it has not taken part in it; it merely finds profits made from what appears to be a trade, and the Revenue laws happen to say that the profits made from trades have to be taxed, and they say: 'Give us the tax'' It is not the purpose in my judgment to say: 'but the same State that you represent has said they are unlawful'; that is immaterial altogether and I do not see that there is any contact between the two propositions . . . It is said again: 'Is the State coming forward to take a share of unlawful gains?' It is mere rhetoric. The State is doing nothing of the kind; they are taxing the individual with reference to certain facts. They are not partners; they are not principals in the illegality, or sharers in the illegality; they are merely taxing a*

[99] Ogunnsanwo, O., *A comparative study and analysis of the taxability of illegal income in South Africa and United States of America*, Unpublished LLM thesis, University of Pretoria, 2013, at page 6.
[100] Hingun, M., and Nafiu, O.S., 2015, '*The scope of taxation of income from illegal activities in selected common law jurisdictions*', page 394
[101] *Mann v Nash (H M Inspector of Taxes) ,1932, 1 KB 752, 16 TC 523*

man in respect of those resources. I think it is only rhetoric to say that they are sharing in his profits, and a piece of rhetoric which is perfectly useless for the solution to the question which I have to decide."[102]

SARS is simply fulfilling its function as a tax collector set forth in the Income Tax Act. The rationale for this inference is that it would not be fair for SARS to allow illegal traders to enjoy better benefits than those engaged in legal business operations. Fiscal neutrality plays a key role in any tax regime and cannot be ignored on the basis of the illegality of certain transactions.

The next section evaluates how courts decide whether income derived from illegal activities falls under the ambit of gross income and therefore taxable for the purposes of ITA. The ITA defines "*gross income*" as the total amount, in cash or otherwise, received by or accrued to, in favour of a person. The meaning of the words "*received by*" is provided for in the definition of *gross income,*[103] and has further been interpreted by the courts with specific reference being made to the Supreme Court of Appeal decision in *MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service*.[104] The question of whether the state is entitled to levy taxes on income is best answered by the phrase 'received by'. The demonstration of how income from illegal activities is subject to income tax, even though there is some doubt whether expenses incurred in generating that income would be deductible is laid out as follows.

2.6.2 Gross income definition discussion and related caselaw

To establish if income from illegal activities is taxable, the definition of gross income will have to be applied since the ITA does not address the taxation of income derived from illegal activities. The "received by"[105] element of the gross income definition is the key aspect that will need to be covered since the debate in the past has been on this element. Because the Act does not define the terms used in the gross income

[102] Ibid at 530–1.
[103] Section 1 of the Income Tax Act,
[104] *MP Finance Group CC supra*.
[105] Venter, J.M.P, Uys, W.R., and Van Dyk, M.C., 2019. 'MP Finance Group CC (In Liquidation) V C: SARS: Adding to the Financial Hardship of Victims of Illegal Transactions'. *Southern African Business Review* 19, February, at page 128.

definition, reliance will be placed on the meaning given to the phrase 'received by' by the courts, as interpreters of the law.

2.6.3 Case Law

In *CIR v Delagoa Bay Cigarette Co Ltd*, the first decided case on the issue, the taxpayer was a company that sold packets of cigarettes. The price of a batch of these packages was considerably inflated. Each packet contained a numbered coupon that allowed the purchaser to win a monthly prize. The issue was whether two-thirds of the inflated price that the taxpayer had spent to distribute the prizes should be included in his gross income, since the amount had been received in violation of a law regulating lotteries. It was found that the transaction between the taxpayer and the buyers of the cigarettes was essentially a sale and that the prices distributed by the company were not a refund of the purchase price. This was because some purchasers received no prizes, while those who did receive a prize received more than they had paid for the cigarettes. Thus, it was a taxable revenue whose taxability was not affected by the illegality.

In 1981, the High court in Zimbabwe in the case of *COT v G*[106] had to deal with a situation where the taxpayer misappropriated funds that were meant for secret operations in his care. The relevant legislation contained a provision similar to our definition of 'gross income'. The court held that the taxpayer in this case, who had misappropriated funds in his care, did not '*receive*' it, because he did not acquire the money '*on his own behalf and for his own benefit'*.[107] It is interesting to note, however, that the Court stated that this meaning cannot extend to a situation where something is obtained by theft, since this is a unilateral act that does not confer a right on the one who takes the thing.[108] The Court held that "the receipt depended not only on the intention of the taxpayer, but also on the intention of the person who passed the money to him. In that case it was clear that the money was passed to the taxpayer not for his own benefit"[109] and it was never intended that he could do with it as he

[106] *1981 (4) SA 167 (ZA).*
[107] De Koker, A.P. & Williams, R.C., *Silke on South African Income Tax* 70th ed (Durban: LexisNexis 2021), page 222
[108] At *SATC 163*.
[109] *Geldenhuys v Commissioner for Inland Revenue 14 SATC 419*. In that case, a usufructuary of a flock of sheep, with the consent of the heirs, sold the flock and converted it into money when the number of the flock was less than its proper complement. She was not deemed to have acted in accordance with her statutory rights

pleased. The Court accordingly held that he was not subject to tax on the stolen money (Williams, 2010).[110]

In 1996, in a case of *ITC 1624,*[111] a taxpayer during the year of assessment ended 28 February 1991, rendered services to a customer, and those services included payment to Portnet, the harbour authority, of certain wharfage fees on behalf of the customer. The Taxpayer was entitled to recover the wharfage fees from the customer. The evidence revealed that the Taxpayer through the efforts of a former member, and without the knowledge of the managing member, had fraudulently rendered accounts to the customer reflecting wharfage fees disbursed to him in excess of the actual expenditure and recovered from the customer, in the relevant year of assessment, more money than he should have received. The taxpayer then sought to rely on the *COT v G* case to argue that it had not received anything for the purposes of gross income, since the amounts had not been received by it on its "own behalf and for its own benefit".[112] The court held that where a trader receives a payment of money in the course of carrying on its trade which it obtains by making a fraudulent or, for that matter, negligent misrepresentation to a customer, it receives that money and has intended to receive it as part of its business income and in the course of its business. The court dismissed completely the cases relied upon by the taxpayer, including *COT v G*, were authority for the argument that where a trader receives payment of money in the course of carrying on its trade which it obtains by making a fraudulent or negligent misrepresentation to a customer, it does not intend to receive it as part of its business and in the course of its business. The court then decided that the amount in question falls under the ambit of gross income and therefore taxable for the purposes of income tax.

In more recent years, during the 2007 year, the Supreme Court of Appeal in *MP Finance,*[113] provided some clarification on this matter of taxing illegal receipts. The

as either the usufructuary or quasi-usufructuary, and the proceeds of these sales were personally deemed to go to the heirs and not to her. Therefore, it was concluded that the proceeds cannot be included in her taxable income.
[110]Williams, R., 2010, '*Income Earned From An Illegal Investment Scheme – A Case Study*', viewed 11 February 2022, from https://www.thesait.org.za/news/97600/Income-Earned-From-An-Illegal-Investment-Scheme--A-Case-Study.htm
[111] *Income Tax Case No 1624 (1996) 59 SATC 373.*
[112] Ibid (note 109)
[113] *MP Finance Group CC v Commissioner, SARS [2007] JOL 20011 (SCA)*

facts of this case were that the taxpayer was operating an illegal and fraudulent investment business, commonly called a pyramid scheme.[114] The purpose of this scheme was to fraudulently take money from investors by promising irresistible but unsustainable returns against various forms of fake investment. The plan benefited some investors with deposits from new investors for a while before finally collapsing, leaving millions in debt. The Taxpayer embezzled significant amounts of deposits. The perpetrators of this scheme knew at the time they received the deposit that it was insolvent and a scam, and that it would be impossible to pay the promised amount to all investors.

The argument by *MP Finance* at page 4 was that:

> *"because, the scheme was liable in law immediately to refund the deposits, there was no basis on which it could be said that the deposits were "received" within the meaning of the Act. They were, it was argued, consequently not subject to tax."*

The court distinguished between the relationship between the investor and the operator of the system, on the one hand, and the relationship between the operator of the system and the Treasury, on the other. It was stated that an unlawful contract is not without all legal consequences and may have tax consequences. The issue that arose between the operator of the system and the tax authorities was whether the amounts paid to the operator of the system in the assessment years in question complied with the literal meaning of the Income Tax Act. The court concluded that they did.[115] The amounts paid to the scheme were accepted by the operators with the intention of retaining them for their own benefit. Notwithstanding the fact that they were legally repayable immediately, they constituted income in the sense of ITA and were properly taxable. The judgment by the Supreme Court of Appeal overruled the decision found in *COT v G* (above) whereby the focus is on the 'intention of the giver' rather than the "intention to repay" illegal amounts received. As this case was

[114] National Consumer Commission, "How to spot pyramid schemes from a distance". The National Consumer Commission defines pyramid schemes as a scheme where participants receive compensation derived primarily from recruiting other people into the scheme. These monies exchange hands and participants make money by recruiting new participants into the scheme. It further says that these schemes are illegal and, in their nature, are not sustainable and are guaranteed to collapse."
[115] Ibid 109 at page 5

held by the Supreme Court of Appeal in South Africa, it will then be the ultimate authority for case law with regards to receipts received from illegal activities.

The ultimate decision ruled in this case was that "proceeds of unlawful activities are taxable provided that the taxpayer had an intention to appropriate the proceeds on his own behalf and for his own benefit".[116] This is also addressed in one of the most popular cases on gross income, *Geldenhuys v CIR*,[117] where Steyn J stated that "received by" means:

> *"received by the taxpayer on his own behalf for his own benefit"*[118]

2.6.4 Role of taxing illegal receipts in assisting to combat corruption

Current income tax laws in South Africa require taxpayers to fully disclose their taxable income to SARS. Taxpayers who fail to disclose complete information could be charged with a tax evasion[119] offence. Tax evasion, in simple terms, is defined as the concealment of illegal income, false declarations, and unreasonable claims for tax deductions. Full disclosure in this sense, therefore, must include an honest disclosure of how the income was earned in order to avoid misrepresentation. In some cases, however, the income is derived from corrupt activities or is otherwise tainted with illegality. In such cases, disclosure of the manner in which the income was obtained would expose the taxpayer to possible prosecution for a criminal offence.[120]

Since now it is known that anyone who earns income from illegal activities as it has been established from the above case law discussions, such a person must disclose to SARS such receipts as they fall under the ambit of gross income. Both the payer and the payee of the amount from the illegal activities cannot escape the tax system

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[116] Mtwana, S.C., '*Taxation of Illegal Income: The Duty to Disclose Income Derived From Illegal Activity and the Constitutional Right Against Self-Incrimination*', LLM degree in Tax Law, Faculty of Law, University of South Africa, page 23
[117] *Geldenhuys v Commissioner for Inland Revenue 14 SATC 419*
[118] Supra at page 430.
[119] Tax evasion is the illegal non-payment or under-payment of taxes, usually by deliberately making a false declaration or no declaration to tax authorities – such as by declaring less income, profits, or gains than the amounts actually earned, or by overstating deductions.
[120] Mtwana, S.C., '*Taxation of Illegal Income: The Duty to Disclose Income Derived From Illegal Activity and the Constitutional Right Against Self-Incrimination*', LLM degree in Tax Law, Faculty of Law, University of South Africa, page 17

because the payer cannot deduct the cost from the illegal activity and the payee must disclose the amount to SARS as gross income.

One then wonders if all the above tax provisions that have been enacted by the South African government have been effective in trying to deter or eradicate corruption practices and mismanagement in South Africa, and particularly in the State-Owned Entities? This question is analysed and attempted to be answered in Chapter 5 below.

2.6.5 Conclusion on the taxation of receipts from illegal activities

The National Treasury is ultimately responsible for ensuring that taxpayers contribute fairly to South Africa's funding and that the country's tax base is protected from unfair tax advantages which are made available to certain persons. Failure to pay taxes on income from illegal activities would be considered unfair to taxpayers who are taxed on income from legal activities, especially because the judiciary believes that such income should be taxed.

It is consequently encouraged that National Treasury needs to offer clear recommendations with a view to help SARS and the taxpayers in figuring out the tax treatment of receipts derived from unlawful or illegal activities similarly to how clear guidance was provided on expenses incurred in relation to unlawful or illegal activities. These recommendations can be issued through the manner of amending the ITA to encompass law with a view to specially adjust and govern the tax effects of unlawful activities or through issuing an interpretation note or practice note, although it is known that interpretation notes will not offer enough authority to make the situation clear and govern the uncertainties referring to the tax effects of profits derived from unlawful activities since they are not legislation. It would be best if the current IN54 can be amended to deal in detail with the tax consequences of income derived from unlawful or illegal activities, especially addressing the aspect that a taxpayer would only be taxed on illegal receipts if it has been determined that it was received on his own behalf for his own benefit and the fact that if the taxpayer has no intentions of repaying back the unlawful or illegal receipts to its owner. Such receipts will be considered gross income in the hands of the taxpayer, and therefore taxable.

Chapter 3: Common corrupt behaviours and financial mismanagement of funds in SOEs. What we know

3.1 Examples of corrupt behaviours

Public corruption for the purposes of this report refers to situations wherein a person engages in outlawed activities to influence the public official responsible for making procurement decisions. This commonly takes the shape of bribes or different non-economic inducements which can be supplied to influence the decision-making process.

There are a few examples reflecting the form that public corruption may take place. It may be as simple as a public official improperly exercising his or her discretion by deciding to which firm to award the tender, or in deciding which firms to invite for tender, or by formulating contract evaluation criteria which may favour a particular bidder.[121] However, it can be more elaborate, such as instances where a procurement official may improperly exercise his or her discretion by deciding to split a large tender into several smaller ones in order to avoid the thresholds set out in the MFMA, PFMA or PPPFA, and the related regulations, in order to avoid the procedural requirements they impose for certain thresholds.[122] Other improper benefits that a bidder may seek from a procurement official include the avoidance of a government-imposed cost, such as, fees or taxes in relation to the tender. A bidder may also request that a condition of tender be waived such as an obligation to provide certain documentation or that a contractual requirement not be applied stringently, for example, to allow the supply of sub-standard products.[123]

One form of public corruption which has gained a significant amount of media attention in South Africa over the course of the last several years is the issue of 'state capture'[124] and it is apposite to deliberate on its effect on public procurement.

[121]Caswell, G.S., (2016), '*Public Procurement Challenges and Reforms for Infrastructure Development in South Africa"*, Public Law Department', Degree LLM in Constitutional and Administrative Law, Faculty of Law, University of Cape Town at page 42.
[122] Ibid.
[123] Ibid.
[124] Ibid at page 43

Defining 'state capture' as a concept is as challenging as defining corruption, given the wide array of definitions, however the following definition has been used by a number of European academics:

> *'[S]tate capture is a group phenomenon whereby some members of the business and/or political elite appropriate some parts or functions of the state and use its resources to benefit the group while harming the public good.'*[125]

This broad definition of state capture does not distinguish between whether it is private businesses capturing the state, whether it is the state capturing non-governmental business interests or whether both are happening simultaneously. In the context of public procurement, state capture tends to involve targeting organs of state or state-owned enterprises that control the distribution and performance of contracts for state functions as these are the primary sources from which funds can be extracted through improper conduct. When an organ of state or state-owned enterprise is 'captured' by private interests, it loses its autonomy to act in furtherance of public goals, thus losing its ability to enter into tender contracts which are competitive, cost effective or of a high quality.[126] In other words, it prevents the procuring entity from being able to contract in accordance with the requirements set out in section 217*(1)* of the Constitution. State capture in public procurement may be defined as institutionalised large-scale corruption centred on certain state organs or state-owned enterprises that cease to serve public goals and instead, are used for the captor group's own objectives.[127]

What the various examples of corruption within the context of public procurement mentioned above, illustrate is that public corruption is arguably the most pervasive kind of corruption which takes place in public procurement in South Africa. They cost the South African financial system and economy hundreds of thousands of Rands. They also deprive citizens entry to infrastructure which will improve their quality of life and prevent the country from realising constitutional goals. These forms of

[125] Ibid
[126] Ibid.
[127] Ibid.

corruption reveal why concerted steps were taken to criminalise corruption in both international instruments and in South Africa's legislation.[128]

The OECD[129] report on preventing corruption in public procurement lists the risks that occur at each point in the procurement process. These risks have been listed as follows:

1. *"Pre-tendering phase*
   a. *Needs assessment and market analysis*
      - *Lack of adequate needs assessment*
      - *Influence of external actors on officials' decisions*
      - *Informal agreement on contract*

   b. *Planning and budgeting*
      - *Poor procurement planning*
      - *Procurement not aligned with overall investment decision-making process*
      - *Failure to budget realistically or deficiency in the budget*

   c. *Development of specifications/requirements*
      - *Technical specifications are tailored for a specific company*
      - *Selection criteria are not objectively defined and not established in advance*
      - *Requesting unnecessary samples of goods and services*
      - *Buying information on the project specifications.*

   d. *Choice of procurement procedure*
      - *Lack of proper justification for the use of non-competitive procedures*

[128] Ibid
[129] OECD, (2016), '*Preventing Corruption in Public Procurement*', available at https://www.oecd.org/gov/ethics/Corruption-Public-Procurement-Brochure.pdf at page 9, (Accessed 20 March 2022)

- *Abuse of non-competitive procedures on the basis of legal exceptions: contract splitting, abuse of extreme urgency, non-supported modifications*

2. *Tendering Phase*
   a. *Request for proposal/bid*
      - *Absence of public notice for the invitation to bid*
      - *Evaluation and award criteria are not announced*
      - *Procurement information is not disclosed and is not made public*

   b. *Bid submission*
      - *Lack of competition or cases of collusive bidding (cover bidding, bid suppression, bid rotation, market allocation)*

   c. *Bid evaluation*
      - *Conflict of interest and corruption in the evaluation process through:*
         - ➢ *Familiarity with bidders over time*
         - ➢ *Personal interests, such as gifts or future/additional employment*
         - ➢ *No effective implementation of the "four eyes-principle"*

   d. *Contract award*
      - *Vendors fail to disclose accurate cost or pricing data in their price proposals, resulting in an increased contract price (i.e., invoice mark-ups, channel stuffing)*
      - *Conflict of interest and corruption in the approval process (i.e., no effective separation of financial, contractual and project authorities)*
      - *Lack of access to records on the procedure*

3. *Post-award phase*
   a. *Contract management/ performance*
      - *Abuses of the supplier in performing the contract, in particular in relation to its quality, price, and timing:*

- ➢ *Substantial change in contract conditions to allow more time and/or higher prices for the bidder*
- ➢ *Product substitution or sub-standard work or service not meeting contract specifications*
- ➢ *Theft of new assets before delivery to end-user or before being recorded*
- ➢ *Deficient supervision from public officials and/or collusion between contractors and supervising officials*
- ➢ *Subcontractors and partners chosen in an non-transparent way or not kept accountable*

b. *Order and payment*

- *Deficient separation of financial duties and/or lack of supervision of public officials*
- *leading to:*
  - ➢ *False accounting and cost misallocation or cost migration between contracts*
  - ➢ *Late payments of invoices*
- *False or duplicate invoicing for good and services not supplied and for interim payment in advance entitlement"*

With all the above risks listed by the OECD, it can be seen the extent to which corruption can cause distress in the economy of the country, because at the end of the day, the payer who is benefiting from the rigged tender process will endeavour to recuperate the funds paid to the provider of the tender by billing for work not undertaken or overstate costs, poor product delivery since cheap materials will be used, which will result in failure to meet the requirements of the contract.[130]

[130] OECD, (2016), '*Preventing Corruption in Public Procurement*', available at https://www.oecd.org/gov/ethics/Corruption-Public-Procurement-Brochure.pdf at page 7, (Accessed 20 March 2022)

3.2 Examples of Financial Mismanagement of SOE funds leading to fruitless and wasteful expenditure

There are several ways in which financial mismanagement takes place in the public entities. More often the existence of financial mismanagement in government institutions may give rise to fruitless and wasteful expenditure. With the recent promulgated provisions of section 23*(o)*(iii) of the ITA, prohibiting the deductibility of any expenditure which falls under the ambit of fruitless and wasteful expenditure definition, public entities are facing a crisis because previously, they could argue that the expenses classified as fruitless and wasteful were incurred in the furtherance of trade and therefore deductible in terms of section 11*(a)* read with section 23*(g)* of the ITA. With the adoption of section 23*(o)*(iii), the South African government hopes that it will encourage accountability and proper governance in state owned entities. On a high-level view, without having to go into details, the below are the common examples of financial mismanagement of SOE funds.

a) Leadership instability and lack of oversight
b) Inadequate procurement practices
c) Employment of incompetent staff
d) Expenditure incurred not approved or unsubstantiated
e) Lack of segregation of duties

If we now must include detailed real-life examples of events that gave rise to fruitless and wasteful expenditure, the AGSA 2020-21 Consolidated general audit report[131] has been used as a source for this information. The AGSA, in its report, provides the top ten SOEs that have contributed to the Fruitless and Wasteful expenditure amount of R1.72 billion for the 2020-21 financial year as follows:

1. Water Trading Entity
   Water Trading Entity incurred fruitless and wasteful expenditure of R0.40 billion and the cause was a result of abnormal costs incurred and internal and external projects.

[131] AGSA Consolidated General Report On National and Provincial Audit Outcomes PFMA 2020-21, at page 52-54

2. Department of Health

   R0.22 billion was incurred in respect of service providers overcharging on procurement of personal protective equipment.

3. South African Post Office

   The R0.14 billion was due to interest and penalties on overdue payments. This amount also included R0.05 billion in respect of interest and penalties paid to SARS.

4. Transnet

   The R0.14 billion is attributed to redundant assets and stock of raw material that could not be used, stolen IT equipment and cell phones, vandalism of motor vehicles, misuse of company assets, employee fraud and poor contract management which included non-adherence to the procurement procedure manual.

5. Department of Human Settlements

   The fruitless and wasteful expenditure incurred by the Department of Human Settlement arose as a result of late payment of employee and employer pension fund contribution. According to the department's annual report, the matter was still under investigation at the time of issuing the report.[132]

6. Airports Company South Africa

   The R0.08 billion was mainly due to interest and penalties paid to SARS.

7. National Treasury

   At National Treasury, the fruitless and wasteful expenditure is attributed to an expense incurred to procure technical support and maintenance on the Integrated Financial Management System programme, which is not being implemented.

8. Department of Agriculture, Land Reform and Rural Development

[132] 2020-2021 Human Settlements Annual Report Vote 33, at page 19

The cause for the fruitless and wasteful expenditure for this entity is mainly attributable to training not attended and payment for the mobile clinics that were not delivered.

9. Department of Education

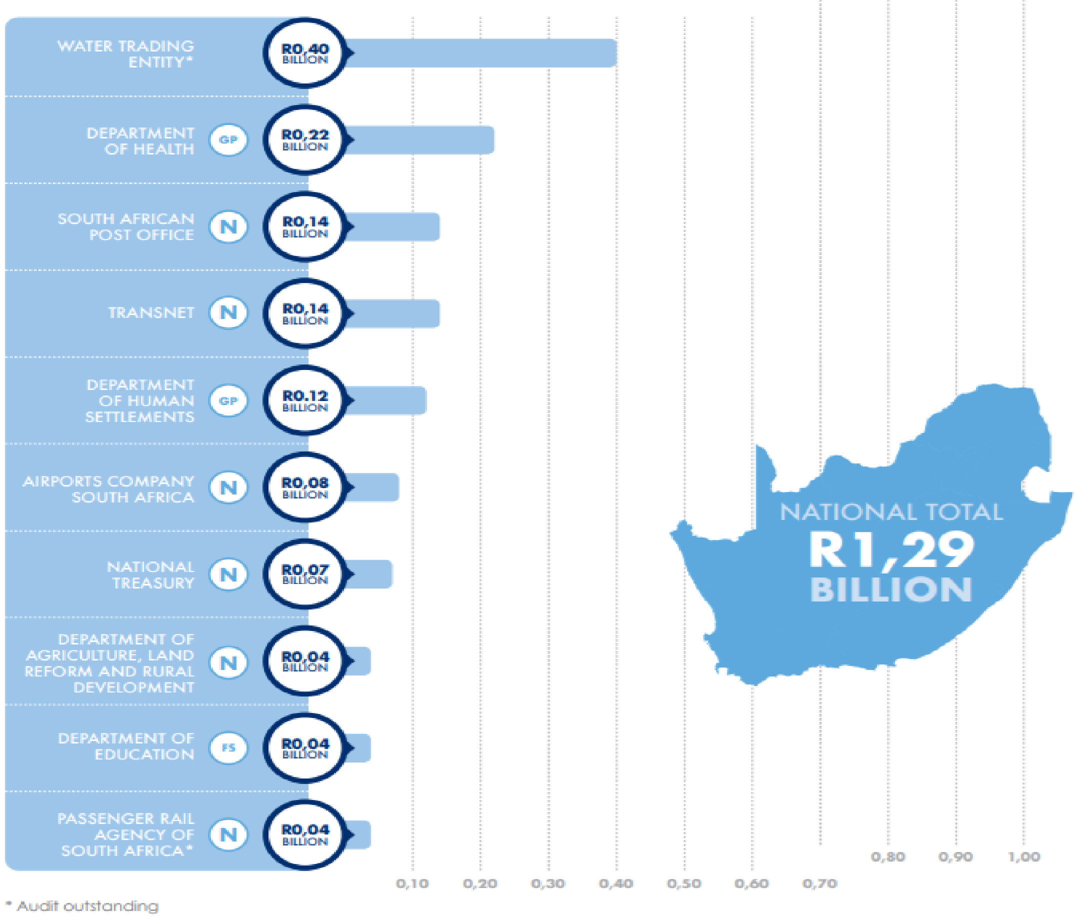
The majority of the fruitless and wasteful expenditure was caused by infrastructure projects that were stopped, as the same projects were implemented by different implementing agents.[133]

10. Passenger Rail Agency of South Africa

The fruitless and wasteful expenditure at Passenger Rail Agency of South Africa is attributed to interest and penalties on late payments to suppliers and other creditors.

Figure 1

Top 10 contributors to fruitless and wasteful expenditure (75% of total)



[133] Department of Basic Education Annual Report, 2020/2021, at page. 285

Figure 1: Top 10 contributors to fruitless and wasteful expenditure

Source: AGSA Consolidated General Report On National and Provincial Audit Outcomes PFMA 2020-21

It could be noted in the AGSA 2020-21 Consolidated general audit report that the total reported fruitless and wasteful expenditure has decreased during the 2020-21 financial year when compared to the 2019-20 financial year with a reported amount of R2.23 billion and 2018-19 financial year with a reported amount R2.76 billion. These are encouraging results; however, the decrease is not that significant and that means the SOEs needs to put more effort into eliminating the fruitless and wasteful expenditure.

In the next chapter, we examine the impact that the tax laws have had in attempting to curb the occurrence of corruption and financial mismanagement in the SOEs. It is important to highlight at the outset that the role of the tax regulations implemented to deter corruption and eliminate fruitless and wasteful expenditure caused by financial mismanagement cannot be looked at singlehandedly but will have to be evaluated in conjunction with the PFMA and the PAAC-Act.

Chapter 4: Have the tax laws imposed by the South African government as a corruption and financial mismanagement deterrence mechanism in SOEs been effective?

The Income Tax Act's level of participation in the fight against corruption and financial mismanagement in a country will depend on the legal and institutional framework of that country. Regarding that institutional framework, it is important to know a number of elements for a better understanding of this situation. [134]

It would be important to know first, which are the bodies responsible for investigating and prosecuting corruption crimes. Secondly, it is necessary to examine the ways in which the ITA co-operates with these bodies to establish the issue of the communication of corruption indications and if the laws of the region provide for the non-deductibility of expenses that constitute illegal expenses and taxing of income generated from illegal activities.[135]

4.1 Bodies responsible for investigating and prosecuting corruption crime.

In general, the power to investigate and to call for the relevant procedures for corruption offences are outside the ITA competence.[136] For the purposes of this paper, the relevant statutes which have the mandate to investigate and prosecute offences are as follows:

- Prevention and Combating of Corrupt Activities Act, 12 of 2004 which directly links with the provisions of section 23(o)(i) as discussed in point 3.2 above. This statute applies to both the payer and receiver of the unauthorised gratification.
- Competition Act Competition Act, 89 of 1998 which directly links to the provisions of section 23(o)(ii) as discussed in point 3.2 above.

[134] Redondo, J.F., 2019, '*The Role of Tax Administrations in the Fight Against External Corruption*', page 6
[135] Ibid
[136] Ibid

- PFMA Public Finance Management Act of 1999 which regulates fruitless and wasteful expenditure. This statute directly links to the provisions of section 23(o)(iii), as discussed in point 3.2 above.

Therefore, if we ask how far the ITA could play a role in fighting corruption and fruitless and wasteful expenditure, according to the results obtained from the Afrombarometer[137] and AGSA[138] reports, the tax authorities cannot, by themselves and without a relationship with the abovementioned authorities, carry their objective of helping to eradicate corruption and the occurrence of fruitless and wasteful expenditure in SOEs.

The Afrombarometer report is a set of perception and experience indicators on corruption. This report is used to provide an overview on whether the tax laws put in place have been effective in deterring corruption. This also incorporates information obtained from the AGSA PFMA 2020-21 report about the status of corruption and fruitless and wasteful expenditure in South Africa. The result of the Afrombarometer and AGSA reports are properly discussed in the following sections.

4.2 Considerations on the effectiveness of disallowing expenses constituting illegal activities and taxing of income derived from illegal activities as a deterrence mechanism

It is not possible to measure corruption, but it is possible to measure perceptions of corruption[139]. Most South Africans are of the opinion that corruption is increasing rather than decreasing. Furthermore, it is seen that a huge portion of the corrupt activities that are taking place involve elected government officials and public/civil servants. This is based on a survey and study that was undertaken by Afrobarometer[140] in year 2021. Afrobarometer is a pan-African research network that

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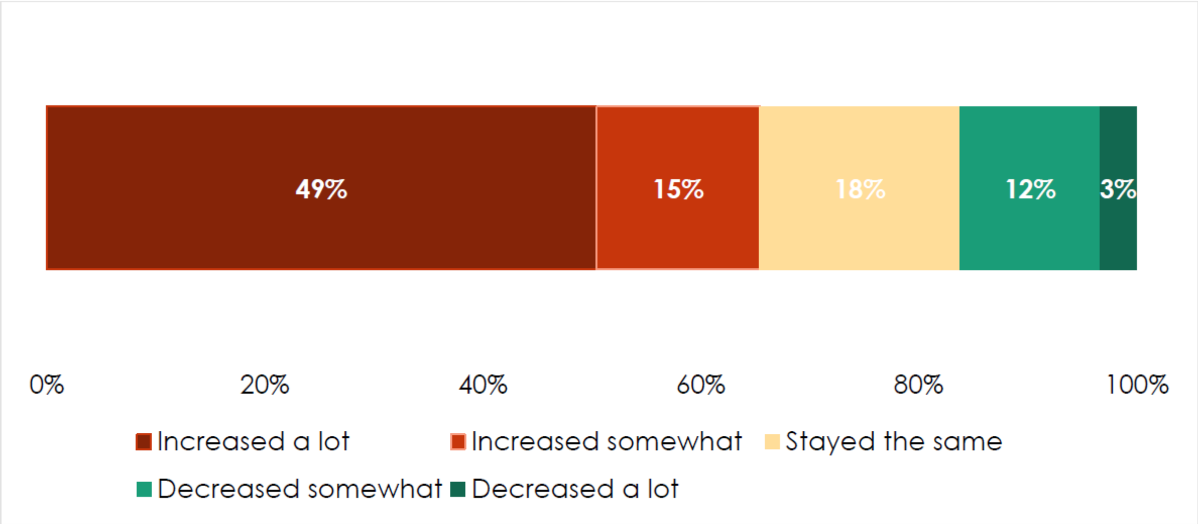
[137] Afrobarometer Dispatch No. 476, Patel J. and Govindasamy P., '*South Africans see corruption as worsening during President Ramaphosa's tenure*', accessed 16 January 2022, from https://afrobarometer.org/sites/default/files/publications/Dispatches/ad476-south_africans_see_corruption_as_worsening_under_ramaphosa-afrobarometer_dispatch-15sept21.pdf
[138] AGSA Consolidated General Report on National and Provincial Audit Outcomes PFMA 2020-21
[139] International Monitory Fund, Tanzi, V., 1998, 'Corruption Around the World: Causes, Consequences, Scope and Cures', page 3
[140] Afrobarometer Dispatch No. 476, Patel J. and Govindasamy P., '*South Africans see corruption as worsening during President Ramaphosa's tenure*', accessed 16 January 2022, from https://afrobarometer.org/sites/default/files/publications/Dispatches/ad476-south_africans_see_corruption_as_worsening_under_ramaphosa-afrobarometer_dispatch-15sept21.pdf

provides reliable data on Africa's experience and assessment in the fields of democracy, governance, and equity of life. The Afrobarometer team, led by the Institute for Justice and Reconciliation and 94 Research, surveyed 1,600 South African adults on corruption in South Africa. Key findings from the study include:

- *"Almost two-thirds (64%) of South Africans say that corruption increased in the past year, including half (49%) who believe it increased "a lot."*
- *State institutions are widely seen as corrupt. Half or more of citizens say "most" or "all" officials participate in corruption in the police (56%), the president's office (53%), local government councils (51%), and Parliament (50%). Non-governmental organizations, traditional leaders, and religious leaders are less commonly seen as corrupt.*
- *Three-fourths (76%) of South Africans say the government is performing "fairly badly" or "very badly" in the fight against corruption,*
- *Among citizens who interacted with key public services during the past year, substantial numbers say they had to pay a bribe to avoid a problem with the police (24%) or to obtain a government document (21%), police assistance (15%), public school services (10%), or medical care (8%).*
- *Three out of four South Africans (76%) say people risk retaliation or other negative consequences if they report incidents of corruption, a 13-percentage-point increase compared to 2018.*
- *Seven in ten citizens (71%) believe that officials who break the law "often" or "always" go unpunished, while half (49%) say ordinary people who commit crimes enjoy such impunity".*

Below is a diagram that summarises the key findings from the report when the 1600 South African adults were asked, "*is corruption getting worse?"*

Figure 1: Change in level of corruption | South Africa | 2021



Respondents were asked: *In your opinion, over the past year, has the level of corruption in this country increased, decreased, or stayed the same?*

Figure 2: Change in level of corruption

The Afrobarometer report has shown that, despite the high visibility of corruption on the national agenda, almost two-thirds (64%) of South Africans say corruption has become worse over the past year, including half (49%) who say it has "increased a lot" (Figure 1). Only 15% of people believe it has decreased.[141]

According to the Afrobarometer report,[142] the corruption in the presidency could be attributable to the ongoing and widely publicized Zondo Commission that is inquiring into the allegations of State Capture, corruption, and fraud in the public sector including the organs of state. Despite that the recent Transparency International Perceptions Index suggests that there was a slight decrease in corrupt activities in South Africa during the 2020 year, South African society is of the view that it keeps increasing rather than decreasing. The most recent Transparency International Corruption Perceptions Index ranked South African, 71 out of 180 countries which are facing issues of corruption. 44 out of 100 was the score that was assigned to South African for that year compared to 43 out of 100 that was assigned during the 2017 year. Although there was a slight improvement, the score of 44 remains below 50,

[141] Ibid
[142] Ibid

which still does not change the narrative that countries with scores that are below 50 are believed to have profoundly serious corruption issues.[143]

In recent times since the outbreak of the Covid-19 pandemic in 2020, government has put in place multi-billion-rand emergency relief packages to provide social, health and economic relief for vulnerable citizens and businesses. Various news reports have been published in relation to the looting of the Covid-19 pandemic relief funds; this could be one of the major reasons why South African society perceives that corruption has increased in 2021 according to the Afribarometer survey, especially corrupt activities involving government officials, parliamentary officials, and the public servants. To evidence this, AGSA in its 2020/2021 audit report[144] mentions that they have been auditing the Covid-19 initiatives introduced by the government and the funds provided to respond to the outbreak of the Covid-19 pandemic. The AGSA says the multi-billion-rand Covid-19 relief packages actually landed in the environment with many weaknesses. AGSA tabled three special reports on the outcomes of the audits in national, provincial, and local governments. The special reports highlighted that there were significant deficiencies in the procurement and contract management processes. There were also inadequate controls around the proper payment management system. There was unfair awarding of tenders, supply of poor-quality personal protective equipment, lack of care in protecting state funds against overpricing, financial loss, fraud, and abuse of the system. Some people, including government officials, received benefits and grants to which they were not entitled as a result of deficiencies in the Information Technology system controls. The report also highlighted that there was indication of fraud as a result of poor controls around record keeping and financial management.

The South African government, in its efforts to combat corruption, enacted the PAAC Act which is aimed at preventing and fighting corruption in government and in the private sector. The Act provides a detailed definition of what is perceived as an offence of corruption. The PAAC Act, in section 26, further lists the penalties that will be charged to any person convicted of an offence of corruption. Regardless of the

[143] Wikipedia, '*Corruption in South Africa*', viewed 16 January 2022 ,from https://en.wikipedia.org/wiki/Corruption_in_South_Africa#Perception_of_corruption_in_South_Africa

[144] AGSA Consolidated General Report on National and Provincial Audit Outcomes PFMA 2020-21, at page 134

fact that there are penalties imposed should a person be found guilty of an offence of corruption, people still partake in corrupt activities. It is clearly evident that there is no regard whatsoever to the law and the wrongfulness of stealing state funds. Since it has been proven that the corrupt activities have increased rather than decreased, this also suggests that no regard has been taken into account when it comes to the tax implications to any amounts derived from corrupt activities or paid to benefit from corrupt activities. This means that section 23*(o)*(i) and section 23*(o)*(ii) tax implications, as discussed in point 3.2 above, are not even considered. Furthermore, one does not even think of the tax consequences the receipts from illegal activities will be exposed to. Amanda *et al*. (2021), suggest that a high level of perceived corruption in SOEs is significantly associated with a low likelihood of tax compliance and tax morale. This means that it is unlikely that any person involved in corruption can disclose the illegal expense or illegal income to SARS, which then undermines the tax provisions imposed by the ITA.

4.3 Considerations on the effectiveness of disallowing expenses constituting fruitless and wasteful expenditure as a deterrence mechanism

The AGSA report shows that fruitless and wasteful expenditure remains high, although it has decreased in the 2020-21 period compared to the 2019-2020 and 2018-2019 periods. As explained above, fruitless and wasteful expenditure is expenditure that was made in vain and that could have been avoided if reasonable care had been taken.

The AGSA report mentions that:

> "*Government cannot afford to lose money because of poor decision-making, neglect, or inefficiencies, making the extent of fruitless and wasteful expenditure a good indicator of how the public purse is being managed. The reduction in fruitless and wasteful expenditure from the previous year is encouraging, but losing just over R1,7 billion that could have been used for the pressing service delivery needs of citizens is a red flag for government and needs urgent attention*."

Sections 83*(1)* of the PFMA states that an accounting officer or authority commits an act of financial misconduct if that accounting officer or authority wilfully or negligently makes or permits a fruitless and wasteful expenditure. The government has put measures in place with the intention of recovering any losses suffered by the government entities. The measures that SOEs must put in place is consequence management which will ensure that the loses that could be suffered by the SOEs are accounted for by the responsible people. The 2020-21 AGSA report[145] mentions that there are two components to accountability:

- First, being those who take actions and make decisions must answer for these actions and decisions.
- Second, being those who do wrong, do nothing or perform poorly should face consequences.

In enforcing the above components of accountability, SOEs may be able to recover losses incurred by those officials and may discourage others from breaking the law. Furthermore, by effecting consequence management, the SOEs show their dedication and devotion to prudent financial management.

The AGSA finding in the 2020-21 audit report[146] pertaining to the fruitless and wasteful expenditure is that the identified fruitless and wasteful expenditure in the previous years was not investigated, nor was consequence management effected. This finding relates to 17% of the total audited government institutions. From the figure 3 below, it can be noted that only 1% of the fruitless and wasteful expenditure has been recovered or is in the process of recovery. As a result, the fruitless and wasteful expenditure continues to grow, meaning if fruitless and wasteful expenditure continues to grow, more of the non-deductibility of these amounts will take place in the tax computations. Therefore, it is clear that there is no regard whatsoever towards the implications of section 23*(o)*(iii) of the ITA.

For the purposes of this section, irregular and unwanted expenditure as shown in figure 3 below are not discussed. This section rather focused on the fruitless and wasteful expenditure since section 23*(o)*(iii) of the ITA makes reference to fruitless and wasteful expenditure.

[145] AGSA Consolidated General Report On National and Provincial Audit Outcomes PFMA 2020-21, at page 77
[146] AGSA Consolidated General Report On National and Provincial Audit Outcomes PFMA 2020-21, at page78

Figure 3

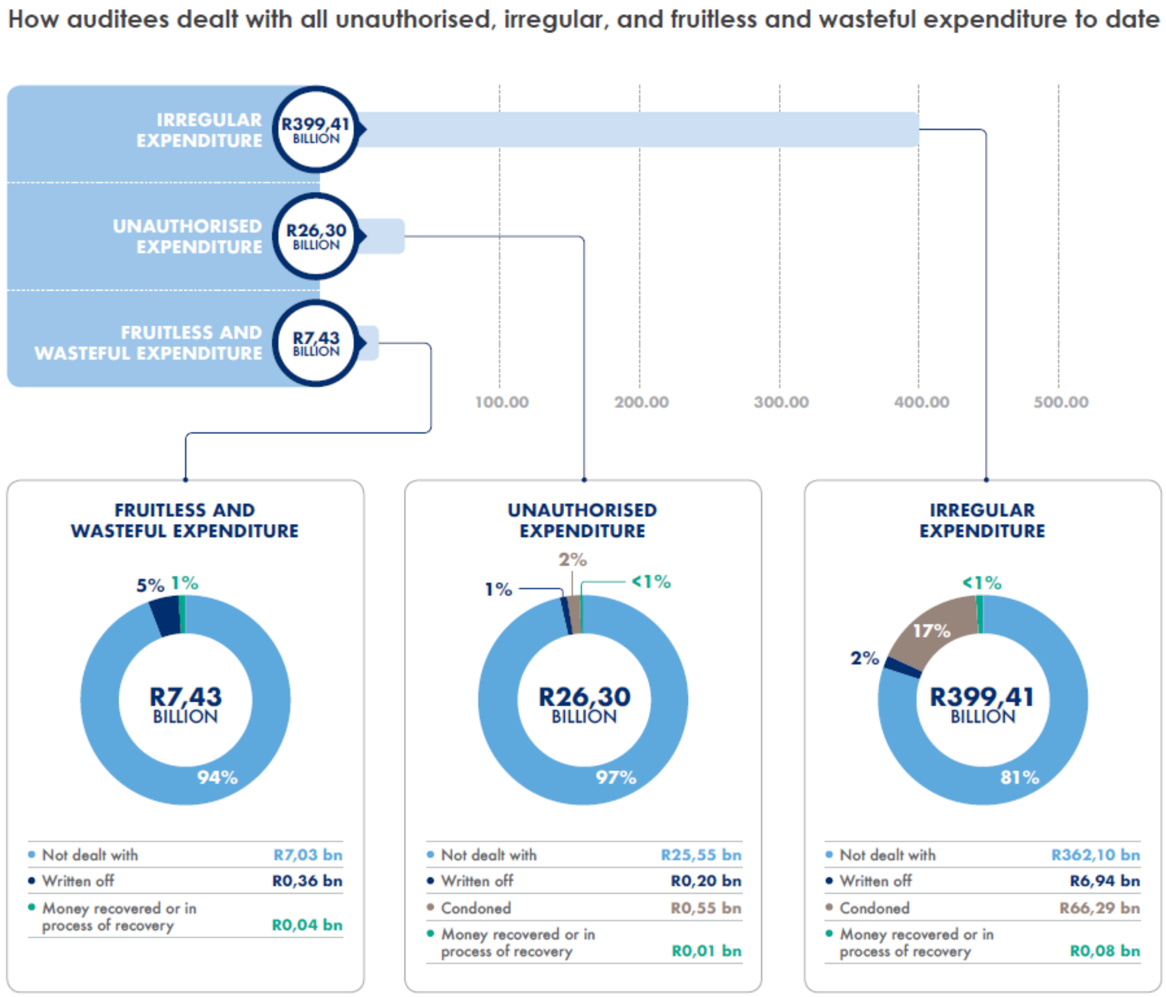


Figure 3: How auditees dealt with all unauthorised, irregular and fruitless and wasteful expenditure to date

Chapter 5: Conclusion

Tax laws imposed by the South African Government in deterring or eradicating corrupt behaviour and fruitless and wasteful expenditure caused by financial mismanagement in SOEs.

5.1 Tax provisions on the deductibility of illegal expenses

Before 1 January 2006, the courts were faced with having to decide the deductibility of fines and penalties for breaking the law, as well as any payments made that constitute illegal activities as contemplated in Chapter 2 of the PCCA Act. In deciding whether a fine or illegal expense was deductible, the requirements of section 11*(a)* read with section 23*(g)* had to be relied on, especially the requirement of “in the production of income". This was done in conjunction with the reliance on public policy. With effect from 1 January 2006, the South African government enacted sections 23*(o)*(i) and section 23*(o)*(ii), which are clauses in the ITA that deal specifically with the deductibility of any payments made that constitute illegal activities contemplated in Chapter 2 of the PCCA Act, as well as fines and penalties for breaking the law, respectively. On 1 April 2019, the section was further amended to include section 23*(o)*(iii) which provides for the prohibition of the deduction of fruitless and wasteful expenditure incurred by SOEs. Section 23*(o)* was enacted to promote good governance, reinforce South Africa’s anti-corruption drive, and encourage accountability in South African SOEs.

5.2 Tax provisions on taxing income derived from illegal activities

It has been established that the courts in the *MP Finance Group CC (In Liquidation) v Commissioner, South African Revenue Service* make it clear that receipts from illegal activities are regarded to be gross income and therefore taxed. This is a well-established principle in South Africa, and it is submitted that the illegality of income cannot repudiate its tax obligations.

In as much as it is put beyond reasonable doubt by the courts that income tainted with illegality is taxable, the ITA does not entail specific provisions that address the taxability of income derived from illegal activities. National Treasury, as the responsible body that ensures that taxpayers contribute fairly to the South Africa’s funding, is encouraged that it needs to offer clear recommendations with a view to help SARS and the taxpayers in figuring out the tax treatment of receipts derived from unlawful or illegal activities, similarly to how clear guidance was provided on expenses incurred in relation to unlawful or illegal activities. This could encompass amending the ITA to include specific law that deals will the taxation of income derived from illegal activities. The current IN54 could be amended to provide details with the tax consequences of income tainted with illegality.

5.3 Common corrupt behaviour and financial mismanagement leading to fruitless and wasteful expenditure in South African SOEs

To address this part of the research question, some common corrupt behaviours and fruitless and wasteful expenditure were discussed. The tender process was identified to be the process that is most vulnerable to corruption in the SOEs. The research went on to discuss the risks that occur at each stage of the tender process, i.e., from the pre-tender stage to when the payments is made to the service provider. To determine the common fruitless and wasteful expenditure that occur in state-owned entities, the AGSA report was studied. It was found that the interest and penalties paid due to late payment of creditors and those that are paid to SARS take centre stage.

5.4 Effectiveness of the tax laws imposed by the South African government to promote an anti-corruption drive and eliminating fruitless and wasteful expenditure caused by financial mismanagement in SOEs

It is evident, judging from the results of the Afrobarometer report,[147] that corruption is perceived to have increased in South Africa. The increase in corruption is not just attributable to procurement, which for the purposes of this research paper refers to government tenders, but also includes paying bribes to gain easy access to government resources or services. Furthermore, what appears to be evident is that many of the corruption cases relating to government institutions in South Africa, are broadly relating to a leadership crisis. Consequently, the country's democracy is unguarded because government officials, politicians, local government councillors, and public servants in general, are serving personal and factional interests instead of serving the people of South Africa. According to Amanda et al. (2021), a high level of

[147] Supra

perceived corruption in SOEs is significantly associated with a low likelihood of tax compliance and tax morale, meaning it is unlikely that any person involved in corruption can disclose the illegal expense or illegal income to SARS, which then undermines the tax provisions imposed by the ITA under section 23*(o).*

When looking at the AGSA 2020-21 audit report, it has also been established that although the fruitless and wasteful expenditure has decreased in the 2020-21 financial period, the decrease is not significant, and this remains a concern. A huge portion of the fruitless and wasteful expenditure is attributable to penalties and interest paid to SARS and creditors. This has been the case even in the past three years. The higher the fruitless and wasteful expenditure in the SOEs' financials, the higher the expenditure that will not be deductible in the SOEs' tax return. This impacts adversely on the liquidity of these entities.

5.5 Recommendations

In addition to the tax laws discussed above as corruption deterrence mechanism, the South African government could also consider imposing penalties that will be at a high level which exceeds the benefits that persons involved in corruption of SOEs stand to gain from such illegal activities. The penalties that will be imposed should be linked to the provisions of section 23*(o)* and should be non-deductible for tax purposes.

Another recommendation would be that, despite the justifiable focus on public sector corruption, it is apparent that without private sector collusion, South Africa's numerous corruption scandals would have been near impossible. The government can consider penalising the private sector companies for their complicity in corruption and recompense the public purse for the wider damage wrought, by introducing a corruption tax. This would entail companies that have been found guilty of engaging in corrupt activities paying an additional percentage of company tax above the country's corporate tax rate. In the long run, the taxes returned to the state are likely to outweigh the benefits of corrupt activities, making them less economically enticing.[148]

5.6 General remarks

As correctly alluded by the Auditor General in its report, that one cannot cease to emphasize that "sustainable solutions are required to ensure that control environments in public entities are mature so that the risks are minimised when these environments are exposed to abnormal and disruptive circumstances. Designing and implementing controls that prevent and/or detect fraud, errors and abuse is an investment that pays off when an institution is called upon to deal with a crisis. It is a far better approach than having to deal with lengthy and costly investigations and a loss of resources and public confidence."[149] Corruption is likely to remain a problem if certain reforms are not implemented, despite measures aimed at directly curbing them.

For any endeavour to succeed, everyone involved should share a common goal as well as embrace and commit to the role they play in achieving that particular goal. Therefore, to curb the risk of corruption and financial mismanagement in SOEs, its executive authorities, officers and employees should be devoted in ensuring that all controls are adhered to so that any kind of corruption is not successful. Again, leadership should prioritize consequence management and loss recovery so that those involved in corrupt activities should be held accountable.

[148] Gossel, S., 2022, '*SA needs a corruption tax on companies that collude in State Capture'*, viewed 21 June 2022 from: https://www.news.uct.ac.za/article/-2022-02-01-sa-needs-a-corruption-tax-on-companies-that-collude-in-state-capture

[149] AGSA Consolidated General Report On National and Provincial Audit Outcomes PFMA 2020-21, at page144

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