

## **THE SCOPE OF TAXATION OF INCOME FROM ILLEGAL ACTIVITIES IN SELECTED COMMON LAW JURISDICTIONS**

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### **ABSTRACT**

The taxation of income from illegal activities is well established in several common law jurisdictions. In the broader sense income or profits from a trade, profession or vocation irrespective of the issue of legality will be taxable. The courts have drawn a distinction between cases where normal income producing activities become illegal due to non-compliance with licensing requirements or acting in contravention to a ban in trading on one hand and profits acquired as a result of the commission of systematic crimes such as burglary on the other hand. Income from the latter source is not taxable. The objective of this paper is to argue against such a distinction, to highlight the problems inherent in computing income from an illegal source and to examine the difficulties in formulating rules governing the deductibility of expenditures incurred in earning income from illegal activities.

**Keywords:** illegal activities, taxable income, allowable expenditures

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## SKOP PENCUKAIAN PENDAPATAN HASIL DARIPADA KEGIATAN HARAM

### ABSTRAK

Pencukaian pendapatan daripada aktiviti haram sudah termaktub di beberapa bidangkuasa 'common law'. Mahkamah telah meggariskan perbezaan diantara kes yang melibatkan penghasilan pendapatan biasa yang berubah menjadi kesalahan disisi undang-undang akibat kegagalan mematuhi keperluan perlesenan atau akibat perlakuan yang melanggar sebarang larangan terhadap perniagaan di satu pihak, dan juga kes di mana keuntungan diperolehi hasil daripada perlakuan jenayah sistematik seperti rompakan. Pendapatan yang diperolehi dari perbuatan jenayah yang sistematik ini tidak tersenarai sebagai pendapatan yang boleh dicukai. Objektif kertas ini adalah untuk memberi hujah membantah perbezaan didalam pencukaian dan juga untuk menyorot permasalahan yang wujud didalam perkiraan pendapatan yang diterima daripada sumber yang menyalahi undang-undang dan juga untuk mengkaji permasalahan didalam merumuskan formula yang mentadbiri potongan perbelanjaan yang terbayar di dalam mendapatkan pendapatan daripada aktiviti yang menyalahi undang-undang.

**Kata kunci:** aktiviti haram, pendapatan yang boleh dicukai, perbelanjaan yang dibenarkan.

### INTRODUCTION

The tempo of social change, even before the turn of the last millennium, has accelerated beyond imagination and impacts in various ways on the rule of law. Given that the challenge to the law has become more powerful and more urgent, legal practices and institutions cannot remain static in our fast-changing world. Undoubtedly, the history of law is not only logic, but also experience and it is the experience in particular that goes to show that many issues that started out as anomalies in the course of time and by a process of refinement were brought into alignment so as to ensure the evolution of a just solution. It is within this precinct that the issue of taxation of income from illegal activities falls. The history of the development of the equitable jurisdiction of courts is replete with many examples like that; so, too, is the history of

the development of the law relating to taxation in general, and income tax in particular.

It may sound surprising to some people that in most common law jurisdictions, courts have upheld the taxation of income earned from illegal sources. If a taxpayer declares his illegal income for tax assessment, he is entitled to the benefit of deducting allowable expenditures from his gross income unless he is specifically prohibited from doing so under the relevant tax law. In other words, business expenses incurred in an illegal business are allowable expenditures for tax purpose just as business expenditures would be deductible from the gross income of a legitimate business. Taxable income is defined as assessable income less deduction.<sup>1</sup> On this basis, if the activities of the taxpayer give rise to taxable income, it is reasonable to hold that, regardless of the legality of the activities undertaken, any income so produced would be subject to income tax after the deduction of outgoings and expenditures wholly and exclusively incurred in producing the income in question.<sup>2</sup> The force in this argument simply states that in applying income tax law to the proceeds of illegal activities, assessment is based on characterising the receipt as ordinary income, irrespective of the legality of the source of income, and this would include taking advantage of legal provisions which permit the deduction of allowable expenditures.

As John Williams<sup>3</sup> observes: “the object of this bill is to tax a man’s net income... the law does not care where he got it from, so far as the tax is concerned.”<sup>4</sup> This is in line with the position of the courts as acknowledged in *MacFarlane v Commissioner of Taxation*<sup>5</sup> that there is established case law across several jurisdictions justifying the taxation of income from unlawful activities. Let us reiterate it here that the evolution of the common remedies by judicial interpretation is

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<sup>1</sup> See Malaysian statutory provisions on allowable expenditures, sections, 33, 34 and 39 of Malaysian Income Tax Act, 1967. The opening paragraph of section 33(1) provides what may be considered as general test on deduction of business expenses. Other common law jurisdictions have similar statutory provisions.

<sup>2</sup> Section 33(1) of Malaysian Income Tax Act, 1967.

<sup>3</sup> John James Williams was an American businessman and politician from Millsboro, in Sussex County, Delaware. He was a member of the Republican Party, who served four terms as U.S. Senator from Delaware from 1947 to 1970. He was born on May 17, 1904 and died in January 11, 1988, alias, “Whispering Willie”.

<sup>4</sup> See Carol E Hoffecker, *Honest John Williams: US Senator from Delaware* (University of Delaware Press, 2000). John Williams was described as the orchestrator of the income tax bill in USA.

<sup>5</sup> (1986) 13 FCR 356, 380-381.

a well-established procedure, though it can be affected by the Acts of the Parliament, and this is demonstrated in the course of this article. However, it is somehow difficult to dispute the argument that the common law would no longer exist if judges had not from time to time accepted the challenge and boldly laid down new principles to meet new social problems.<sup>6</sup>

It is even more important in common law jurisdictions such as Malaysia, with a written Constitution, that the countries face the problems of the role of the courts in the evolution of law relating to taxation of illegal income or any other law. Logic, history, custom, utility and acceptable social behaviour are factors that act either unilaterally or collectively to mould the emergence of new legal principles. Whichever of these forces will dominate in any case must depend largely upon the comparative importance of value of the social interest that will be thereby promoted or impaired. This may have informed the suggestion of Hederman J in which he holds that “symmetrical development of the law based on history, custom and precedent must be balanced against the social interest served by equity and fairness or other elements of social welfare”.<sup>7</sup> It is submitted that this kind of view provides the ground for the position taken by most of the common law jurisdictions on the issue of imposing tax on illegal activities that serve as a source of income to some taxpayers. The history of tax jurisprudence indicates that the interpretation of tax laws has brought about distinct views that struggle in competition with outcomes that sometimes favour the Revenue Authority and sometimes are in favour of the taxpayer. These views include a literal approach, the golden rule and purposive approach. In the latter, the courts are directed to favour the construction of the legislation which gives effect to the legislative purpose<sup>8</sup> while Lord Wensleydale in *Grey v Pearson*<sup>9</sup> explains the other approach to interpretation as follows: “In construing wills and indeed statutes, and all written instruments, the grammatical and ordinary sense of the words is to be adhered to, unless that would lead to some absurdity, or some repugnance or inconsistency with the rest of the instrument...”<sup>10</sup> These identified different approaches to the

<sup>6</sup> See *Finola McKinley v The Minister for Defence, The Minister for Justice, Daniel Green, Ireland and Attorney General* [1992] 2 I.R.S.C. or [1984] 1268P: S.C. No 428 of 1989 (per Hederman J).

<sup>7</sup> Ibid.

<sup>8</sup> Robin Woellner et al., *Australian Taxation Law*, 13th ed. (North Ryde, New South Wales: CCH Australia, 2003), 49.

<sup>9</sup> (1857) 10 ER 1216.

<sup>10</sup> *Grey v Pearson* (1857) 10 ER 1216, 1234; D Graham Hill, “A Judicial Perspective on Tax Law Reform,” *Australian Law Journal* 72, no. 9 (1998): 687.

interpretation of laws come into play when the issue of tax relating to illegal income arises.

## ILLEGAL ACTIVITIES AND TAXABLE INCOME

What constitutes illegal activities? One is tempted to say any act which the law disapproves of, frowns upon or completely bans is illegal activity, but in answering this question, let us look at how Lord Denning considered the operation of a gang of burglars in *J P Harrison (Watford) Ltd v Griffiths*,<sup>11</sup> in the following way:

Take a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade. You cannot point to any detail that it lacks. But still it is not a trade, nor an adventure in the nature of trade. And how does it help to ask the question; if it is not a trade, what is it? It is burglary, and that is all there is to say about it.<sup>12</sup>

In the above puzzle as raised in the quoted case lies one of the concerns of this article in relation to the distinction the court has drawn between cases where normal income producing activities become illegal due to non-compliance with licensing requirements or acting in contravention to a ban in trade on one hand and on the other hand, profits acquired as a result of the commission of systematic crimes such as burglary whose income is not taxable due largely to its source. In a Canadian case, *Smith v Minister of National Revenue*,<sup>13</sup> it was argued that the statutory definition of income is wide enough to include income derived from a business the carrying on of which is expressly prohibited by law, but the issue here is whether it would be wide enough to comprise gains resulting from commission of crimes, such as burglary or highway robbery, if such crimes, as often happens, were resorted to frequently or habitually as a means of making gain or profit. The real question however is whether the court should place on the statute a construction which implies that the Parliament intended to levy income tax on the proceeds of crime or on the gain derived from

<sup>11</sup> [1962] 40 TC 281, 299.

<sup>12</sup> See *J P Harrison (Watford) Ltd v Griffiths* [1962] 40 TC 281 (per Lord Denning), 299.

<sup>13</sup> [1925] S.C.R. 405.

business which cannot be carried on without violating the law.

If we compare the illegal activities of the burglars with the symbols of business, such as a systematic, organised trade-like manner, it will be discovered that the team of burglars is providing goods to a third party customer,<sup>14</sup> members of this team are seeking to make a profit by their activities,<sup>15</sup> in essence, they are in it for profit seeking motive, they have an organisation and use specialised equipment,<sup>16</sup> and that they carry out repeated operation.<sup>17</sup> What is lacking is the commercial character, bearing in mind that they do not obtain their goods by normal commercial means such as buying or growing them. The UK Revenue Authority notes it is difficult to argue that someone who acquires an asset as a gift or inheritance is trading when he comes to sell the asset in question.<sup>18</sup>

However, let us, at this juncture recall the opinion of Denman, J. in *Partridge v Mallandaine*<sup>19</sup> where he suggests that someone carrying on a “systematic business of receiving stolen goods” (a ‘fence’) would be taxable which is entirely in line with the argument of some courts that if the activity is carried out as a business the profits are assessable as trade profits but if it is not, then the transaction is not liable to tax on income. This view was expressed by Rowlatt, J. in *Ryall v Hoare*<sup>20</sup> when he says “a casual profit made on isolated purchase and sale, unless merged with similar transactions in carrying on of a trade or business is not liable to tax.”<sup>21</sup> The conclusion one is likely to reach is that the test is simply whether the generation of income results from the provision of goods or services for a consideration? Although it may be argued that certain systematic criminal undertakings such as burglary would be excluded from the scope of provision of goods and services but others, for example trading in prohibited drugs may well fall within the concept.

The complexity of law relating to illegal activities and taxation is not in doubt but it is settled law now that the tax is not confined to

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<sup>14</sup> UK HM Revenue and Customs, “Business Income Manual (BIM) of UK Revenue Authority” (HM Revenue and Customs, 100 Parliament Street, London SW1A 2BQ), accessed October 24, 2014, <http://www.hmrc.gov.uk/manuals/bimmanual/Index.htm> BIM20102.

<sup>15</sup> *Ibid.*, BIM20210.

<sup>16</sup> *Ibid.*, BIM20280.

<sup>17</sup> *Ibid.*, BIM20235.

<sup>18</sup> *Ibid.*, BIM20315.

<sup>19</sup> [1886] 2 TC 179.

<sup>20</sup> [1923] 8 TC 521, 525.

<sup>21</sup> *Ryall v Hoare*[1923] 8 TC 521 (per Rowlatt J), 525.

lawful businesses only.<sup>22</sup> Once the character of an enterprise has been ascertained as being in the nature of business, the person, who carries it on cannot found himself upon elements of illegality if any, to avoid tax.<sup>23</sup> By subjecting the profit to tax, the authority does not condone or take part in the illegal enterprise.<sup>24</sup>

Again, let us compare the above burglary consideration by Lord Denning with the following scenario involving the death of a passenger in a high-speed boat down by the old Silver Bridge in Pitt Meadows, British Columbia Province, Canada in the late 1980s. A tax auditor showed an interest in the newspaper report and this led him to investigate the driver's financial status in affording such an expensive boat when his income declared to the revenue was modest. He was ultimately charged with tax evasion. In a similar case, when a Canadian television channel featured the story of a "successful home renovation contractor who could not resist showing off his big house and fancy cars" the revenue became suspicious and the tax audit that followed exposed the taxpayer's undeclared income for tax purposes.

*Inland Revenue Commissioners v Aken*<sup>25</sup> concerned the taxation of income from prostitution. The taxpayer appeared on national television and spoke of her earnings as a prostitute. This came to the attention of the Crown and the Inland Revenue Department assessed her unpaid tax and interest in the sum of £58,000. In court proceedings her defence to the claim was based on prostitution as an illegal activity. In determining whether prostitution was a trade the judge referred to the famous dictum of Lord Reid in *Ransom (Inspector of Taxes) v Higgs* that the word trade 'is sometimes used to denote any mercantile operation, but it is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services.'<sup>26</sup> Applying this dictum to the facts, the Court of Appeal reached the conclusion "that the provision of services for reward can properly be called 'trade'. A prostitute does provide services for reward, and accordingly her activities in my view come within the charge to tax in Sch D."<sup>27</sup> As prostitution was not illegal *per se* in England, income derived from prostitution was a normal trading activity for tax purposes.

Undoubtedly, one of the most notable cases concerns the notorious

<sup>22</sup> *Canadian Minister of Finance v Smith* [1927] A.C. 139, 198.

<sup>23</sup> *Lindsay, Woodward and Hiscox v Commissioners of Inland Revenue* [1932] 18 Tax Cas. 43, 54, 56.

<sup>24</sup> *Mann v Nash* 1932] 16 Tax Cas. 523, 530.

<sup>25</sup> [1990] STC 497.

<sup>26</sup> *Ibid.*, 503.

<sup>27</sup> *Ibid.*, 504.

American gangster Al Capone, who having successfully avoided prosecutions for criminal activities, fell victim to tax laws and was finally imprisoned for failure to declare his income. It was reported:

Al Capone evaded several prosecutions for racketeering until the authorities played the revenue card. He was jailed for tax evasion in 1931. He was convicted of evading tax for the years 1925 to 1929 and of failing to make a tax return for 1928 and 1929. He was defended by a trial attorney named Mike Ahern and a tax lawyer called Albert Fink. He was sentenced to ten years in Federal Prison and one year in the County Jail and fined \$50,000.<sup>28</sup>

## UK and Ireland

Prior to 1922 when Southern Ireland became a free state, it was ruled by UK as the latter governed virtually all the countries practicing common law today before they all attained sovereignty which history recorded at different times. In addition to this unequal relationship between these two common law countries, their proximity in terms of geographical location makes it inevitable for legal precedents of one to impact on similar judicial proceedings of the other. Now, on the issue of taxing income from illegal activities, the Irish authority initially refused to tax illegal income. This was underscored in the approach taken by the courts where they took the view that illegality was a relevant factor in taxation. The courts were of the view that profits from illegal activities were not lawfully taxable. In *Hayes v Duggan*<sup>29</sup> there was an illegal lottery, the profits from which the Supreme Court held could not be subject to tax. According to Fitzgibbon, J., it was hard to believe that any well-ordered state can consider that its own criminal law will not be enforced. "The carrying on of the lottery in question was criminal and contrary to law as the case stated admits, and I can find no intention in ITA 1918, that it contemplated such a state of affairs"<sup>30</sup> In this case, the court was said to have relied on a dictum of Scrutton LJ in *RC v Von Glehn*<sup>31</sup> where he says: "I am inclined to think, though I do not wish finally to decide it, that the Income Tax Acts are to be confined to

<sup>28</sup> Patrick Hunt, "Criminal Assets Bureau and Taxation Matters," *Taxation Conference of The Bar Council of Ireland*, 1, accessed October 19, 2014, [http://www.lawlibrary.ie/docs/Criminal\\_Assets\\_Bureau\\_and\\_Taxation\\_Matters\\_By\\_Patrick\\_Hunt\\_/143.htm](http://www.lawlibrary.ie/docs/Criminal_Assets_Bureau_and_Taxation_Matters_By_Patrick_Hunt_/143.htm).

<sup>29</sup> [1929] IR 406.

<sup>30</sup> [1929] IR 406 or 1 ITR 195.

<sup>31</sup> [1920] 2 KB 553, 572.



lawful businesses, and to businesses carried on in a lawful manner.”<sup>32</sup> Similarly, the Irish High Court in *Collins v Mulvey*<sup>33</sup> held that profits from unlicensed slot machines were non-taxable.

By contrast, in the UK, although the *Hayes v Duggan* case was cited in *Mann v Nash*,<sup>34</sup> in the Kings Bench Division, Rowlatt J, refused to follow it. Although it was one of the earlier Irish cases considered in a British Court, it was not followed. In response to the taxpayer’s pleading that income derived from illegal operation of gambling machines was not taxable, Rowlatt J reasoned as follows:<sup>35</sup>

I myself cannot see why this letting out of the machines in a commercial way, with a view to the reception of profits in a commercial way, is not trade, adventure, manufacture or concern in the nature of trade. On the words, it clearly is. The question really is whether as a matter of construction those words are to be cut down by an overriding consideration that the trade is tainted with illegality. The great mainstay of Mr Field’s argument, quite rightly his point of view, was the case of *Duggan*, decided in the Irish Free State, and that decision of the Supreme Court seems to have gone upon this principle, that no construction could be admitted which recognised that the State should come forward and seem to take a profit from what the State prohibited, because the State ought to have prevented it; and it was argued, if I may venture to say so, in somewhat rhetorical style: does the State keep its Revenue eye open and its eye of justice closed? I must say I do not feel the force of that observation at all... But, in truth, it seems to me that all that consideration is misconceived. 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 to the purpose in my judgement to say: “But the same State that you represent has said they are unlawful...”

He went on to say:

It was said in the Irish case that *allegans suam turpitudinem non est audiendus*, I cannot see that the State are alleging their own turpitude. It is the appellant who is alleging his own turpitude. The State says ‘it is business, the appellant says ‘it is an unlawful one.’ He is alleging his own turpitude. It is said again: Is the State coming forward to take

<sup>32</sup> *RC v Von Glehn* [1920] 2 KB 553, 572 (Scrutton LJ).

<sup>33</sup> 2 ITR 291.

<sup>34</sup> [1932] 16 TC 523.

<sup>35</sup> *Ibid.*, 529-530.

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 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 of the question which I have to decide.

This decision was followed and endorsed by Finlay J in *Southern v AB*.<sup>36</sup>

I desire to point out exactly why, assuming as I am quite willing to assume, the burglar does not come within the purview of the Income Tax Acts: if he does not come within the purview of the Income Tax Acts, it is because what he does is not the carrying on of a trade within Case I, and it is not because, carrying on a trade within Case I, he is taken out by some considerations of morals or anything of that sort. The question always is, I think, a short question of construction: is there a trade - I use «trade» compendiously; trade, or the other words referred to - carried on within the meaning of Case I?

More recently, although in a different context, Lord Browne-Wilkinson in *McGuckian v CIR*<sup>37</sup> reaffirmed the principle that “liability to tax depends on statutory construction not moral disapproval.”

There is an interesting contrast between the way the law was applied in the UK and in the Republic of Ireland. The non-taxability of illegally derived income in Ireland is further buttressed by the judgment of Geoghegan J in *Gayson v Allied Irish Banks plc*<sup>38</sup> in which the failure to advise on an illegal option to the knowledge of the taxpayer was held not to ground an actionable duty of care.

However, changes in Ireland today have resulted in alignment of Irish law with other common law states in which taxing illegal income is recognised, accepted, rationalised and upheld. In response to the murder of Veronica Guerin in 1996, the Irish lawmakers realising the deterrent and punitive potential of revenue laws enacted a number of legislation in quick succession: the Proceeds of Crime Act, 1996, the Criminal Assets Bureau Act, 1996, preceded by the Disclosure of Certain Information for Taxation and Other Purposes Acts, 1996. This new legal regime enabled the exchange of information between the Revenue Authorities, Department of Social Welfare Officials and the Garda Síochána (the Irish Police).

<sup>36</sup> [1933] 18 TC 59, 73.

<sup>37</sup> [1997] 69 TC 1, 77.

<sup>38</sup> The case is unreported, 28 January 2000.

Historically section 19 of the Finance Act, 1983, for the first time in Ireland provided imposition to taxation on revenues from unlawful sources or activities. It also subjected profits to tax from other sources which are “not known to the inspector.”<sup>39</sup> ‘Source of income’ has a technical meaning for tax purposes, but it appears to provide extensive power to revenue officials to initiate assessments. This provision was re-enacted in 1997 in section 58 of the Taxes Consolidated Act but it should be noted here that the effect or rather the essence of 1983 amendment in relation to the Finance Act was aimed at reversing the reasoning in *Hayes v Duggan*<sup>40</sup> and *Collins v Mulvey*.<sup>41</sup> Section 5 of The Criminal Assets Bureau Act, 1996 enacted on Friday, the 11<sup>th</sup> of October, 1996, empowered the Bureau under the Revenue Act to impose tax on the proceeds of criminal activities or suspected criminal activities. When alluding to the positive aspects of this law, an Irish Judge (Moriarty J) in *M v D*<sup>42</sup> says:

it seems to me that I am clearly entitled to take notice of the International phenomenon, far from peculiar to Ireland that significant numbers of persons who engage as principals in lucrative professional crime, particularly that referable to illicit supply of controlled drugs, are alert and effectively able to insulate themselves against the risk of successful criminal prosecution through deployment of intermediaries and the Act of 1996 is designed to enable the lower probative requirements of civil law to be utilised in appropriate cases, not to achieve penal sanctions, but to effectively deprive such persons of such illicit financial fruits of their labours as can be shown to be proceeds of crime.<sup>43</sup>

## Australia and Canada

Though located in two different regions that are thousands of miles apart, both Australia and Canada have in common, judicial systems that are rooted in common law which qualifies them as states worth examining in relation to the application of income tax to illegal activities under consideration. It has been held in both countries in various cases by their courts that the primary function of the Income Tax Acts are meant to bring income of various kinds into the tax net and earnings tainted with illegality has no bearing on its taxability; if

<sup>39</sup> Section 19 of the Irish Finance Act, 1983.

<sup>40</sup> 1 ITR 195.

<sup>41</sup> 2 ITR 291.

<sup>42</sup> [1998] 3 IR 178.

<sup>43</sup> *M v D* [1998] 3 IR 178.

a taxpayer acquires income in an unethical manner or by resorting to acts forbidden by law, the income earned by such taxpayer would still be liable to tax assessment.

The Canada Revenue Agency (CRA) issued a notice to the effect that since 1972, it has closely monitored taxpayers who derive income from illegal activities. A special program set up by the Agency seeks to identify people who derive income through illegal activities and ensures that they comply with tax returns and financial statements. "The program's primary objective is to minimise the funds and property accumulated illegally by these individuals. It does this by ensuring that the taxes related to this income are assessed and collected."<sup>44</sup> Similarly, in Australia, the Commissioner of Taxation issued a public ruling where the opinion is expressed that "receipts from systematic activity where elements of a business are present are income irrespective of whether the activities are legal or illegal."<sup>45</sup> The implication of the Canadian notice and the Australian Commissioner Public Ruling is that in the eyes of these two sovereign states income is income; their tax authorities are not particularly concerned with the legal nature of an activity, at least from the income tax point of view.

#### *The Effect Of Illegality On Deduction Of Expenditures*

If the income from an illegal source is taxable, the logical inference would allow the deduction of expenses normally incurred in the production of the income. The general formula in tax legislation provides for the deduction of expenses wholly and exclusively incurred in the production of income<sup>46</sup> for the purposes of the trade, profession or vocation.<sup>47</sup> This provision is strictly construed and all the elements must be satisfied to qualify an expense as an allowable expenditure."<sup>48</sup> It is not enough that the disbursement is made in the course of, or arises out of, or is connected with the trade, or is made out of profits of the trade. It must be made for the purpose of earning the profits."<sup>48</sup> While genuine expenses are allowable, money spent on fines, penalties and similar payments are not expenses incurred in the production of income and it would be against public policy to allow such deductions. Lord Hoffman in *McKnight v Sheppard*<sup>49</sup> emphasises the reason as follows:

<sup>44</sup> Jim Maroney, "Taxpayers Obtaining Illegal Income Get Closer Scrutiny by CCRA Auditors," *Income Tax Canada*, accessed September 6, 2015, <http://www.incometaxcanada.net/news/illegal-income-taxable.htm>.

<sup>45</sup> Taxation Ruling TR 93/25.

<sup>46</sup> Section 33(1) ITA (Malaysia).

<sup>47</sup> Section 34 Income Tax (Trading and Other Income) Act 2005(UK).

<sup>48</sup> Lord Davy in *Strong & Co of Romsey v Woodfield* [1906] 5 TC 215 at 220.

<sup>49</sup> [1999] 71 TC 419.

Its 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 with the rest of the community by a deduction for the purposes of tax.

This is what informed the decision in *R v Farquhar*<sup>50</sup> following *McKnight*, it was held that a confiscation order is ‘not about compensating the loser, but penalising the offender and therefore no such deduction is allowed for tax purposes.’

Beyond general principles of revenue law governing the deductibility of expenditures from illegal income, specific statutory provisions may apply to deny certain types of expenses. For example, in UK statutory provision expressly prohibits the deduction of payment made for the commission of a crime and expenditures incurred in making a payment induced by a demand constituting the offence of blackmail.<sup>51</sup> In *Commissioner of Taxation v La Rosa*<sup>52</sup> the Federal Court in Australia allowed a convicted drug dealer to deduct money stolen from his business during a drug deal. Legislation was passed which effectively denies deductions to convicted criminals.<sup>53</sup> Statutory intervention in this instance has rightly been criticised as having been motivated by public outcry and cannot be explained either on legal principle or grounds of public policy.<sup>54</sup> If the income of a criminal is chargeable to tax there is no reason to disallow deductions of the usual expenditures, which would have been allowed had the income not been tainted with illegality.

## MALAYSIAN POSITION ON TAXING ILLEGAL INCOME

In Malaysia the Income Tax Act 1967(ITA) governs all aspects of income taxation, several provisions of which are common to similar legislation in several commonwealth countries. Section 4 which provides for classes of income, consonant with the rest of the Act, is

<sup>50</sup> [2008] EWCA Crim 806.

<sup>51</sup> Section. 577A, Income Tax(Trading and Other Income) Act 2005(UK).

<sup>52</sup> [2003] FCAFC 125.

<sup>53</sup> Section 26-54, Income Tax Assessment Act 1997.

<sup>54</sup> ‘... the provision contravenes fundamental principles on which Australia’s tax system is based; advocates for the disallowance disregard the injustice, inefficiency and complexity caused by its implementation...’ Jillian Hall, “Public Policy, Principles and Politics: The La Rosa Amendment,” *Austl. Tax F.* 23 (2008): 230.

silent on illegal income although section 4(f) covers gains or profits not falling under the classes specified in Section 4(a)-(e). *DGIR v LTS*<sup>55</sup> is the only reported case on the subject of taxing illegal gains to have reached the apex court in 1975. Permits to extract timber was granted only to concessionaires under an express condition that they were non transferrable except with the written permission of the relevant authority. In breach of the condition the taxpayer was the transferee of a concession. His operation as transferee was clearly illegal.<sup>56</sup>

The judge reminded himself that in the opinion of the Privy Council in *Minister of Finance v Smith*<sup>57</sup> ‘there is nothing in the Act which points to any intention to curtail the statutory definition of income, and it does not appear appropriate under the circumstances to import any assumed moral or ethical standard, as controlling in a case such as this the literal interpretation of the language employed.’ He concluded that notwithstanding the illegality of the contract, the income of the taxpayer was liable to tax but he was also entitled to the deductions allowed under the Act. An appeal by the Internal Revenue Department on the issue of allowable expenditure was dismissed by the Federal Court on the basis that it fell within the ambit of Section 33 as expenditure wholly and exclusively incurred in the production of gross income. Furthermore it was not excluded in the list of expenditures disallowed by Section 39. The contrary ruling would be tantamount to saying that “whereas income earned by virtue of an illegal contract is taxable, the expenses which were wholly and exclusively incurred in the production of that income cannot be allowed by reason of the illegality of the contracts.”<sup>58</sup>

It is also interesting to note that the secret commission paid to obtain the transfer of the logging rights fell within the scope of prohibited deductions under Section 39(1)g as “any sum, by whatever name called, payable (otherwise than to a State Government) for the use of a licence or permit to extract timber from a forest in Malaysia”. Essentially, the Income Tax Act of 1967 and cases from common law jurisdictions will guide Malaysian courts in deciding cases relating to taxation in general and illegal income in particular and the possibility

<sup>55</sup> [1975] 1 MLJ 187(High Court); [1975] 2 MLJ 30(Federal Court).

<sup>56</sup> On the basis of *Tan Bing Hock v Abu Samah* [1967] 2 MLJ 148 and *Lo Su Tsoon Timber Depot v Southern Estate Sdn Bhd* [1971] 2 MLJ 161 being decisions on similar provisions of comparable legislation where it was held in no uncertain terms that the purported assignments in breach of the regulations and conditions of the permits were illegal and unenforceable, the judge felt bound and had no doubt in his mind about the illegality of the contract.

<sup>57</sup> [1927] AC 193, 197.

<sup>58</sup> [1975] 2 MLJ 30, 31.

of following in the foot-path of other common law countries in taxing gains from the growing trend in illegal activities.

## CONCLUSION

In view of the opinion expressed above, it seems to be realistic to conclude without any manipulation on the concept that the history of the enactment of income tax legislation in various common law jurisdictions suggests that the legislature passes such Act with the primary aim of generating revenue to the state and is not meant to be interpreted in a way to regulate the manner in which taxpayers earn their income. Nor it is intended as a punitive device to prohibit certain types of activities. Parliament can of course amend the law, when there is need to do so, to reflect social changes and probably equity and fairness. The more reason for the courts not to draw a distinction between cases where normal income producing activities become illegal due to non-compliance with licensing requirements or acting in contravention to a ban in trading on the one hand and profits acquired as a result of the commission of systematic crimes such as burglary. Income from all sources should be taxable which, to some extent, may even discourage illegal income earning activities.

All income accrued in, derived from, or remitted to Malaysia are liable to tax<sup>59</sup> and the law does not specifically differentiate between legal income and income from illegal activities. As noted earlier, there is only one decided case reported so far on this issue in Malaysia, and there was no detailed argument as to whether, and if so in what circumstances, a decision of a court in this country could or should operate to determine taxing illegal income, particularly in relation to drug trafficking proceeds and other related criminal activities; nevertheless, it may be safe to presume that as a common law country, Malaysia will tend towards imposing tax on all income regardless of legality.

The lesson which Malaysia can draw from countries such as Australia, Canada, United Kingdom, USA and several others is to have affirmative notices on the declaration of income from certain illegal activities. Among the notorious illegal activities prevalent in the country at the present time is illegal logging, trafficking in subsidised

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<sup>59</sup> Section 3, ITA which provides: 'Subject to and in accordance with this Act, a tax to be known as income tax shall be charged for each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia.'

fuel, and illegal gambling, to name a few. If the Revenue authority demands the declaration of income from such activities by positive statements on its website, through public education and on the relevant income tax documents coupled with tracking down convicted criminals for income investigation, a number of positive results may follow. The rate of illegal activities may decrease and the public coffers will swell. It may also break hardened criminals who have managed to escape the full brunt of the law as it did to Al Capone.<sup>60</sup>

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<sup>60</sup> [1990] STC, 504.