TAXATION OF ILLEGAL ACTIVITIES IN NEW ZEALAND AND AUSTRALIA

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The article explores the gaps that exist with regard to the taxation of illegal activities in New Zealand and Australia and the impact of proposed legislative reform on the application of constructive trusts in the area of taxation. It sets out the tests applied by the Courts to determine whether an illegal activity is taxable. The paper shows that while some criminal activities are taxable others are not.

The author then considers the deductibility of expenses, particularly fines imposed by the Courts, incurred through criminal activity. The judiciary and the Commissioner of Taxation have relied upon a number of arguments to deny deductibility of expenses that would otherwise appear to meet the general statutory test for deductibility. In the absence of a clear statutory prohibition the paper attempts to establish a guide on which expenses should be deductible. The author hopes that this will serve as a guide in the event of future disputes in the area.

I INTRODUCTION

Taxation, in theory, knows no morality.[1] The Commissioner of Taxation will tax any income within the scope of the Income Tax Act and allow any deductions within the scope of the Act. It is not, in theory, an issue of fairness but of statutory application and that is the same for the taxpayer earning income from criminal activities which constitute business as it is of the ordinary legitimate taxpayer.

Does the broad approach of equality before the Income Tax Act actually exist in practice? Are all illegal activities taxable? Is a career burglar taxable on the proceeds of his activity? As will be discussed, not all illegal activities are taxable even though at first glance, it might appear so.

Income tax applies to increases in economic capacity (i.e. income as defined by case law) and applies equally to all increases in ability to pay.[2] Expenses incurred in deriving assessable income are deductible.[3] There are two conceptual issues to consider in determining whether the doctrines make any sense in terms of taxation principles. First, do we want to tax illegal profits more harshly than other profits to discourage the activity? Secondly, do we want to use tax law to reinforce criminal law or do we want to distinguish illegal profits that the criminal might have to return? In the latter case we would treat profits as the equivalent of untaxed loans or borrowed funds on the basis that the criminal has no true claim to keep them.

Following on from this introduction, the scope of illegal enterprise within the New Zealand and Australian economy and as an element of the tax base is explored in Part 2. The paper considers the distinction between the treatments of the income from illicit activities, compared to the income earned by ordinary taxpayers in Part 3. It

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1 Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part IV: Operational Issues, Ch 16: Relationship with Taxpayers. The two features of a benchmark income tax are horizontal equity and vertical equity.

2 A Smith, *An Inquiry into the Nature and Causes of Wealth of Nations* , Chicago, Encyclopaedia Britannica, 1952, at p 362. Adam Smith's four canons of taxation are generally taken to include equity.

3 Income Tax Act 2007 (ITA 2007), s DA 1.

provides an overview of the application of the ordinary concepts of income to illicit activity. There is particular reference to relevant New Zealand and Australian cases. Cases from other jurisdictions are also examined to determine if indeed the application of the ordinary concepts of income to illicit activity does exist. Part 4 of the paper considers the distinguishing characteristics of illegality, reviewing the possible contribution of incidental illegality and property rights applied by the courts to determine whether an illegal activity is taxable. There is particular reference to *A Taxpayer v CIR*,[4] an embezzlement case which held the criminal was technically not subject to tax and resulted in a statutory reform. The next part of the paper sets out the deductibility of expenses, particularly fines imposed by courts. It considers tax precedents and principles of income tax for deduction, reviewing several approaches taken by courts to deny deductibility: illegality severing deductibility on a quasi-capital basis, public policy reasons, and treating fines as private expenditure. It also examines the Commissioner's approach to the deductibility of fines and concludes that the deductibility of fines is not analogous to the treatment of income from illegal activities. Part 6 includes a summary of the key tests covered in the article and suggests that in New Zealand and Australia, in the absence of unified test for deductions, a more consistent approach would be achieved by simply applying the statutory test more rigorously.[5]

II THE SCOPE OF ILLEGAL PROFITS IN NEW ZEALAND AND AUSTRALIA

Dr P Caragata[6] identified a number of models to estimate the size of the hidden economy in New Zealand. According to Dr Caragata's figures from his preferred model the average size of the hidden economy during 1969 to 1994 was 8.8per cent of gross domestic product (GDP).[7] However when those figures are broken down into distinct time periods the annual average for the hidden economy as a part of GDP is increasing: in 1990 to 1994 it was 9.5% and in 1994 alone it was 11.3per cent. This equates to approximately $7.1 billion. Caragata believes that these figures are "conservative".[8]

Those figures relate to the hidden economy and that concept is not identical to the illicit or illegal economy. The hidden economy represents economic activity that is not covered by conventional statistics and includes both illegal activities and tax evasion. Tax evasion refers to an activity that, in itself, is not illegal but is being conducted knowingly to evade the incidence of tax.[9] Examples include undisclosed cash payments for goods and services[10] or under the counter payments to employees.

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4 *A Taxpayer v CIR* (1997) 18 NZTC 13,350.

5 ITA 2007 s DA 1; s 8-1 of the Income Tax Assessment Act 1997 (ITAA97)

6 PJ. Caragata, *The Economic and Compliance Consequences of Taxation*: *A Report on the Health of the Tax System in New Zealand*, Boston, Kluwer Academic Publishers, 1998.

7 This compares well with other countries and put New Zealand's hidden economy at the lower end of the scale. The estimates range from approximately 27 per cent of GDP for Italy to 6 per cent of GDP for Switzerland for 1994. See Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part II: Robustness Against Avoidance and Evasion, Ch 7.21: Tax Evasion and the Hidden Economy.

8 An accurate estimate of the hidden economy is, by its very nature, unlikely to be obtained but estimates can vary markedly between observers depending upon the country concerned, the availability of data and the method employed in estimating it. See Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part II: Robustness Against Avoidance and Evasion, Ch 7.22: Tax Evasion and the Hidden Economy.

9 *Taylor v Attorney-General* [1963] NZLR 261 (SC).

10 It includes income from prostitution. Prostitution is legal in New Zealand.

This type of behavior is referred to by Carataga as "soft core" hidden economic activity and represents behavior entered into predominantly to escape the incidence of tax. The illegal economies, or the "hard core" hidden economy, are activities that are not disclosed because undertaking them is in itself illegal e.g. illegal gambling, drug dealing, white-collar crimes, theft and frauds. I shall refer to this as the illicit economy.

Therefore, when considering the extent of illicit economic activity, this must be distinguished from the wider concept of the hidden economy. In the model adopted by Caragata, where there is a zero per cent tax rate the hidden economy is only 40% of its former size.[11] According to Caragata the illicit economy is approximately 4.52% of GDP or $2.84 billion per year when using the 1994 figures. Caragata suggests that theft and fraud constitute 70 per cent of the illicit economy and that therefore approximately 3.8 per cent of GPD relates to theft and fraud, making this type of activity the major source of illegal profits. He suggested that theft and fraud constitutes 70% of the illicit economy. This conclusion seems to ignore that the balance of GDP he attributes to the illicit economy is less than one per cent (representing the level of illegal income from drug dealing, prostitution,[12] illegal gambling, poaching, money-laundering, people-smuggling and any other potential source of illegal income). However, Caragata relies upon an interpolation from United States figures and defines his conclusion as no more than a suspicion; therefore, it is submitted than the breakdown suggested by Caragata may be less than accurate.

During May 2006 a report on Observance of Standards and Code prepared by Financial Task Force Action stated that Australian Government estimate suggested that the amount of money laundering in Australia ranges between AUD 2-3 billion per year.[13] It is a starting point that indicates the monetary importance of the illicit economy to the tax base within New Zealand and Australia. While it can be accepted that indirect taxation is more efficient in attaching itself to the illegal income,[14] it is unlikely that the Government will abolish direct taxation in its favour. Indeed, Caragata advocates directing more resources into auditing criminals[15] as the dollar return from such audits is so high. Accepting that such activity is worth pursuing from a revenue gathering perspective, this raises the question of whether or not it can be so pursued but a discussion of this issue is beyond the scope of this paper.

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[11] The significance of that is that, with a zero percent tax rate there is no incentive to enter into tax evasion – there is no tax to be evaded. Therefore the remaining hidden economy must be the illegal economy, hidden for reasons other than taxation. The 40 percent remaining is the natural underground economy.

[12] The Prostitution Reform Act 2003 governs the rules when or where an individual sex worker may work for the business of prostitution, which has now been legalised.

[13] International Monetary Fund, *Australia: Mutual Evaluation Report - FATF Recommendations for Anti-money Laundering and combating the financing of Terrorisom* (Report No. 06/424, November 2006).

[14] Income from the illegal economy will eventually be returned to the ordinary economy, otherwise it is rendered of negligible value, GST will be payable upon that application of hidden income. See Committee of Experts on Tax Compliance, *Tax Compliance, Report to the Treasurer and Minister of Revenue* (Wellington, December 1998), Part II: Robustness Against Avoidance and Evasion, Ch 7.17: Tax Evasion and the Hidden Economy.

[15] P Caragata, "Tax Evasion: What the Tax System Health Report Really Said" (1998) 42:14 *Current Taxation* 27.

III ILLEGAL PROFITS AND ORDINARY PROFITS

Australian and New Zealand common law, is based on the doctrine of precedent. The challenge for the courts is to find the most appropriate precedent to the facts in hand. The concept of the "transplanted category" – using concepts from one area of law to interpret another area of law (tax law in this case) - sometimes yield results that are inappropriate in terms of the policy objectives underlying the recipient body of law.[16] The British legislation was, and remains, in a schedular format: what constitutes income is determined by its source; if it has a source within the Income Tax Act it is income.[17] Therefore, British developments must be considered in the context of a different tax base.

The fundamental question is whether there is any logical distinction between the treatments of the income from illicit activities, compared to the income earned by ordinary taxpayers.

The legislation is of no help here. Australian Income Tax Assessment Act 1997(Cth)(ITAA 1997) and New Zealand Income Tax Act 2007 (ITA 07) includes provisions specifically dealing with how the victims of theft should manage the taxation consequences of the loss and how property in the hands of a criminal should be defined for tax purposes.[18] In Australia Tax Ruling 93/25 (1993)[19]deals with the taxation of illegal businesses. Parsons suggests, "an item of an income character is derived when it has 'come home' to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation".[20] The principles which determine the derivation of an item express a general concept of realisation as essential to income derivation. Where the item results in an increase in the value of property it would be possible to regard the increase as unrealised gain. [21] According to accrual based accounting, income is generally considered to be earned when the taxpayer has a legal right to receive payment,[22] but for an illegal activity where purported contracts would not be enforceable, the taxpayer would not have a legal right of payment and therefore in practice only cash accounting could operate. Parsons[23] suggests that a claim of right, rather than legal entitlement may be sufficient for derivation of income.

A *Taxability of Illegal Profits*

The taxability of illegal profits relies upon the application of the ordinary concepts of income to the illicit activity, in short, ascertaining whether or not there

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16 R Krever, "Taming Complexity in Australian Income Tax" (2003) 25:4 *Sydney Law Review* 467.

17 J Glover, "Taxing the Constructive Trustee: Should a Revenue Statute Address Itself to Fictions", in *A* J Oakley (ed), *Trends in Contemporary Trust Law*, Clarendon Press, Oxford, 1996 at p 315.

18 ITA 07, ss DB 42, CB 32and cases *Gold Band Services Ltd v CIR* [1961] NZLR 467, *W G Evans & Co Ltd v CIR* (1976) 2 NZTC 61,080, and *Case K39* (1988) 10 NZTC 129.

19 ATO, Income tax: Assessability of proceeds from illegal activities, treatment of amounts recovered and
deductibility of fines and penalties.

20 RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, Sydney, The Law Book Co. Ltd.,1985, Proposition 1 at para 2.7.

21 Ibid at paras 2.10 – 2.29. A detailed discussion of principles of ordinary income can be found especially in chapter 2.

22 *J Rowe and Barratt v Federal Commissioner of Taxation* (1992) 92 ATC 4275.

23 RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, Sydney, The Law Book Co. Ltd., 1985, at Para 2.7.

is a business being undertaken. In *Partridge v Mallendaine*,[24] one of the earliest cases to consider the taxability of illegal income, where the legislation was silent as to the legality or illegality of the activities, unlawful businesses were not to be given the advantage of being free from income tax.

In *Minister of Finance v Smith*,[25] a case involving an illegal business, namely bootlegging, the Privy Council considered that the position of an activity of illicit traffic in liquor which was illegal under a particular Canadian province's law but which could potentially have been carried out legally under other provinces' laws (it was not in itself a criminal offence under common law – only an illegal activity under statute) . Viscount Haldane held that the power of the Dominion Legislature to impose income tax would not be limited by provincial law declaring an activity illegal.

The public ruling issued by Australian Tax office states that 'receipts from a systematic activity where the elements of a business are present are income irrespective of whether the activities are legal or illegal'. [26] In New Zealand the courts have had little difficulty in accepting that the proceeds of illegal activities are taxable. There have been numerous cases dealing with the calculation of assessable income as a result of illicit activities such as drug dealing and bookmaking.[27] There have been other cases dealing with the Commissioner's debt recovery powers where the debt arises, in part, from illegal proceeds[28] and with the Commissioner's powers[29] to request information regarding a taxpayer's illicit activities to enable an assessment to be made.[30] However, there has been little authority of the basis upon which such proceeds are, taxable. This appears to have been taken for granted with one judge simply saying, in response to a submission illegal profits are not taxable: "[I]t would be an absurd situation should the Commissioner be unable to assess income simply because a taxpayer's activities were illegal."[31]

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[24] *Partridge v Mallendaine* (1886) 2 TC 179 at p 181, where Justice Denman said, "In my opinion if a man was to make a systematic business of receiving stolen goods, and to do nothing else, and he thereby systematically carried on a business and made a profit of £2,000 a year, the Income Tax Commissioners would be quite right in assessing him as if it were in fact his vocation. There is no limit as to its being a lawful vocation, nor do I think that the fact that it is unlawful can be set up in favour of these persons as against the rights of the revenue to have payment in respect of the profits that are made."

[25] *Minister of Finance v Smith* [1927] AC 193.

[26] Taxation Ruling 93/25, 5. TR 93/25, 2 states any activity not permitted by law, such as drug dealing, insider trading, misappropriation, prostitution and SP bookmaking is illegal activity. Some of these activities may no longer be illegal under the relevant State or Territory legislation.

[27] *Case T2* (1997) 18 NZTC 8,007; *Case F146* (1984) 6 NZTC 60,283; *Case D57* (1980) 4 NZTC 60,852; *Case B3* (1975) 2 NZTC 60,020; and *Case Z23* 92 ATC 235.

[28] *Yee v CIR* (1988) 10 NZTC 5,258. The taxpayer's default assessment was based on estimated profits from heroin trafficking. The taxpayer subsequently used his motor vehicle as security pursuant to an instrument by way of security against the money owed under the default assessment. The security was given on some implied basis that the Commissioner would not demand the tax owing or exercise the security if proper returns were filed within a reasonable time. According to the Commissioner satisfactory returns had not been filed therefore, the CIR could realise a security of the taxpayer given to him.

[29] Tax Administration Act 1994, s 81.

[30] *Wojcik v Police* (1996) 17 NZTC 12,646. An illegal search and seizure by police did not stop the Commissioner from being able to use a taxpayer's seized property as the basis for making an assessment.

[31] Case D 57 (1980) 4 NZTC 60,852, per Judge Lloyd Martin, Taxation Review Authority. The taxpayer was convicted on charges of possessing and selling heroin. In the decision the comment was made that it was quite immaterial as to whether a business or other income was legal or illegal. The Court's analysis of the actions of taxpayer was premised on the notion that they amounted to business.

However, it could not be said that the proceeds from all forms of illegal activity have been consistently treated as taxable. For example, the proceeds of burglary have for a long time been considered, at least in dicta, as not taxable.[32] However, *Southern v AB Ltd* case *and Lindsay v CIR* case the decision commented that burglary was not a trade. As will be discussed, the proceeds of embezzlement have been determined to be not assessable in New Zealand.[33] The courts have considered whether an activity is a trade or a business as a recognisable basis for the differing treatments of the proceeds of differing types of illegal activity.

The early cases stress that the taxability of the proceeds of illegal activity arises because of the scope of taxation legislation. In one of the few such cases to reach the Privy Council,[34] their Lordships grounded their decision that the proceeds of illegal alcohol exports were taxable on the ordinary principles of taxation.

In New Zealand and Australia courts have based their decision regarding taxability of illegal incomes on the normal tests of whether or not there is a business activity: in effect the *Grieve*[35]and *Walker*[36] test of a business activity applied evenhandedly to any activity. Australian Tax Ruling stated: "What is normally accepted as income is determined according to ordinary usages and concepts of mankind. Receipts from a systematic activity where the elements of a business are present are income irrespective of whether activities are legal or illegal".[37] If this is the case the exceptions become less easy to understand. No one commits a fraud or theft without intending to benefit from that action. It seems illogical to levy taxation on a drug

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[32] Southern v AB Ltd [1933] 1KB 713 at 719; Lindsay v CIR [1932] 18 TC 43.

[33] A Taxpayer v CIR (1997) 18 NZTC 13,350. It is noted that the majority at the Court of Appeal open their judgment defining the issue as '.the taxation consequences of engaging in criminal activity for financial gain.' This, it is submitted, is too wide a formulation of the particular issue before the Court. The issue was merely the tax treatment of the proceeds of embezzlement and not all forms of criminal endeavor as Tipping J recognised commencing his judgment: 'the issue in this case is whether a thief as liable to pay income tax on the moneys stolen'.

[34] Minister of Finance v Smith [1927] AC 193 at 197 per Viscount Haldane:

Nor does it seem to their Lordships a natural construction of the Act to read it as permitting persons who come within its terms to defeat taxation by setting up their own wrong. There is nothing in the Act which points to any intention to curtail the statutory definition of income, and it is not appropriate under the circumstances to impart any assumed moral or ethical standard as controlling in a case such as this the literal interpretation of the language employed.

Also see Southern v AB Ltd (op cit) and Mann v Nash [1932] 1 KB 752 at 758 per Rowlatt J, 'The revenue authorities ... are merely looking at an accomplished fact. It is not condoning it, or taking part in it. It merely finds profit made from what appears to be a trade, and the revenue laws say that profits made from a trade are to be taxed'.

[35] Grieve v CIR (1984) 6 NZTC 61,682 at 61,689. See also at 61,691 where Richardson J said:

It follows from this analysis that the decision whether or not the taxpayer is in business involves a two-fold inquiry – as to the nature of the activities carried on, and as to the intention of the taxpayer in engaging in those activities. Statements by the taxpayer as to his intentions are of course relevant but actions will often speak louder than words. Amongst the matters which may properly be considered in that inquiry are the nature if the activity, the period over which it is engaged in, the scale of operations and the volume of transactions, the commitment of time, money and effort, the pattern of activity, and the financial results. It may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those which are characteristic of ordinary trade in the line of business in which the venture was conducted. However, in the end it is the character and the circumstances of the particular venture which are crucial. Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably, or because the taxpayer derives personal satisfaction from the venture. Nor because that business is illegal.

[36] Federal Commissioner of Taxation v Walker (1985) 85 ATC4179. The court identified number of tests to determine whether a taxpayer was carrying on a business but nowhere in these tests is there a requirement that the activities undertaken be legal.

[37] ATO Tax Ruling 93/25 (1993) at [5].

dealing transaction but not on the selling of stolen goods.[38] Both are conducted with a view to making a profit (regardless of what motivates that profit). The white-collar criminal will be no less organised than a thief (and probably a good deal more effective as a criminal). An illegal activity, if not engaged in with an intention to make profit and with sufficiently regularity to be a 'business', may not be taxable, even if profitable, as it is more akin to a hobby, the gains derived from which are not subject to income tax.

IV DISTINGUISHING CHARACTERISTICS

A *Incidental Illegality*

Whether or not the illegality is at the heart of a transaction may determine assessability of the activity.[39] Theft is of its very nature illegal and would never be considered otherwise whereas some illegal activities such as the resetting of stolen gems in jewellery[40] or the sale of liquor[41] could be pursued legitimately. By this approach "illegality goes to the root of the transaction so that it is incapable of being a trade under any circumstances whatsoever, whereas in the example of resetting stolen gems the illegality may only be an incident of the trade, leaving out any consideration of any contravention of the law".[42]

Part of the problem may arise from the nature of the British legislation against which these earlier cases were determined. The British legislation determines income by its source; therefore need to identify a legitimate parallel "trade" become more understandable. When considering an activity which is not illegal per se, the illegality of the components of that activity or the illegality of particular transactions may be ignored in determining the overall profits earned. However when the activity as a whole is illegal, that activity is not within the notion of a trade or business as contemplated by the relevant legislation.

In my view, this reasoning seems unconvincing. In essence this approach requires the identification of a parallel legal activity to which the illegal one can be compared to determine assessability. For example in the *Lindsay* case Lord Sands gives the illustration of drug trafficking saying: "Trafficking in drugs, for example, is of the nature of trade, albeit such trafficking may in the circumstances be illegal".[43] Because there is a legal activity of drug sales, profits from illegal drug dealing can be assessed. Therefore the test of incidental illegality is to identify a similar or identical legal business, if this can be done the activity is taxable. In the *La Rosa*[44] case the taxpayer was involved in drug dealing. In 1996 he was sentenced to more than 12 years in prison, after pleading guilty to charges relating to the importation

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[38] *Lindsay v IR Commrs* [1932] 18 TC 43. In *Lindsay* Lords Clyde said (at p 54), 'a distinction seems to be drawn between illegal or unlawful but commercial activities and crime'. In *Lindsay* Lords Clyde and Morison considered that persons reselling stolen goods or committing burglaries would not per se, from those activities alone, be assessable for income tax. Their Lordships agreed that if the proceeds of their crimes were used in business the profits of that business would be assessable income.

[39] K Day, "The tax consequences of illegal trading transactions", (1971) *British Tax Review* 104.

[40] *Lindsay v IR Commrs* [1932] 18 TC 43 – where this example was developed.

[41] *Minister of Finance v Smith* [1927] AC 193; *Lindsay v IR Commrs* [1932] 18 TC 43..

[42] K Day, "The tax consequences of illegal trading transactions" (1971) *British Tax Review* 104 at p 108.

[43] *Lindsay v IR Commrs* [1932] 18 TC 43. .

[44] *CIR v La Rosa* (2003) 53 ATR 1.

and possession of heroin.[45] Francesco Dominico La Rosa forfeited personal property, real property and money valued at $264,610 under the *Proceeds of Crimes Act 1987*. It came to the Commissioner's attention that the taxpayer had not lodged income tax returns for seven years from 1990 to 1996 inclusive. Accordingly, the Commissioner issued default notices of assessment[46] to the taxpayer for the relevant years, including interest and penalties.[47] The first three years' assessments were based on the default assessment provision, with the first three years based on averaging income derived in previous periods where returns have been furnished and the final four years' assessment were based on the 'T' accounts provided to the Commissioner by the Commonwealth Director of Public Prosecutions.[48]

In *LA Rosa* case since there is a legitimate parallel to drug sales, profits from illegal drug dealing were assessed. However, it appears from the earlier cases that the usual test of business activity, in practice, is not used when faced with illegal activities. A burglary ring can be very well organised; intended to make a profit and actually achieve a profit and yet may not be a business as there is no legitimate parallel to theft. In the *Lindsay* case[49] the manufacturing and sale of liquor was legal in Scotland, but the sale to Prohibition America was illegal. The activity was able to be conducted domestically without any illegality but could not be carried out between two countries without breaking the laws of both jurisdictions. This illegality did not prevent assessability as illegality was not of essence in trading in rye whisky. While profits from an illegal activity amounting to a trade will constitute assessable income from a trade, not all criminal activities will amount to a trade, of course. Whether an illegal activity amounts to a trade will depend on the ordinary tests used by courts to identify trades.

In *Southern v AB Ltd* Finlay J commented as follows:

> I express no opinion upon a case which is quite unlike the case which is before me, but 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.[50]

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45 *La Rosa v The Queen* (1999) 105 A Crim R 362,363.

46 Pursuant to s 167 of the Income Tax Assessment Act 1936 (Cth).

47 The Commissioner of Taxation issued him with a tax debt of $960,000.

48 To determine the appropriate amount of income to be assessed some adjustments were made to the T accounts prepared by the Commonwealth Director of Public Prosecutions in determining the appropriate amount to be assessed. Refer to *CIR v La Rosa* (2002) 50 ATR 450 at 453.

49 *Lindsay v IR Commrs* [1932] 18 TC 43. at pp 54-55. The Lord President (Clyde) went on to distinguish between illegal or unlawful but commercial activities and crime:

> There are many transactions which are illegal in the sense that the obligations upon which they depend are not such as the law will enforce…I do not, however, think that, merely because the contract was not enforceable by law, profits actually made by the partnership's trading operations must necessarily be placed beyond assessment to Income tax as profits of 'trade'….It is plain enough, I think, that the profits of crime could not be assessable to Income Tax as the profits of trade. If – to take an example – the mode of living followed by an individual consisted of nothing – or practically nothing – but the commission of the crime of re-setting stolen goods, it might be difficult to say that the profits were assessable to Income Tax as the profits of 'trade'---.

In *Lindsay* Lord Sands stated: (at p 56): 'Crime, such as housebreaking, is not trade, and therefore the proceeds are not caught by tax…' In *Lindsay* in the words of Lord Morison (at p 58): 'A question was raised as to whether the profits or gains of a burglar were subject to tax. Obviously not, because burglary is not a trade or business'.

50 *Southern v AB Ltd* [1933] 1KB 713at p 727. The taxpayer, AB, and his company AB Ltd, carried on an illegal bookmaking (street betting and ready money betting) business. Finlay J was of the opinion that the activities constitute a trade notwithstanding the fact that they involved illegality.

It seems illogical that an incidental illegal profit is fully taxable, whereas one that is wholly illegal is not.[51] This approach is not followed in New Zealand except to the extent that specific legislative intervention has occurred.[52]

However, in New Zealand the Income Tax Act taxes gains in the nature of income, itself undefined[53] and generally authorities look for some link between receipt and activity of a taxpayer that parallels the British concept of trade. But there is an additional twist in New Zealand where the courts distinguish between proceeds of a trade (illegal or legal) that are derived absolutely by a taxpayer and those to which the taxpayer has only a tentative claim because of their illegal nature (and the fact that they will have to be returned if the taxpayer is caught). In this approach it is the nature of the receipt in the hands of the taxpayer that determines taxability, not its source. But the same distinctions are broadly maintained. An apposite case is that of *A Taxpayer*.[54] The Court of Appeal determined that the proceeds of embezzlement were not income to the thief. Therefore, there is a need to investigate the reasons for that treatment.

B *Property Based Distinctions*

It is submitted that the broad distinguishing characteristic is property right rather than legal activity parallels. In the case of illicit gambling, drug dealing, and prostitution there are no prior property rights being abused or ignored. In the case of most forms of commercial poaching,[55] theft, fraud and embezzlement, there are clear prior property rights that the criminal intends to defeat by his or her actions. Rather than determining whether that illegality is incidental to the activity being conducted, in my submission, it is the lack of a property right that distinguishes one form of illegality from another for taxation purposes.

The case of *A Taxpayer* offers an example of this approach. In that case an accountant systematically embezzled over $2 million from his employer, which he used to speculate in the futures market. Unfortunately his future trading was not successful and he made losses. Eventually he was caught and had to repay the funds embezzled, of which he could repay only half. The Commissioner assessed him on the funds stolen and income from his trading activities but did not allow a deduction for the trading losses. The taxpayer objected and a case was stated.

In the Taxation Review Authority,[56] Judge Willy found in favour of the taxpayer because he considered the money stolen to be circulating capital in the hands of the

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[51] K Day, "The tax consequences of illegal trading transactions", (1971) *British Tax Review* 104,115 - 116; as per s 25-15 of ITAA 1997 the proceeds of crime to be ordinary income, and therefore subject to income tax , the criminal activities must amount to business.

[52] ITA 2007, s CB 32, referred to at paragraph 4.3 of this paper.

[53] ITA 2007, s CA 1:

CA 1 Amounts that are income

Amounts specifically identified

(1) An amount is income of a person if it is their income under a provision in this Part.

Ordinary meaning

(2) An amount is also income of a person if it is their income under ordinary concepts.

[54] *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA); *Case W27* 89 ATC 280 at 287 and *FCT v Elton* 90 ATC 4,078 where a fraudulently negotiated cheque was not considered to be income by either party.

[55] This is true, it is submitted, of the most common poaching in New Zealand; over-fishing of quota. There is no property right in the fish prior to the over-fishing but there is a breach of the regulations making the over-fishing illegal.

[56] Case Q3 (1993) 15 NZTC 5,033.

taxpayer rather than income. This conclusion is questionable, as it seems to determine the assessability based upon the application of the funds rather than its character upon receipt.[57] His Honour also considered that the futures trading activity was a business and that the losses should have been allowed. This latter finding is not surprising and the Commissioner has advanced no logical reason why the profits from that activity were taxable but the losses not deductible. The issue of the accountant's property in the funds stolen was not discussed.

The Commissioner appealed to the High Court solely on the issue of the assessability of the stolen funds.[58] The issue of ownership of the funds was argued before Morris J. The taxpayer argued that the funds were received subject to an obligation to repay the amount stolen and therefore were in the nature of a loan, albeit involuntary. The Commissioner canvassed numerous Canadian and American decisions regarding the quality of stolen funds in the hands of the taxpayer[59] to argue the taxability of such money is not affected by an obligation to repay the money or any concept of a constructive trust. [60]

In equity constructive trust arises at the time the thief commits the act that obligates him or her to account to the rightful owner of the property. This equitable remedy ensures that the thief does not acquire beneficial ownership of the property stolen. It is the lack of constructive trust that distinguishes the property interests involved for different form of illegal activities. In case of simple theft a thief has no fiduciary duty as compared to a case of embezzlement where there is existence of fiduciary duty on the part of the embezzler which results in a constructive trust.

In reaching his decision Morris J implicitly accepted the reasoning used in the Canadian and American cases:

> The respondent was under an obligation to return the stolen money. For the monies that he did return no question of taxation arises. The remaining money he converted to his own use. While he is still liable in law to account for the monies, he is taxable on them because he was in effect holding and using the money for his own account. He is obliged to return the money because of the manner in which he acquired it. He is taxable on the money because of the manner in which he held it. His duty to return the money is a separate issue to the question of taxation. While he is not the strict legal owner of the money he is holding it for his own use. The reality of the situation is that the respondent regarded the money as his own to use for his purposes as he chose. I therefore, conclude that the stolen monies do constitute income and are assessable for income tax.[61]

This approach equates to the North American concept of the claim of right. The doctrine of claim of right would allow the Commissioner to ignore any issues of restitution or constructive trust and to tax the funds stolen as a gain to the thief. In the words of Morris J:

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[57] RJ Wallace, "Taxation of the Proceeds of Embezzlement" (1996) 2(4) New Zealand Journal of Taxation Law and Policy 201 at p 202.

[58] CIR v A Taxpayer (1996) 17 NZTC 12,574 at p 12,578

[59] R v Poynton [1972] CTC 411(embezzlement by manager of a construction society using false invoices); and James v US (1961) 366 US 213 (Union official embezzling from the union and an insurance company). See also Curlett v MNR [1991] CTC 338; and Buckman v MNR [1991] 2 CTC 2,608 (solicitor embezzled clients money when repaid by borrowers).

[60] In equity a constructive trust arises at the time the thief commits the act that obliges him or her to account to the rightful owner of property. This equitable remedy ensures the thief does not acquire beneficial ownership of the property stolen.

[61] *CIR v A Taxpayer* (1996) 17 NZTC 12,574 at 12,578.

> When a person receives money, whether it's lawful or not, if there is no consensual recognition of a right to repay, then income has been received even if it must be repaid. The receiver has had the benefit of the money so must pay tax on it.[62]

This would mean a person could be taxed on gains even if they have no right to ownership of the gain. Glover stated that the claim of right doctrine basically imputes beneficial ownership in the thief or embezzler for taxation purposes.[63]

The Court of Appeal[64] decided in favour of the taxpayer. The Court rejected any reliance upon the North American cases,[65] preferring an Australian case[66] as more consistent with the usual approach to determining whether or not a gain has been made. The Court of Appeal rejected any reliance upon the economic reality of the situation and based its decision upon the application of property and trust concepts. Referring to *Arthur Murray (NSW) Pty Ltd v C of T* [67] the majority at the Court of Appeal said:

> The Court obviously considered that sums received subject to a trust or charge did not have the quality of income derived by the recipient. In principle, an embezzler is liable to return or repay the stolen property and the innocent party to embezzlement retains the right to trace the property or its proceeds into the hands of the embezzler.[68]

Again referring to *Arthur Murray (NSW) Pty Ltd v C of T* the Court Appeal it in the *Taxpayer* case decided that:

> The embezzler does not have any claim of right to the stolen property. In the absence of a specific statutory provision allowing for a recharacterisation or different characterisation of the misappropriation receipt for tax purposes, the ordinary rules apply. Legal rights and obligations cannot be ignored. There is no gain to a taxpayer unless the receipt is derived beneficially by the taxpayer. Taxation by economic equivalence is impermissible (*CIR v Europa Oil (NZ) Ltd* [1971] 1 NZLR 641, 648; *Europa Oil (NZ) Ltd v CIR* (No 2) [1976] 1 NZLR 546, 552 [also reported at (1976) 2 NZTC 61,066, 61,071; (1976) 1 TRNZ 369, 376]).[69]

Therefore, if Morris J derived implicit support from the doctrine of claim of right, it has been expressly rejected by Richardson P, Keith and Elias JJ at the Court of Appeal. That rejection was firmly based on the ordinary approach of income being a benefit to the person receiving it and not subject to some other beneficial interest.

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62 *CIR v A Taxpayer* (1996) 17 NZTC 12,576.

63 J Glover, "Taxing the Constructive Trustee: Should a Revenue Statute Address Itself to Fictions", in *A* J Oakley (ed), *Trends in Contemporary Trust Law*, Oxford, Clarendon Press, 1996, 315 at p 322.

64 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA).

65 Except for the dissenting judgment of Black J in *James v US* (1961) 366 US 213.

66 *Zobory v FCT* (1995) 30 ATR 412. (Taxpayer embezzled money from employer. Returned the interest made by investing that money but had to repay the stolen funds and interest earned to the employer. The Court directed FCT to accept his amended returns excluding the interest.) This case is not without its critics: see Glover , above n 62, and RJ Wallace, "Taxation of the Proceeds of Embezzlement", (1996) 2 (4) *New Zealand Journal of Taxation Law and Policy* 201 at p 202. However it was relied upon in *Norilya Minerals Pty Ltd v Cmr of State Taxation (WA)* (1995) ATC 4,559 where it was said (at p 4,566):

> Once it is established that the circumstance of fraud surrounding the payment of the money was such as to cause it to be held ... on constructive trust for the [taxpayer], it is clear that the [taxpayer] has simply retained the beneficial interest in the money and it is abundantly clear that in the circumstances of this case the trust would arise immediately upon the payment secured by the false pretence...

The case went on to accept that the tracing was available; as the taxpayer's beneficial interest had not been defeated by the fraud of the criminal.

67 *Arthur Murray (NSW) Pty Ltd v C of T* (1965) 114 CLR 314 where the High Court of Australia found that sums for pre-paid dance lessons could not be considered income until the services for which the sums were paid were performed.

68 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,358.

69 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at 13,359.

This reflects the importance of property when determining whether receipt is income. Parsons[70] identifies that there is no gain unless the receipt is beneficially derived by the taxpayer and the Court of Appeal's approach in *A Taxpayer is* consistent with this concept.

Issue has been taken to this approach by at least one commentator.[71] Glover argues that the sole concern of Inland Revenue is the assessing of a gain in the hands of the taxpayer and there is no need to concern itself with issues of property right. However, it is submitted that the gain to the taxpayer needs to be identified by reference to the usual tests of property rights rather than simply accruing any sum received as a gain. No one would seriously contend that a sum borrowed is a taxable gain; economically the sum is a gain but it is subject to counterbalancing obligation to repay the sum, which prevents it being a gain for income tax purposes.[72] In *Hadlee and Sydney Bridge Nominees Ltd v CIR*[73] the taxpayer was a partner in an accounting firm where the partnership agreement provided the profits to be given to partners in proportion to the number of units of partnership capital held by them. The taxpayer transferred certain of his partnership units to a discretionary family trust. Glover points to *Hadlee and Sydney Bridge Nominees Ltd*[74] as an example of courts ignoring a beneficial interest to determine the taxpayer had a gain. But the Privy Council did treat the income subject to a family trust as a gain to the settlor because the assignment of income was not effective to remove the benefit from the settlor prior to its receipt by the trust.

Therefore, it is passing of beneficial ownership that determines, in part, whether a receipt is taxable as the approach in *A Taxpayer*[75] confirms. Thus the proceeds of drug trafficking, gambling and poaching can be seen to be beneficially derived by the taxpayer (and thus taxable), whereas the proceeds of burglary or embezzlement are not beneficially derived (whether as a result of a constructive trust or a right of restitution) and therefore not taxable.

Consequently the application of ordinary concepts of property rights is a component in determining whether or not the taxpayer has received a gain. It is submitted that this offers a more consistent test to determining which taxable activities give rise to assessable income than the "incidental illegality" test. The issue of whether the "degree" of illegality of the activity giving rises to the gain becomes irrelevant. A completely illegal activity in which property rights in gain pass, without reservation to a criminal will be taxable (for example gambling) whereas a gain in which no property passes to the criminal will not be considered a gain at all and therefore not taxable (for example fraud, theft or burglary).[76] On this basis determining legitimate parallel activity is unnecessary.

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[70] RW Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting*, Sydney, The Law Book Co. Ltd.,1985, at para 2.27 and paras 2.41- 2.44.

[71] J Glover, "Taxing the Constructive Trustee: Should a Revenue Statute Address Itself to Fictions", in *A* J Oakley (ed), *Trends in Contemporary Trust Law*, Oxford, Clarendon Press, 1996, at p 322.

[72] *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at p 13,359.

[73] *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1993)15 NZTC 10,106 (PC).

[74] *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1993)15 NZTC 10,106 (PC).

[75] *A Taxpayer v CIR* (1997) 18 NZTC 13,350.

[76] The newspaper publisher may have to give up all his profits if it turns out he sold papers by writing stories that defamed people. The manufacturer may have to give up profits if it turned out that he entered into an illegal monopolistic agreement. The retailer may have to give up profits if it turns out the goods or services were not as promised and there is a price adjustment or refund. If we took this "claim of right" idea to its limit, we'd tax nothing.

C *Statutory Reform*

Following the Court of Appeal ruling in *A Taxpayer*[77] that unless stolen money was made subject to income tax by express provision it was not taxable, the Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill 1998 was introduced. To protect the tax base the bill proposed amendment to the Income Tax Act 1994 by including within the meaning of "gross income" property obtained without colour of right. The main purpose of the proposed amendment was to prevent people from evading income tax by recharacterising their income as stolen. The officials' report on the bill stated that the taxation of stolen property in no way provides a legal sanction to theft or like conduct. The report stated that the taxation of stolen property can be justified on the basis that by not taxing it, the tax system is in effect subsidising those who choose to steal property.

Following on from this Parliament enacted an amendment to make the proceeds of embezzlement, fraud, misappropriation and theft taxable by inserting section CB 32 of the ITA 2007.[78] Although this is inconsistent with the common law treatment discussed above,[79] the Court of Appeal recognised the need for statutory authority to make stolen funds income.[80] It can not be doubted that Parliament has the authority to cut across any constructive trust or possibility of restitution imposed by the operation of equity, which the section expressly does at CB 32(3).[81] In making such an amendment Parliament can be taken to have considered the underlying public policy issues and determined that the taxability of the gain in the hands of the criminal overrides any restorative property reservations that equity would impose on the receipt of the sum.

This reform would enable the treatment of stolen funds to be more consistent with other provisions in the Act. For example, the victims of embezzlement are able to deduct the losses resulting from the theft as a result of the ITA 2007 s DB 42.[82] Any recoupment is deemed to be gross income derived by the victim in the income year in which the amount is recouped. However, if the constructive trust is imposed, as the Court of Appeal found, there has been no loss to the victim, as the victim is entitled absolutely to beneficial ownership.

Under section HC 6 of the ITA 07 beneficiary income, under a trust, is income that "vests absolutely in interest" in the beneficiary which is consistent with the amendment. This phrase is undefined by the Act but in an explanatory statement on

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77 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA).

78 Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Act 1998 inserted s CD 6 of the ITA 94 and it takes effect from 1 April 1995. This is somewhat later than the initially proposed date of 1st April 1989 and reflects a general repugnance of retrospectivity. As per s CB 32 of the ITA 07 (equivalent to s CD 6 of the ITA 94 and s CB 28 of the ITA 04) gross income of a person is deemed to include the market value of misappropriated property without colour of right of which that person has obtained possession or control. Under s 219(1) of the *Crimes Act* 1961 and in s YA 1 of the ITA 07, "claim of right" means, in relation to any act: ``... a belief that the act is lawful, although that belief may be based on ignorance or mistake of fact or of any matter of law other than the enactment against which the offence is alleged to have been committed". It should also be noted that there is a corresponding deduction for any restitution made of stolen funds at s DB 44 ITA 07 (equivalent to s DJ 18 of ITA 94 and s DB 35, ITA 04). This is broadly consistent with the American approach: see *Chicago RI &PR Co. v CIR* 47 F 2nd 990 at 992. Colour of right was replaced with claim of right from 1 October 2003.

79 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) and *Arthur Murray (NSW) Pty Ltd v C of T* (1965) 114 CLR 314.

80 *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA) at p 13,355.

81 Equivalent to s CD 6 (2) of the ITA 94; and s CB 28(3) of the ITA 04.

82 Equivalent to s DJ 8 of the ITA 94 and s DB 33 of the ITA 04.

the trust regime the Commissioner stated that:

> Income vests in a beneficiary where the beneficiary obtains an immediate fixed right of present or future possession of the income. Thus, income vests absolutely in interest in a beneficiary if the beneficiary obtains an immediate right to possession of the income.[83]

The constructive trust approach would mean the victim could find him or herself taxable on income they have not in reality received but because of the constructive trust are deemed to be entitled to and is consistent with s H 6 of the ITA 07. Interest derived from the investment of embezzled funds though received by embezzler would be treated as income of the beneficiary of the constructive trust. This does seem an illogical (and somewhat unfair) result. The statutory reform[84] would prevent the application of a constructive trust in the taxation treatment of such sums. The existence of constructive trust has prevented the taxation of the amounts as income of the embezzler in Australia. Celeste Black 'submitted that the adoption of similar provision in Australia would be advantageous as it clarify simplify tax obligations where there is a subsequent finding that a constructive trust has arisen'.[85]

As has been argued if the determination of taxable income is based on ordinary principles[86] it is necessary to consider the deductibility of expenses, in particular fines and penalties, to see whether ordinary principles have been applied in order to determine deductibility.

V DEDUCTIBILITY OF FINES AND COURT COSTS

Section 8-1 ITAA97 and s DA 1 of the ITA07[87] states that any expenditure or loss, including a depreciation loss, incurred in deriving assessable income or in the course of carrying on a business for the purpose of deriving assessable income is deductible. The normal test for general expenses deductibility should be determined on a nexus test, that is the deductibility of a given expense is determined by its relationship to the earning of income or the business of earning income. It remains one of the canons of taxation law that it be applied without reading in any intention, i.e. simply relying on the ordinary meaning of the relevant words.[88] There are several limitations under four negative limb of s 8-1ITAA97 and s DA 2 ITA 07, each of which overrides the general permission. There are provisions under s DA 3 of ITA 07 which supplement the general permission and that allows a person a deduction without requiring satisfaction of the general permission. In some circumstances that supplement, and not the general permission, decides whether a deduction is allowed for the expenditure or loss.[89]

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83 Inland Revenue, "Appendix" (1989) 1(5) *Tax Information Bulletin* 32.

84 Section CB 32(3) of the ITA 07 only applies to the thief not the victim. *James v United States*, 366 US 213 (1961) (S C) Amounts received by way of embezzlement were held to be taxable income and provides authority for this approach. Claim of right doctrine as developed, income includes amounts obtained without consensual recognition of the obligation to repay and without restriction as to disposition.; *R v Poyton* (1972) CTC 411 and *Buckman v Minister of National Revenue* (1991) 2 CTC 2608.

85 C Black, "Taxing Crime: the application of Income Tax to illegal activities" (2005) 20(3) *Australian Tax Forum* 435 at p 457.

86 ITA 2007, section CA 1.

87 Section DA 1of the ITA 07 is known as "General Permission".

88 *Mangin v CIR* [1971] NZLR 591 PC and *CIR v Alcan NZ Ltd* (1994) 16 NZTC 11,175.

89 But the courts in the United Kingdom and derivative jurisdictions kept them out using "quasi-personal" rationales which were eventually abandoned for all expenses apart from fines. Courts in

In considering the taxation of the illegal profits there remains a punitive element in the reasoning adopted. While arguing that a taxpayer cannot set up his or her criminality as a reason to escape taxation the courts have not been so evenhanded in dealing with the deductibility of the career criminal's expenses, such as court fines and associated court costs. In this context court costs represent the contributions the convicted criminal is ordered to make to the other party's legal costs and should not be confused with the convicted party's own legal fees.[90] It is trite law to say that fines and court costs, generally, are not deductible by the party paying them.[91] The basis upon which this is so has been discussed in this article.

It appears that, in the case of fines arising in circumstances that would suggest prima facie deductibility of those fines; a gloss has been put on the words of the section to deny deductibility. In Australia and New Zealand three potential reasons for this prohibition have been advanced: that the illegality severs the conduct from the business; that there are public policies reasons to prevent deductibility; and that those costs are private expenditure. Each of these reasons will be examined and, it is submitted, shown not to be apposite to the circumstances of illicit incomes.

A *Illegality Severs Deductibility*

This is the oldest of the reasons given for non-deductibility. As has been recognised by the High Court, the early cases discussed this point on the basis that the illegality which resulted in the imposition of a fine severs that particular expense from any business activity.[92] In essence, this approach argues that there is a distinction between a cost arising from the expenses of a business (i.e.: the day to day expenses of being in business) and the costs of the conduct of the business. In *Robinson v CIR* the taxpayer claimed a deduction from assessable income a fine imposed by the Disciplinary Committee and a fine imposed by a Court. In the words of Tompins J:

> It is clear in my opinion that fines and penalties levied on a taxpayer by the Courts for breaches by him of the law are not deductible by him. It is inflicted on the offender as a penal liability; it is a fine imposed on the offender for professional misconduct; it is inflicted on the offender as a personal deterrent and a punishment.[93]

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other places such as the United States and Canada retained a small narrower carve out from the general deductions principle and based it on public policy grounds.

[90] Robinson v CIR [1965] NZLR 246, Tompkins J found that a fine imposed for negligent act of a practitioner was quite different from payment of damages suffered by a client. The nature of the penalty severed it from the expenses of trading. The fine was a penalty imposed as a personal deterrent and punishment. A taxpayer's own legal costs will be deductible provided these relate to the income earning process with a sufficient degree of nexus: for example A v CIR (1985) 7 NZTC 5,074. In that case the legal expenses of appearing before the Medical Council to avoid suspension from practice were allowed as deductible. The expenditure enabled the taxpayer to earn his income without interruption.

[91] The Canadian courts went further and said even fines are deductible if they're not for serious offences.

[92] Nicholas Nathan Ltd v CIR (1989) 11 NZTC 6,213 per Sinclair J. In Nicholas Nathan case the taxpayer carried on a business of importing goods into New Zealand. The taxpayer imported goods in excess of its licence and was fined. The taxpayer sought to deduct fines, the cost of the forfeited goods, and the legal costs associated with the proceedings. Sinclair J held that the fines imposed were not deductible on the grounds of public policy. Legal costs incurred to obtain advice as to best way to minimise the penalties and losses which would flow through such infringement were held by the judge to be deductible. For examples of this approach see Commissioner of Inland Revenue v Alexander Van Glehn & Co. Ltd [1920] 2 KB 553 at 566; Herald & Weekly Times Ltd v FCT (1932) 48 CLR 113 and Robinson v CIR [1965] NZLR 246.

[93] Robinson v CIR [1965] NZLR 246 at p 249.

The judge concluded that a fine imposed for the negligent act of a practitioner was quite different from the payment of damages suffered by a client. The judge stated that in the case of damages there was a direct nexus to the income earning activity of the taxpayer.

The approach attempts to distance fines from other expenses on a quasi capital-revenue basis: that somehow a fine arises from the income earning structure rather than the income earning process.

There appears to be no basis for any attempt to treat a fine as being a capital expense if it arises from the day to day activity of the taxpayer in business. However, the conduct of business would not appear to sit easily with the approach that matters of capital relate to the business structure. The conduct of business would seem analogous to the idea of the process of business, making such costs deductible provided the nexus between the income earning process and the expense is sufficiently strong.[94] The artificiality of the "illegality severs deductibility" approach has been recognised by New Zealand High Court when it was stated that there is difficulty "in ascertaining just how the illegality, of itself, severs the connection between the business and the expense".[95]

This artificiality is highlighted in the case of profits derived in their entirety from illegal activities. If it is the illegal nature of the activity that determines the deductibility of fines it follows that any expenditure incurred in pursuing the same illegal course must be tainted by the illegality and therefore non-deductible. This results in no permissible deductions whatsoever and consequently in tax being levied on the gross proceeds of criminal enterprises. Given that the tax system is intended not to advantage either the legitimate or illicit taxpayer, it cannot be correct to sever the nexus of deductibility on the basis of the legality or otherwise of the economic activity entered into. This issue was raised in the Australian case of *Commissioner of Taxation v La Rosa*.[96] The Administrative Appeals Tribunal held that, though the forfeiture by a drug dealer of personal property, real property and money valued at $264,610 under the *Proceeds of Crimes Act 1987* was akin to a penalty, the statutory provision relating to penalties did not technically apply in these circumstances[97] but rather, that the connection between the forfeiture and the carrying on of the income producing activity had been severed and therefore the loss did not meet the test of the ordinary deduction provision.[98] This issue was not dealt with at Federal Court. The Administrative Appeals Tribunal (AAT) in *La Rosa* allowed deduction for monies stolen regardless of the illegality of the underlying activities.[99] The funds were lost

[94] Sun Newspapers Ltd v FCT (1938) 61 CLR 337 at p 360.

[95] Nicholas Nathan Ltd v CIR (1989) 11 NZTC 6,213.

[96] Commissioner of Taxation v La Rosa (2000) AATA 625.

[97] Section 26.5 of the Income Tax Assessment Act 1997 (Cth) , (Income Tax Assessment Act 1936 (ITAA 1936) s 51(4)) which denies a deduction for penalties was considered to require that the amount be paid by person whereas forfeiture was not an act of paying an amount: Commissioner of Taxation v La Rosa (2000) AATA 625. In CIR v La Rosa [2002] FCA 1036 the counsel for the Commissioner agreed that the loss in the case La Rosa was not of the same character as a fine; that is, it is not a punishment or personal deterrent.

[98] Sun Newspapers Ltd v FCT (1938) 61 CLR 337 at p 360.

[99] *Charles Moore &Co (WA) Pty Ltd v Federal Commissioner Of Taxation* (1956) 95 CLR 344 was applied. In that case the day's taking were stolen as they were being carried to bank for deposit. In

during operations to acquire trading stock. The loss in *La Rosa* was the theft of assessable income. This position was confirmed by the Federal Court and Full Federal Court of Australia.[100]

It is perhaps this lingering doubt as to exactly how the illegality prevented the deductibility of fines that resulted in an alternative basis for the non-deductibility of fines. Fines are imposed on persons for engaging in unlawful conduct, separate from taxpayer's income earning activities. Fines are not incurred in the course of deriving income because they are levied after income is earned; therefore deduction is not permitted as per section 8-1 ITAA97 and s DA 1 of the ITA07. It can be said that the recurrent penalties for parking infringements incurred by a courier driver or the fines imposed for engaging in unlawful activities such bookmaking or drug dealing for the purpose of earning assessable income are not treated as the business expenses, therefore not deductible.[101]

B *Public Policy Reasons*

It has become more common for the deduction of fines to be denied on public policy reasons. It is these public policy reasons that add a statutory consideration, outside of the necessary nexus to the income earning process, to determining deductibility. Public policy is a nebulous concept but expresses an inarticulate concept of society's norms of accepted behaviour underpinning the law, or as one commentator has characterised it "the unconscious result of instinctive preferences and inarticulate convictions".[102]

The impetus for this approach is to simply say that fines are to punish illegal behaviour and that role would be diluted should such fines be treated as deductible. The US Supreme Court in *Tank Truck Rentals, Inc. v. Commissioner*[103] held that fines are not deductible as the frustration of the state policy would be severe and direct. If deductions were allowed they would reduce the sting of the penalty and thereby would have helped the taxpayer avoid the consequences of the violation. With this approach it does not matter what the nexus to income earning is; fines are imposed to discourage illegal conduct and it would go against public policy to allow a partial recovery of the penalty through the tax system.[104]

By this reasoning any fine is non-deductible regardless of circumstance. Yet there

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Australia in response to the *La Rosa* case, s 26-54 ITAA 97 was enacted. This provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence.

[100] *Federal Commissioner of Taxation v La Rosa* [2003] 53 ATR 1. L Siska, "Deductions arising from illegal activities", (2003) 13 *Revenue Law Journal* 115, at p127: 'By interpreting the tax statute as an instrument simply to collect appropriate taxes, the Federal Court in *La Rosa* brought the law of deductibility of such losses properly into line with the case law defining assessable income.'

[101] Taxation Review Authority No 105/05; Decision No 9/2008 at par 109.

[102] OW Holmes, "Puritanism and the Law", in M.De Wolfe Howe (ed), *The Common Law*, Cambridge, Mss, Harvard University Press,1968, at p 31-32.

[103] *Tank Truck Rentals, Inc. v. Commissioner* [1958] 356 US 30.

[104] *Mayne Nickless Ltd v FCT* (1984) 84 ATC 4,458 at 4,470 and *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213. In *Nicholas Nathan Ltd* the taxpayer was fined for importing goods in excess of its licence. The fines imposed were held by Sinclair J not to be deductible on the grounds of public policy. The legal costs associated with the proceedings were held by the judge to be deductible. It was commercially prudent to take legal advice as to whether in fact there had been a breach of law. Had the taxpayer taken legal advice before importing goods, the judge had no doubt that the costs incurred in taking that advice would have been allowed as deductible expense.

remains the problem of continued dicta to the effect that recurrent regulatory offences, such as parking offences, can be deducted provided there was sufficient nexus to the earning of income or to the conduct of business.[105] In other words depending upon the nature of the offence some members of the judiciary would forego the public policy issue and allow deductibility on ordinary taxation principles. With respect, this would offer a more reliable measure of deductibility than references to public policy. In *Magna Alloys & Research Ltd v FCT*[106] legal costs of defending criminal charges brought against company's directors alleging that its selling methods resulted in the payment of secret commissions were allowed as fully deductible. The basis of that finding was that the provision of the legal assistance to the directors and agents of the company also assisted in protecting the company's marketing methods and the goodwill and reputation of the company.

Further there is the issue of competing public policy issues. Each statute presumably represents some public policy concern. As this discussion shows these are not always consistent. The public policy of gaining revenue from net income rather than gross is contrasted with the public policy of punishing offences. Then the offences need to be ranked. The Courts suggest that at least traffic offences are less important than the public policy underpinning revenue legislation. Another variation on this issue is identifying whose public policy is to be preferred.[107] If there is to be a "ranking" of the importance of those public policies, perhaps it should be done by the legislature.[108]

Thus it seems that a blanket application of the perceived public policy is not possible, as there is no commonly accepted position for such minor regulatory infringements, even within the body that administers those laws. One of the difficulties in citing a public policy reason remains that public policy is based upon society's norms of behaviour and these are not only fluid in time but also across society itself.

The weakness of the public policy argument is highlighted, once again, when considered in the case of a completely illicit income. Again if the public policy against deductibility of fines is correct, then any expense incurred in the earning of illegal income should be treated as analogous to a fine and therefore not deductible by reason of public policy. However, if expenses are inherent to earning income e.g. purchase of trading stock, they are deductible. It is submitted that it is no answer that a fine is imposed from outside (i.e. through the process of law) as public policy; the discouragement of crime, is equally applicable to any expense incurred in the earning of illegal income.

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[105] *Day & Ross Ltd v R* [1976] CTC 707 where a transport firm was able to deduct traffic infringement notices and *Case K62* (1988) NZTC 504 where a mail courier company was able to deduct a double parking infringement notice while delivering an urgent package to a downtown office.

[106] *Magna Alloys & Research Ltd v FCT* (1980) 80 ATC 4,542 at p 4,546.

[107] *Cattermole v Borax & Chemical Ltd* (1949) 51 TC 202 the taxpayer was denied a deduction in Britain for fines arising from trading in the United States (breaching anti trust laws); even though the trading was not illegal in Britain.

[108] R Krever, "The deductibility of fines. Considerations from law and policy perspectives" , (1984) *13 Australian Tax Review 168.* Krever argued for legislative intervention to resolve the issue; in the same year, 1984, s 51(4*)* was enacted into the Federal Tax Acts to prohibit the deduction of any penalty imposed. Also see discussion in R Hamilton, "The deductibility of fines, penalties and legal expenses", (1980) 13 *Australian Tax Review* 168 and K Day, "The tax consequences of illegal trading transactions" [1971] *British Tax Review* 104.

The treatment of so-called "quasi-personal expenses"[109] was considered in *La Rosa*[110] and it was concluded that such analysis was misplaced in the context of the theft loss at issue in the case. The court noted that at the time of loss, the taxpayer's cash had been earmarked for use in connection with the acquisition of drugs as trading stock. That is, the fact that the underlying activity is illegal does not taint the otherwise 'ordinary' expense incurred. Truly tainted outgoings such as bribes are denied deductibility under provisions inserted by the New Zealand and Australian legislature[111] as a matter of public policy. Other outgoings must be analysed to determine whether they are incurred in carrying on the business or income generating activity regardless of whether that activity is legal or illegal. In the special leave to appeal *La Rosa* case to the High Court, the Australian government argued that a public policy doctrine was established by the courts prior to the introduction of s 51(4)[112]of the Income Tax Assessment Act 1936 (Cth) and that it continues to live on – this view forming the basis of the argument that the deductions should have been denied in the *La Rosa* case.[113]

While perhaps a more intellectually honest reason for denying deductibility, the reliance on public policy does not provide a reliable basis for denying deductibility of fines incurred in the earning of or in the course of business to earn assessable income. However, it is possible that an application of the ordinary test of deductibility might provide a single coherent basis.

C *Fines as Private Expenditure*

The third approach to denying the deductibility of fines is to account them to be private or personal expenditure. The genus of this approach is in statements in the early cases that it is the conduct that is being punished.[114] While one line of reasoning concluded that the illegality of that conduct meant the fines incurred were not deductible, another approach is to consider that conduct being punished as private or personal conduct and for that reason the fines incurred are not deductible.[115]

This approach does not favour any reliance on perceived public policy or on the illegality being punished in favour of the illegal activity being something personal to the lawbreaker and therefore not to be considered part of the business of income earning at all. By such an approach any other expenses incurred in the course of an illegal business would be deductible provided these meet the necessary nexus of expenditure to income or business. It is only fines that are attributable to personal conduct and thus unable to be deducted. This approach relies on the form of the normal test of deductibility but it is questionable that the substance is being applied.

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[109] See R Krever, "The deductibility of fines. Considerations from law and policy perspectives" (1984) 13 Australian Tax Review 168 for a detailed discussion of development of the quasi –personal expenses doctrine in Australia.

[110] CIR v La Rosa (2003) 53 ATR 1.

[111] ITA 2007, s DB 45; s 26-52 and s 26-53 ITAA 97. Section 26-52 and s 26-53 ITAA 97 were enacted for 1999-2000 and subsequent years.

[112] Income Tax Assessment Act 1936, s 51(4); also see equivalent section in Income Tax Assessment Act 1997 s 26.5. Section 26-5 provides that a taxpayer is not entitled to deduct: an amount (however described) payable by way of penalty, under an Australian law or 'foreign law', or an amount ordered by the court to be paid on conviction of an entity for an offence against Australian law or foreign law.

[113] Commissioner of Taxation v La Rosa [2004] HCA Trans 420 (27 October 2004).

[114] Herald & Times Weekly Ltd v FCT (1932) 48 CLR 113 at 120 it was said: "The penalty is imposed as a punishment of the offender ... Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it not incurred by him in his character of trader".

[115] Case K62 (1988) NZTC 504 per Barber J and Case L15 (1989) 11 NZTC 1,113.

The difficulty is that some cases accept that the imposition of fines can arise from the conduct of business but deny deductibility for other reasons, as outlined above. Other cases, in dicta, accept that, in an appropriate case, minor infringements would be deductible.[116] This seems to belay the approach that fines are personal behaviour punishments and thus not deductible.

Finally it is submitted that some forms of law breaking are so intimately connected to the business of earning income that it is impossible to deny deductibility on the basis of a lack of the necessary nexus. That appears to be the view considered in the dicta relating to *traffic* fines and, in my submission, is equally applicable where the illegal behaviour being punished is directly responsible for the income that is being taxed, for example bookmaking or drug dealing. The illegality is not peripheral to the income earning process (such as with traffic offences); it is central to that process, making the treatment of fines as personal expenses somewhat difficult to accept as anything but a legal fiction.

D *New Zealand Inland Revenue Approach*

Not surprisingly, the uncertainty regarding the deductibility of fines and similar penalties finds itself repeated in the Commissioner's approach to the issue. The Commissioner issued a draft Interpretation Statement to examine the income tax deductibility of fines, penalties and like payments. In approaching the deductibility of fines and penalties the statement seeks to develop consistent and cohesive conceptual framework based on the existing Commonwealth jurisdiction authorities. In the Draft Interpretative statement,[117] the Commissioner identifies three factors to be considered when determining deductibility of fines and penalties. These are; whether it is incidental to deriving gross income; whether the taxpayer could have reasonably be expected to run his business in consistent conformity to the law; and whether there is a public policy reason to deny deductibility. In the second factor (whether the taxpayer could have reasonably be expected to run his business) in consistent conformity to the law the Commissioner is telling the taxpayer how to run his business. The last item appears to require the Commissioner's officers to determine and balance the completing public policy issues that have concerned the courts and there is no reason to believe they will find this element any easier than the courts.

Further, the policy statement requires a determination of the appropriate method by which the taxpayer should conduct his or her business activities: could the taxpayer reasonably run his business in conformity with the law. An immediate inconsistency would appear to arise in the application of this test. Whereas a completely illegal business can not be run in conformity with the law (and therefore, presumably, any fines would be deductible) if a legitimate business breaches a law and it could be said that the business could have been run in conformity with the law and then fines not deductible. Further this test would appear to substitute the Commissioner's view of the appropriate way to conduct the taxpayer's business for that of the taxpayer – an approach the courts have rejected in the past.[118] Finally it is doubtful this test adds anything to the statutory test of the expense being "necessarily incurred by the

[116] Cattermole v Borax & Chemical Ltd (1949) 51 TC 202: the taxpayer was denied a deduction in Britain for fines arising from trading in the United States (breaching anti- trust laws), even though the trading was not illegal in Britain.

[117] New Zealand Inland Revenue IS 0006[d] issued January 1998.

[118] Grieve v CIR (1984) 6 NZTC 61,682 and Cecil Bros. Ltd v FCT (1964) 111 CLR 430.

taxpayer in the course of carrying on a business...."[119] The draft Interpretation Statement concluded that in certain situations a deduction might be available for fines and penalties. Upon further consideration the Commissioner thought that such an approach did not reflect current law and issued a revised[120] draft Interpretation Statement. The revised draft Interpretation Statement concluded that irrespective of whether the statutory nexus is met, fine and penalties are not deductible in New Zealand because of the application of public policy considerations. However, the revised draft Interpretation Statement could not determine the correct tests that should apply in the New Zealand context therefore, it had not been finalised and issued.

E *Deductibility of Fines and s DA 1 of ITA 07and s 8-1 of ITAA 97*

In *Nicholas Nathan Ltd v CIR* it was suggested by Sinclair J that the non-deductibility of fines is:

> somewhat analogous to the taxation imposed upon gains derived from illicit or illegal operations with the result that there is no discrimination in favour of lawbreaking taxpayers.[121]

His Honour concluded his comments with the oft-heard phrase that there is no equity in tax.

However, as has been discussed above, the treatment of fines is not analogous to the treatment of the income from illegal activity. The courts stress that illegal incomes are taxable in the same way as legitimately derived income, regardless of moral considerations. While considering the deductibility of the hazards of such behaviour sometimes the courts are reluctant to consider applying the same tests of deductibility that are applicable to "legitimate" expenses. If such tests are shorn of the illegality influence and the public policy considerations, we are left with the normal test of deductibility (at least in form, if not application).

While it can be accepted there is no equity in tax, it is submitted that such tests that are applicable to taxation, should be applied evenhandedly. When considering the issue of deduction of fines or other expenses for legal or illegal activities as per s DA 1 of ITA 07 and section 8-1 of ITAA97 deductions should be allowed for all expenses incurred in the course of deriving assessable income, leading to a determinate result.

VI CONCLUSION

The scope of illegal profits is significant to the New Zealand and Australia tax base. Therefore, it is necessary to develop a unified approach to taxation of this income. While the ordinary concepts of taxation are capable of being applied to determine taxability it is clear that these have not been applied by the legislation in a consistent manner.

In the case of a gain to a criminal, in New Zealand from 1 April 1995, legislation is being put into place to override the impact of equity on the passing of property in determining whether the taxpayer made a taxable gain. Without this legislation the ordinary tests of assessability would be applicable and where the criminal failed to obtain the beneficial ownership of the money received, there is no income to the

[119] ITA 07, s DA 1; Section 8-1 ITAA 97.

[120] New Zealand Inland Revenue Department (IRD) IS 0006[d 2] issued October 1999.

[121] *Nicholas Nathan Ltd v CIR* (1989) 11 NZTC 6,213 at B23.

criminal. The New Zealand Court of Appeal has unequivocally rejected the doctrine of claim of right (regardless of inconsistencies this creates within the Act). Now, however, such legislation would disregard the application of the ordinary principles by legislating, for the taxability of such sums. This would appear to be based upon policy arguments in favour for taxability. However, the existence of constructive trust has prevented the taxation of the amounts as income of the embezzler in Australia.

The courts and the Commissioner in Australia and New Zealand have relied upon a number of arguments to deny deductibility of expenses that would otherwise appear to meet the statutory test[122] of deductibility. Broadly these reasons are that illegality severs deductibility on quasi-capital basis, public policy grounds, and treating expenses as private expenditure. Upon examination of each of the purported bases for disallowing such deductions, the overwhelming conclusion is that there is no particular reason for denying deductibility of such expenses. None of these arguments are particularly convincing – even in the courts themselves there are numerous dicta indicating some forms of fines are potentially deductible. It is submitted that this prohibition (both in terms of ordinary and illicit business activity) appears to have no justification other than judicial repugnance to allowing such a deduction.

In 1982, on public policy grounds the United States Internal Revenue Code[123] was amended to deny deductions for expenses incurred in carrying on a trade or business of drug trafficking and there appears to be no similar provision directed at other serious crimes.

In Australia in response to the *La Rosa* case [124], s 26-54 ITAA 97[125] was enacted. This provision denies deductions for losses and outgoings to the extent that they are incurred in furtherance of, or directly in relation to, a physical element of an offence against Australian law in respect of which a taxpayer has been convicted of an indictable offence[126]. The new provision applies to amounts incurred after 29 April 2005. It seems to indicate that the punishment of those engaged in unlawful activities is not only imposed by criminal law, but also by the income tax provisions. The amendment to Australian ITAA was made under political pressure[127] and had been seen to raise several tax principle[128] issues. The author thinks that it was deliberately drafted narrowly and it is doubted would the amendments have any application if the

[122] ITA 2007, s DA 1; s 8-1 ITAA 97.

[123] Internal Revenue Code (IRC) s 280E provides: "No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedules I and II of the Controlled substances Act) which is prohibited by Federal Law or the Law of any State in which such trade or business is conducted".

[124] *CIR v La Rosa* (2003) 53 ATR 1.

[125] Section 26-54 Income Tax Assessment Act 1997(ITAA 97) provides: "You Cannot deduct under this Act a loss or outgoing to the extent that it was incurred in the furtherance of, or directly in relation to, a physical element of an offence against an Australian law of which you have been convicted if the offence was, or could have been, prosecuted on indictment".

[126] Tax laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005 (Cth), Explanatory Memorandum at [6.8] interprets "on indictment" as meaning an offence punishable by imprisonment for 12 months or more. This appears to be position under federal law ; it may vary from state to state.

[127] The day after the decision of the Federal Court, numerous articles appeared in Australian newspapers and topic was discussed extensively on radio. For example, "Drug dealer to get tax breaks", *The Age* (Melbourne), 22 August; "Illegal loot still income, but very few may claim", *Sydney Morning Herald* (Sydney), 23 August 2002.

[128] Section 8-1 ITAA 97 provides that taxpayers are allowed to claim deductions for expenses incurred in gaining or producing their assessable income e.g. If the money is stolen when the manager drives up to the bank to drop it in the deposit slot, there is an offsetting deduction.

facts in *La Rosa* were to occur today would the amendment amount to an additional penalty with respect to the illegal activity and be able to stop the deduction of expenses he incurred in that case. The section 26-54 ITAA 97 applies to expenses incurred in the course of illegal activity.[129] The loss in *La Rosa* was the theft of assessable income; the funds were lost during operations to acquire trading stock.

The Literature review shows that New Zealand legislature has two options: to incorporate a provision similar to United States Internal Revenue Code Section 280E or to incorporate a provision similar to s 26-54 ITAA 97. In the United States, an adjustment for the cost of goods sold is made to the gross proceeds in determining the gross income from the transactions. From gross income then deductions are allowed for expenses and losses such as wages and rent. However, this provision has no affect on the adjustment to gross receipts with respect to effective cost of goods sold. In contrast, in New Zealand, the gross proceeds are treated as ordinary income (s BC 2 ITA 2007), the cost of trading stock is allowed as ordinary deduction (s DA 1 ITA 2007). Therefore, incorporating a no deduction provision similar to that in the United States would mean that those who deal in illegal goods will be assessed on gross proceeds without an adjustment for cost. This would obviously lead to tax policy issues. Incorporating a provision similar to the Australian no-deduction provision for expenses incurred in the course of carrying out of an indictable offence is also not a particularly appealing choice to deter people from engaging in such activities. Philip commented that s 26-54 ITAA 97 should be repealed. [130] Taxation law should be applied neutrally and equally and not as a punitive measure. Therefore, to justify the adoption of a no deduction provision, strong policy reasons would have to be provided by the legislature for violating the principles of neutrality and equality in the eyes of taxation law.[131] It is further submitted that in the absence of a clear statutory prohibition of deductibility, and to provide increased certainty to all taxpayers, a more transparent approach would be achieved by simply applying statutory test[132] of deductibility for all expenses incurred in the course of deriving assessable income and putting no gloss on the words of the section to deny deductibility.

However, if New Zealand Parliament decides to adopt no deduction provision the legislature could specify the activities which it considers warrant this treatment; e.g. indictable offence or similar to the treatment of bribes paid to public officials. [133] Another important issue which this article does not consider is whether it will be appropriate to use income tax as a potential weapon to deter income generating crimes. Future research should examine the effectiveness of such a tax penalty to deter crime and policy reasons for violating the principles of neutrality and equality.

[129] Section 26-54 ITAA 97 preserves the deductibility of expenses which are not illegal in themselves to the extent they are not directly used for illegal purpose. This is not easy to apply in practice. For example, the owner of a bar is prosecuted trading after hours. Is he denied deductions for all or part of his expenses (incurred after hours)? What is the basis for allocation of rent, power, depreciation, telephone rental, rates etc?

[130] P Burgess, "Deductions and illegal Income" (2008) 34(1) Australian Tax Review 7 at p 13: "in writer's view, it would be simpler to repeal s 26-54 of ITAA 97.

[131] S Lund, "Deductions Arising from Illegal Activities" (2003) 13 Revenue Law Journal 115.

[132] ITA 2007, s DA 1; ITAA 97, s 8-1.

[133] ITA 2007, s DB 45; ITTA 97, s 26-52 and s 26-53.