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**TAXATION OF GAINS FROM ILLEGAL ACTIVITIES IN KENYA: A CASE FOR
LEGISLATIVE INTERVENTION**

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DECLARATION

CANDIDATES DECLARATION

This thesis is my original work and has not been presented for a degree or for any other purpose to any institution other than University of Nairobi for academic credit.

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SUPERVISOR'S DECLARATION

This thesis has been submitted with my approval as the supervisor.

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It has been a worthwhile journey.

DEDICATION

To my loving husband Julius Wamae and my lovely daughters Ariella Wamae and Isla Wamae.

ABSTRACT

Revenue collection is vital for any state in order to fund government programmes. Taxation is the main revenue earner for the Kenyan government. The mandate of any government across the world include promoting peace, securing the general welfare of its citizen and ensuring that human rights and rule of law are fully realized. The government has to meet its mandate. Realization of such mandate requires funding. The government has constantly been broadening the tax base in order to collect funds to enable it to fulfill its roles.

Section 3 of the Income Tax Act has provided for the imposition of tax on income that has been derived from Kenya. Taxation in Kenya not only extends to legal income but also illegal income. This was established in the case of *Republic vs. Kenya Revenue Authority ex-parte Yaya Towers*. The court held that income from illegal activity was subject to taxation. The Income Tax Act however does not have specific provisions on imposition of tax on illegal activities. This is on the deductibility of expenses and protection against self-incrimination during disclosure of illegal incomes. Lack of adequate provisions on the two areas has led to uncertainty.

The research study has analyzed the deduction of expenses on income derived from illegal income and the protection of one's right against self-incrimination. The study will also have a comparative analysis with other jurisdictions being the United States of America and South Africa. This is in order to relate the principles applied in these jurisdictions on the taxation of illegal income specifically on the two issues stated above.

The data utilized in this study is both qualitative and quantitative. It is derived from primary and secondary sources. Secondary sources includes the internet, books, and journals while the primary sources include interviews conducted on small business owners and specialists in the tax sector in Kenya. The study concludes that tax reforms on taxation of illegal income would bring fairness and equity, which are key cannons of taxation. The law on taxation of income

requires one to disclose all his income. If one discloses illegal income, there is no law protecting the taxpayer from self-incrimination, which arises because of that disclosure. The study recommends for the need to balance the obligation to file returns and the protection against self-incrimination. The study also concludes that the law does not provide adequate provisions on tax assessment of illegal income. This touches on aspects of which deductions can be termed as allowable deductions for purposes of taxation. The study recommends that there be classifications of deductions based on the illegal income. The very offensive illegal income may have fewer deductions or no deductions at all. Clarity on the aspect of deductions can help a lot in ensuring that the taxation is unequivocal.

LIST OF CASES

- 1) *Caltex Oil (SA) Ltd v SIR* 25 SAT 67
- 2) *CIR vs. Gen & Co (Pty) ltd* 1965 (1) SA 59
- 3) *CIR vs. Delagoa Bay Cigarettes Co ltd* 1918 TPD 391
- 4) *Commissioner vs. Sullivan Commissioner v Sullivtm* 356 U.S. 30 (1958)
- 5) *Commissioner of Income Tax vs. Westmont Power (k) ltd Income Tax Appeal No 626 of 2002*
- 6) *Edgars Stores Ltd v CIR* 50 SAT 81
- 7) *FCOT vs. La Rosa* [2003] FCAFC 125
- 8) *Garner v United States* 424 U.S. 648 (1976) at 666;
- 9) *Haas Bros.Inc. vs. Commissioner* 73 T.C 1217 (1980)
- 10) *Hancock vs. General Reversionary and Investment Company, [1919] 1KB.25*
- 11) *Income Tax vs. T Ltd EA* (1971) 569
- 12) *Inspector of Taxes vs. J.P Harrison* [1963] AC 1 at 20
- 13) *Johnson v. United States, 228 U.S. 457, 458 (1913).*
- 14) *Kenya Revenue Authority v Yaya Towers Limited* [2016] eKLR (CA)
- 15) *London County Council & Others vs. The Attorney General* (1901),
- 16) *Max Sobel Wholesale Liquors vs. Commissioner* 630 F.2d 670 (9th Cir. 1980)
- 17) *New Colonial Ice Company v Helverin* 942 F.2d 444 (7th Cir.1991)
- 18) *Ramsay Ltd vs Inland Revenue Commissioner* [1991] AC 300
- 19) *Rosedale Dairy Co. vs. Commissione* 16 T.C.M (CCH) 1121 (1957)
- 20) *Southier vs Borax Consolidated Ltd* 23 T.C 597
- 21) *Tank Truck Rentals Inc. v Commissioner* 356 US. 30 (1958)
- 22) *The DPP v Michael Collins. Unreported Circuit Court judgment delivered on 27 September 2007.*
- 23) *United States v Josephberg* 459 F.3d 350 (2d Cir. 2009)
- 24) *United States v Sullivan* 274 U.S. 259 (1927) at 264;
- 25) *United States v. White, 322 U.S. 694, 698 (1944).*
- 26) *United States v. White, 322 U.S. 694, 704 (1944).*
- 27) *United States v. Silverstein, 314 F.2d 789,191-92 (2d Cir. 1963).*
- 28) *Wilson v. United States, 221 U.S. 361, 382 f1911)*

LIST OF STATUTES

Constitutions

- 1) Constitution of Kenya, 2010
- 2) Constitution of South Africa
- 3) Constitution of United States of America

Statutes

- 1) Custom Tax Act
- 2) Interpretation of Statutes Act
- 3) Income Tax Act
- 4) Kenya Revenue Act,
- 5) Tax Procedure Act
- 6) VAT Act

LIST OF ABBREVIATIONS

CSARS- Commissioner for the South African Revenue Service

CSAPS - Commissioner for the South African Police Services

IRC - Internal Revenue Code of 1986

IRS - Internal Revenue Service

KRA- Kenya Revenue Authority

DPP - Director of Public Prosecutions

RSA - Republic of South Africa

SAPS - South African Police Services

SARS - South African Revenue Service

TAA - Tax Administration Act

USA - United States of America

VAT - Value-Added Tax

CHAPTER 1

INTRODUCTION

1.1 Introduction

The Kenya Revenue Authority (KRA) can levy tax on both legal and illegal income. The Court of Appeal in the case of *Kenya Revenue Authority vs Yaya Towers Ltd* held this to be the interpretation of the Section 3 of the Income Tax Act. ¹It was of the view that so long as it constituted a gain from an employment or business, it was taxable.² This decision meant that income from activities such as prostitution, arms dealing, smuggling and drugs dealing among others were taxable. This decision enabled the taxman to increase the tax base by bringing in income from sources viewed as illegitimate.

The court did not view it as a breach of public policy.³ South African and United Kingdom courts have also held the same.⁴In South Africa, Malan J in the case of *CIR vs Delagoa Bay Cigarette Co Ltd* stated that it was irrelevant whether the income derived came from illegal activities.⁵ However, from the analysis of the Kenyan case, it is apparent that the decision of the court did not settled the “complex and intricate” issues surrounding taxability of income from illegal activities in the country.

The study does not seek to question the taxability of illegal incomes. It proceeds from the premise that the answer is in the affirmative. The study makes on the privilege against self-incrimination in tax. Kenyan taxation law has many provisions on filing of tax returns. Every tax payer is required to file accurate tax returns. The Kenyan Constitution provides for the right against self-incrimination.⁶ Article 49 states that one cannot be made to commit or admit

¹*Kenya Revenue Authority v Yaya Towers Limited* [2016] eKLR (CA)

²*Ibid*

³*Ibid*

⁴ *London County Council & Others vs. The Attorney General* (1901), *CIR vs. Delagoa Bay Cigarettes Co Ltd* 1918 TPD 391 at 394

⁵[1918] TPD 391

⁶ Constitution of Kenya, Article 50 (2)(i)

evidence that can be used against him. This therefore requires the government to prove a case against an individual without his co-operation. Government interest and privilege against self-incrimination has be balanced. It is hard to prove criminal intent without analyzing the

Since these questions are not unique to the Kenyan taxation system, it is significant to examine them with reference to other jurisdictions. These will mainly include United States of America and South Africa. These jurisdictions have a number of judicial decisions on the issues of deductions and self-incrimination in relation to illegal income. Moreover, the decision in the *Yaya Towers* ' case relied a lot on court decisions from these two jurisdictions.

The provisions comprising the general deduction formula (or any other provisions) make no mention that the deductions and allowances are prohibited in the case of illegal activities. The practice in many jurisdictions has been to disallow the deduction of expenses in taxation of illegal incomes.⁷ The rationale behind the denial of deductions is to deny wrongdoers the benefit of their wrongful action in tax law.⁸ An open question is whether considerations of public policy should deny a person involved in illegal activities the deduction of the expenses they incur in deriving their illegal income.

Revenue laws should tax the economic gain derived by the taxpayer by allowing the taxpayer to reduce his or her taxable income by the cost of earning the income.⁹ Thus, if tax law is looked at in isolation, the ideal outcome would be to include the proceeds from illegal activities in the gross income, while the allowing the perpetrator to claim the deductions to which he or she would have been entitled, had he or she been an 'honest' trader¹⁰. A legal system is made up of a body of laws that deal with different issues but at the same time, they all have the same purpose. Tax law is designed to collect revenue and criminal law is

⁷ Stephen Breitstone, ' The Economic Benefit Concept of Gross Income Applied to the Tax Treatment of Illegal Payments,' (1982) 3 Cardozo Law Review page 319

⁸ Siska Lund, ' Deductions Arising from Illegal Activities,' (2003) 13 Revenue Law Journal 117

⁹ Colliton, 'The Tax Treatment of Criminal and Disapproved Payments' (1989) 9 Virginia Tax Review 273,274

¹⁰Monteiro and Bonthuys, 'Sex for sale: the prostitute as businesswoman' (2007) [Online]. <<http://wwwserver.law.wits.ac.za/workshop/workshop03/WWLSBonthuysandMonteiro.doc>> accessed 21 January 2017

designed to punish wrongdoers.¹¹ Tax law should therefore be neutral and provide for the taxation of the income and allow deductions of expenditure incurred in earning such income.¹²

Tax law has to be evaluated with other laws. This includes the supreme law of Kenya, which is Constitution of Kenya.¹³ Chapter four of the Constitution provides for Bill of Rights. Both Article 49 and 50 provide safeguards against self-incrimination.

The main role of the Kenya Revenue Authority is to collect revenue.¹⁴ Other roles include giving advice to the government on areas of taxation, tax assessment, and tax administration.¹⁵ They have a duty of ensuring that all available revenue has been identified and collected.¹⁶ Revenue collection is essential in order for the government to fulfill its duties.¹⁷ KRA can only levy taxes that has been provided for in a legislation.¹⁸ The National government has the exclusive role of imposing income tax.¹⁹ The KRA is only an agent of the state in matters of tax.

The Income Tax Act makes it a criminal offence if one gives an incorrect or a fraudulent return.²⁰ Failure to disclose such income can amount to tax evasion.²¹ This in turn makes the one who has made an illegal income to disclose it. The disclosure is self-incriminating since there are no legal provisions in tax law to prevent such.²² This is unconstitutional since it infringes on one's right against self-incrimination.²³ Article 25 provides that the right to a fair

¹¹ Boris Bitker, 'Taxing Income from Illegal Activities,' (1974) 2289 Faculty Scholarship Series Paper page 1333

¹² Louis Kaplow, 'An Optimal Tax,' (2011) Harvard Discussion Paper 4

¹³ Constitution of Kenya, 2010, Article 2

¹⁴ Kenya Revenue Act, Section 5

¹⁵ Ibid

¹⁶ Ibid

¹⁷ Broun Mark, 'Remedies of Illegal Taxation,' (1981) 29 American Law Registry page 1

¹⁸ Constitution of Kenya, 2010 Article 210

¹⁹ Ibid Section 209

²⁰ Ibid, Section 110 and 111

²¹ Ibid, Section 111(3)

²² Eva Maina & Edward Paranta, 'Taxing Income from Illegal Activity: The Kenyan Perspective,' (2017) 2 Strathmore Law Review 115

²³ Constitution of Kenya, 2010 Article 50

hearing is a non-derogable right.²⁴ Kenya needs to legislate on this aspect of taxation to ensure that the right of a taxpayer is not infringed.

The income tax legal framework aims at levying tax on the net income.²⁵ Net income is computed by deducting the expenses that were incurred in obtaining returns.²⁶ There is uncertainty in law whether deductions are allowable in illegal income.²⁷ Section 15 of the Income Tax Act stipulates that all expenses, which have been used entirely for the generation of profits, are allowable deductions. However, since it was decided that illegal income are taxable, it is not clear if the provision on allowable deductions also extend to such income.

In ascertainment of illegal income, there are those expenses that are legal and those that are illegal.²⁸ For instance, when one is engaged in smuggling, there expenses such as bribing police officers that the smuggler will incur. It is an illegal expense. They are also those expenses such as transportation, salaries, and storage. These are legal expenses. Jurisdictions such as United States of America allows deductions when it comes to illegal income so long as the expenses are legal.²⁹ This has been held in several court decisions such as *Max Sobel Wholesale Liquors vs. Commissioner*³⁰, *Haas Bros.Inc. vs. Commissioner*³¹, *Rosedale Dairy Co. vs. Commissioner*³² among many others. These cases among many others will be compared to the Kenyan cases.

The two concepts above require strict analysis if Kenya is to have a solid legal framework for illegal income. The law needs to protect the rights of persons against self-incrimination. The law should also expressly provide for the aspect of deductions in ascertaining net income.

There are options that can be adopted. One option, the law can disallow any deductions

²⁴Ibid, Article 25

²⁵Celeste Black, 'Taxing Crime; The Application of Income Tax To Illegal Activities,'(2005) 20 Australian Tax Forum page 438

²⁶Ibid

²⁷ Ibid No 22, page 110

²⁸ Ibid no 6

²⁹Ibid

³⁰630 F.2d 670 (9th Cir. 1980)

³¹73 T.C 1217 (1980)

³²16 T.C.M (CCH) 1121 (1957)

whether legal or illegal since it is an illegal income. This is in order to obtain revenue but discourage such activities. The law can allow legal expenses but disallow illegal expenses even though they have been exclusively incurred in obtaining returns. This study will substantively address the two issues.

The aspect of self-incrimination operates where there is an element of government compulsion.³³ Filing of tax returns is not an aspect of compulsion as the filing is not for the purpose of getting evidence for criminal prosecution. But where such information is being obtained to be used against the person in criminal proceedings, it affects the right to self-incrimination.³⁴ Therefore procedural constraints are necessary. The study agrees that the privilege against self-incrimination is unavailable in making tax returns to tax authorities. However, where there are criminal investigations in tax related matters, one should not be compelled to produce his records as such would amount to disclosure of information of incriminating nature.³⁵ No one can be compelled to be a witness against oneself.³⁶ A Tax payer being investigated for a possible criminal violation of tax related laws should be able to avail himself the privilege.³⁷ The right against self-incrimination is extended to speech and papers as determined in the case of *Boyd vs. United States*.³⁸ If one is being investigated for tax evasion, he should not be compelled to produce his records. A criminal defendant should not be compelled to incriminate himself.³⁹

³³ Graham Stafford, 'The Privilege Against Self Incrimination in Federal Tax Investigations,' (1974) 34 Louisiana Law Review, page 708

³⁴ Peter Alldridge, *Criminal Justice and Taxation*, (Oxford University Press, 2017), page 92

³⁵ Ibid

³⁶ Norvie Lay, 'Attorney's Assertion of His Clients Privilege Against Self Incrimination in Criminal Tax Investigations,' (1967) 21 University of Miami Law Review, page 856

³⁷ Ibid

³⁸ 116 (1866) USA

³⁹ Joseph Ross, 'Constitutional Law-Privilege Against Self Incrimination – Federal Tax Registration Statutes,' (1968) 18 DePaul Law Review, page 96

1.2 Problem Statement

Taxation of income from illegal activities raises two issues. One is on the aspect of self-incrimination in criminal investigations of tax related offences and the aspect of allowable deduction in illegal income. These issues need to be expressly clarified in order to ensure that uncertainties are cleared and one's rights are guaranteed. There needs to be caution on how illegal income is treated for taxation purposes.⁴⁰ A look into the legal framework is very essential in order to address the loopholes.

In the *Yaya Case* the court pronounced itself and stated that illegal business is subject to taxation. The thesis is not arguing against or for the determination but the consequences of it. If illegal income is deemed taxable, then all those having illegal income are required to file tax returns. In filing their returns, the Income Tax Act allows the taxation authorities to investigate one's books of accounts. Under its investigative powers, tax officers can ask any questions or seek any books of accounts. The information solicited has the potential of self-incriminating to the tax payer. Furthermore, there is no provision that prevents such information from being used by the prosecuting authorities. The *Yaya case* has opened this loophole in law and thus allowed the infringement on the right against self-incrimination.

The basis of Article 49 and Article 50 is that one cannot be compelled to give self-incriminating evidence and one has a right from self-incrimination. The nature of Income Tax Act and Tax Procedure Act in requiring total disclosure of disclosure through tax returns is not an aspect of self-incrimination if used for determination of tax obligations and compliance. However, it becomes an aspect of self-incrimination whereby it is aimed at someone who is suspected of a crime, there are criminal offences under the statute and one is

⁴⁰ Donald DePass, 'Reconsidering the Classification of Illegal Income,' (2013) 66 Tax Lawyer page 771

required to provide the information that that he/she knows will be available to prosecuting authorities. This are the three tenets established in the case of *Macheti vs. United States*.⁴¹

Section 58(2) of the Tax Procedure Act states that an officer may require any owner, employee or representative to give him all assistance and to answer all questions relating to an inquiry. Section 59 states that the Commissioner, or any authorized person can by notice require one to produce information, furnish information or give evidence. The provision allows a tax officer to compel for evidence and information even in criminal investigations. If an officer is investigating criminal tax offences, he can compel one to produce self-incriminating evidence. While the right against self-incrimination cannot be pleaded in filing of tax returns for illegal incomes, it can be pleaded where there are criminal investigations on a tax payer in relation to tax matters. Once one is a suspect in a criminal act, the right against self-incrimination arises.

Ascertainment of allowable deduction in illegal income is one area of uncertainty. To qualify for deduction, the expenditure in question must, in addition to satisfying the 'trade' requirement, be incurred wholly in the generation of income. This is well provided in Section 15 of the Income Tax Act. This means that the only deduction that is allowed in one which is so directly associated with the purpose of raising the income. The policy on deductions of expenses should be based on establishing equality between those who earn legal income and those who receive illegal income. There should be no moral interpretation or consideration of public policy in interpreting the provisions of the Income Tax Act. United States of America has a long history of taxation of illegal income. It has been established that those who report illegal income become more susceptible to investigations for non- tax offences.⁴² The *Yaya Towers* case has potentially brought this situation in Kenya The rights to self-incrimination

⁴¹ 390 [1968]

⁴² Borris Bittker, 'Taxing Income from Unlawful Activities,'(1974) 25 Case Western Reserve Law Review , page 140

arises once one is deemed s suspect, if authorities in their mandate to investigate both tax related and non-tax related obligate a tax payer to produce evidence or give information , it is a direct violation of this right.

1.3 Justification of Study

The issues that the research seeks to evaluate are vital in tax computation. The research seeks to analyse whether to allow deductions on illegal income and if allowed, the extent that is allowable. The research will aid in analysing the grey areas in the legal framework and pointing out the inadequacies.

Secondly, taxation of illegal income will require disclosure. Every person has the freedom not to be compelled to produce self-incriminating evidence. The state has an obligation to protect and enforce the fundamental rights and freedoms. Filing of tax returns is a civil duty and one cannot plead self-incrimination. However, where there are criminal investigations in tax related matters, a tax payer should not be compelled to produce any information that can be used as evidence against him. This research seeks to contribute to this issue in order to ensure the protection of fundamental rights of each person to its greatest extent.

1.4 Statement of Objective

The objectives of this research are

- 1) To analyse the deductibility of expenses from income gained from illegal activities.
- 2) To analyze how mandatory disclosure of income and taxation of illegal income can lead to the taxpayer giving self-incriminating evidence.
- 3) To analyze if the right not to give self-incriminating evidence is protected when illegal incomes are disclosed.
- 4) To make a comparative analysis with other jurisdiction such as United States on taxation of illegal income.

1.5 Research Question

The research seeks to analyse the following:

- 1) Should Kenya allow deductions incurred in income gained from illegal income?
- 2) Does the mandatory full disclosure of income affect ones right from self-incrimination?
- 3) What measures have other jurisdictions taken on allowable deductions of illegal income and the right from self-incrimination?

1.6 Conceptual Framework

The conceptual framework of this research is based on five concepts. These are self-incrimination, expenses, illegal income, taxation and jurisdiction. These concepts link to the aspect of taxation of illegal income and self-incrimination in production of tax records. While taxing illegal income is an attempt to hold those who participate in illegal income accountable, there is need to ensure that constitutional limits are abided by especially where criminal investigations are involved.

Taxation

The system of taxation bases itself on the principles of taxation advanced by Adam Smith.⁴³ Certainty, convenience, equity, ability to pay and cost effectiveness in collection are the major principles guiding collection of taxes.⁴⁴ These principles guide any decision in tax. Taxation of illegal income should consider such principles. The moral and ethical principles are not among the essential principles of taxation. Each state ought to analyse how such issues impact on its taxation system.

⁴³ Robert Haig, 'The Concept of Income- Economic and Legal Aspects,' in Federal Income Tax (1921) American Association 1921 page 59

⁴⁴Ibid

In the case of *Mathews vs. Chicory Marketing Board*⁴⁵ tax was defined as a compulsory exaction of money by a public authority for public purposes, enforceable by law and is not a payment for services rendered. The Income Tax Act does not explicitly define what tax is as it only defines as income tax under the Act. In general terms it has come to be defined as a forced extraction of wealth.⁴⁶

Illegal income

The term illegal income is broad. It can result from getting income from an illegal activity or payment that is illegal. From the *Yaya towers* case, the illegal income resulted from an illegal contract. This made the income illegal. The concept that is vital when it comes to taxation of illegal income is whether the legal framework governing taxation ought to consider ethical issues in the assessment of tax.⁴⁷ Should the public policy doctrine be considered in tax assessment of illegal incomes? Allowing deductions when it comes to illegal income can seem to give benefits to those who benefit from illegality. It can frustrate the national values and principles set under Article 10 of the Constitution of Kenya, 2010.

Expenses

Tax law recognizes both deductible and nondeductible expenses. A tax payer, based on the provisions of the income tax, is allowed to deduct expenses directly incurred in the business. It provides for allowable expenses which are deducted from the taxable income and disallowable expenses which cannot be deducted from illegal income. Section 15 and 16 provide for deductions allowable and disallowable respectively. Salaries and rent expenses used in the business are examples of deduction allowable while expenditure for one's family maintenance is considered disallowable.

⁴⁵ (1938) 60 CLR 263

⁴⁶ Michael Doran, 'Tax Penalties and Tax Compliance,' (2009) 46 Harvard Journal of Legislation, page 112

⁴⁷ Siska Lund 'Deductions from Illegal Activities,' vol 13 2003 revenue law journal

The expenses incurred in deriving illegal income can be both legal and illegal. Cost such as transport, salaries and utility bills are legal expenses. On the other hand, bribery is an illegal expense. Those who benefit from illegal income can demand for deduction on the legal expenses incurred. This can be justified from the action of the state to tax an illegal income. The state on the other hand can disallow deductions on both the legal and illegal expenses in order to act as a deterrence to those who derive illegal income. The court in the case of *Commissioner vs. Sullivan*⁴⁸ stated that deductions should be allowed with no regard if they are legal or not. The court was of the idea that denying such deductions will be a departure from the taxation policy. In Australia, in the case of *FCOT vs. La Rosa*, the court was of the view that tax law ought not to be used in imposition of penalties in wrongdoing.⁴⁹

In order to tax illegal incomes, disclosure of such incomes is required. Those earning illegal incomes cannot disclose if it can lead to them giving out self-incriminating evidence. Taxation of illegal income violates the right against self-incrimination.⁵⁰ Taxation enables a state to derive revenue. It should not be used to catch offenders but deriving maximum amount of revenue.

1.7 Theoretical Framework

Taxation of illegal income can derive support from a number of theories with regard to allowable deductions and the right from self-incrimination. They include the benefit theory, principle of horizontal equity and ability to pay theory. The theories can be applied in the determination of deductions in taxation of illegal income.

⁴⁸356 U.S. 27 (1958)

⁴⁹ [2003] FCAFC 125

⁵⁰A Bucci, 'Taxation of Illegal Narcotics: A Violation of the Fifth Amendment Rights or an Innovative Tool in War against Drugs;' (1996) 11 Journal of Civil Rights and Economic Development 776

One theory that supports the taxation of illegal income is the theory of public policy.⁵¹ The theory posits that certain acts are injurious to public hence they should be subjected to more burden.⁵² The proponents of this school of thought advocate for denial of deductions on those transactions that are against public policy. They posit that allowing illegal income the benefit of deductions will encourage many people to engage in illegal activities.⁵³ Taxation of illegal income and allowing deduction of expenses reduces the risk of carrying out a crime.⁵⁴

When taxing illegal income such as smuggling, if such activities enjoy the benefit of deductions such as transport or even fines and penalties, it will encourage more people to engage in such activities.

Another theory is the rational choice theory. This theory posits that people engage in illegal activities weighing potential risks.⁵⁵ Deductions of expenses from illegal income reduces the potential risk of an illegal act.⁵⁶ If one can be protected from self-incrimination when declaring illegal tax and he or she can deduct the fines or penalties imposed on the income, the risk on engaging on illegal activities is heavily reduced. Taxation of illegal activities should not enjoy the benefit of deductions. On the other hand, if there is no protection against self-incrimination when disclosing illegal income, then many of those who earn from illegal activities will not disclose illegal income and less will engage in illegal activities.⁵⁷

1.8 Research Methodology

The research methodology adopted is desk based. It does not seek to use primary methods of data collection since taxation of illegal income is still new in Kenya. The research is based on

⁵¹ Crown Dwight, 'Deductibility of Expenditure Offending Statutes and Regulations,' (1959) 17 New York University Journal of Taxation, 157

⁵²Ibid

⁵³ GG Tyler, 'Disallowance OF Deductions on Public Policy Grounds,' (1965) 20 Tax Law Review 665

⁵⁴ Avraham Tabbach, 'Criminal Behavior, Sanctions and Income Taxation: An Economic Analysis,' (2002) 169 Economic Working Paper University of Chicago page 1

⁵⁵David Cornish, Theories in Criminology: learning theory and rational choice approaches, routine activity and rational choice by r v g Clarke and Marcus Felson 351

⁵⁶Avraham (n48) page 3

⁵⁷ Boris Bitker, 'Taxing Income from Unlawful Activities,' (1974) 1 Yale Law School Legal Faculty Scholarship page 130

looking at the effect of the declaration in Yaya Towers case that illegal income is taxable. In looking at the effect of this judgement on the right to self-incrimination, it is based on qualitative analysis therefore it does not need to conduct interviews. The research is more of a conceptual research as it presents the apprehension of the effect of the judgement which is yet to be effectively felt but imminent.

It derives information mainly from books, journals and case law. It analyses a number of writings with regard to taxation of illegal income. It focusses specifically of deductions and right against self-incrimination. The research will be library based. The methodology is through analysing the countries that have for a long time taxed illegal income and the issues of self-incrimination that have arisen.

1.9 Literature Review

The study has looked into various writings on the area of taxation of illegal income. There are quite a number of writings on this area. However, this study is unique since it focusses on the Kenyan jurisdiction and deals specifically on the area of deductions and the right against self-incrimination.

One author that informs this study is Avraham Tabbach.⁵⁸ The writer has looked into the effect of taxing illegal income. He argues that jurisdictions that allow deductions on illegal income are susceptible to increase in crime as compared to those that do not allow deductions on illegal income and those that do not charge tax on illegal income. He argues that most illegal income will arise from legal businesses. Fraud, corruption and insider trading can result to illegal income but from legal businesses. He argues that tax of illegal income leads to lower levels of illegal activities.

The author also has a good analysis of the jurisdiction of the United States of America on illegal income. This article is essential in this research as it enables a comprehensive

⁵⁸Avraham (n48)

comparative analysis with the USA jurisdiction. However, it does not conduct a deep analysis on matters of deductions and self-incrimination, which this research seeks to do.

Celeste Black also has a deep analysis on taxation of illegal income.⁵⁹ The author looks into taxation of illegal income in Australia. The author states that without disclosure it is hard to determine illegal income. Like Kenya, taxation of illegal income in Australia has been determined by court and not expressly provided in a statute. This was in the case of *Federal Commissioner of Taxation vs. La Rosa*. The author states that the intention of government is not explicit on taxation of illegal income. From his analysis, taxation ought to be on the whole amount arguing that illegal income does not enjoy deductions like the legal income. He also looks at the role income tax can play against illegal income. This article is essential in this study since it analyses a jurisdiction whereby taxation of illegal income arises out of a judicial interpretation and not expressed in a statute. It forms a good basis for comparative analysis. However, it does not discuss much on deductions and right against self-incrimination.

Eva Maina and Edward Paranta have a deep discussion on taxation of illegal income in Kenya.⁶⁰ They make an analysis on taxation of illegal income in Kenya. The essay makes an analysis on the legal framework governing taxation of illegal income and examine the judicial precedent that held that illegal income was chargeable to tax. They have made a comparative analysis with other jurisdictions such as South Africa and United States of America. They conclude that illegal income is taxable. They also conclude that it will contravene public policy if the government does not tax illegal income. Concerning deductions, they argue that the allowable deductions should be those that are legitimate. This research informs this study especially on the Kenyan jurisdiction. However, it dwells much on whether Kenya should tax

⁵⁹ Celeste Black, 'Taxing Crime : The Application of Income Tax to Illegal Activities,' (2005) 20 Australian Law Forum

⁶⁰Eva Maina& Edward Paranta ,' Taxing Income from Illegal Activity : The Kenyan Perspective,' (2017) 2 Strathmore Law Review

illegal income, which is different from this study. This study does not argue whether illegal income is taxable or not. The basis of its argument is on the effect of it on the right to self incrimination and whether deductions ought to be allowed.

Siska Lund⁶¹ makes an analysis on taxation of illegal income. She states that income in tax captures all from all sources income regardless of the source. This is another American author who makes a deep analysis on the issue. Her main argument is that the tax regime in United States of America was never intended to look into how one got the income nor was it intended to act as a deterrence. Her analysis is that not allowing deductions on illegal income goes against the tax principles of neutrality and equality. Her argument is that the USA jurisdiction should allow give illegal income a similar treatment with legal income. This thesis is essential in this research as it one of the few articles providing support for deductions on illegal income. This provides a room for different points of critique in the Kenyan jurisdiction.

Lynette Oliver has also written on this area with regards to the South African Jurisdiction.⁶² The article is mostly an analysis on the decision by the court of appeal of South Africa that held that illegal income was taxable. It also analyses similar decision in other states such as Zimbabwe. The article discusses on what can be termed as received in illegal income. It takes the position that before taxing illegal income, it must first be established that it is an income. Money obtained from theft cannot be defined as income as it is not received. This article forms a good basis for comparative analysis and provides a platform for better understanding on what can be termed as illegal income.

Donald Eckhart⁶³ makes an analysis on criminal prosecution in illegal income. He argues that one cannot plead illegal tax information was obtained illegally as a defence to criminal prosecution. He makes a deep analysis on the historical development of the issue. He makes

⁶¹ Siska Lund, 'Deductions Arising from Illegal Activities,' (2003) 13 Revenue Law Journal

⁶² Lynette Oliver, 'Taxation of Illegal Income,' (2008) Journal of South African Law page 814

⁶³ Donald Eckhart, 'Illegal Income as a Defense in Criminal Prosecution,' (1955) 38 Marquette Law Review

an analysis on both the state law and federal law in USA jurisdictions. He argues that in criminal prosecutions, even though illegal income is taxable, it does not stop prosecution. He argues that tax law can be a tool to impose sanctions on such income. This article offers great insight for comparative analysis.

1.10 Limitations of The Study

The study is fully desk based. It relies a lot on secondary information. This makes it unable to obtain primary data.

1.11 Hypothesis

The thesis is based on several hypotheses. The hypothesis are as follows.

1. Allowing deductions on illegal income can encourage people to engage in illegal activities
2. The obligation to file tax returns does not violate ones right from self-incrimination but opens up criminal investigations by the tax authorities for tax offences and also respective authorities for non-tax offences which in turn can abuse the right to self-incriminations.
3. The right to self-incrimination begins when one is deemed a suspect and not when one is arrested.

1.12 Assumption

The study premises itself on the assumption that the existing Income Tax Act in Kenya is inadequate to effectively tax illegal activity. The study relies on assumption that the existing laws relating to Income Tax requires review to address the issue on deductibility of expenses and protecting taxpayers against self-incrimination.

1.13 Chapter Breakdown

This thesis has five chapters.

Chapter 1: Introduction

This chapter serves as an introduction to the thesis. This chapter contains the purpose, research questions, methodology, limitations and rationale of the study. The structure of this dissertation is also set out.

Chapter 2: Privilege against Self-Incrimination, the constitution and Tax Law

This chapter looks at the protection of one against self-incrimination after disclosure of illegal income. It looks into the legal framework and analyzes it provides enough protection.

Chapter 3: Deductibility of Expenditure from Illegal income

This chapter is an analysis on the expenditure that result from illegal income. The analysis under this chapter looks at examining the law on deductions provided under the various statutes on taxation.

Chapter 4: Comparative Analysis: South Africa and United States of America.

This chapter looks at how United States of America a developed nation and South Africa a developing nation has dealt with deductibility of expenses incurred in the production of illegal income and the constitution protection against self-incrimination during disclosure of illegal incomes.

Chapter 5: Summary, conclusions and recommendations

This chapter will summarize the findings of chapters 2 to 4 and draw conclusion and recommendations.

CHAPTER 2:

PRIVILEGE AGAINST SELF-INCRIMINATION, THE CONSTITUTION AND TAX LAW

2.1 Introduction

The Latin maxim of ‘*nemoteneturseipsumaccusare*,’ denotes that no person ought to accuse himself or herself⁶⁴. This is the maxim behind the right against self-incrimination.⁶⁵ The right provides that no person should be compelled to give evidence to be used against him or her. This applies where one is under criminal investigations whether arrested or under deemed a suspect. Where authorities investigate a criminal act, they cannot compel one to give evidence that is to be used against him or her. This right goes hand in hand with the right to remain silent.⁶⁶

When a taxpayer discloses illegal income, such information should not in turn be used against him in a court of law. This is because he has disclosed it willfully only for the purpose of making a declaration as required under tax law. If the authorities get such information in another manner, the right against self-incrimination does not operate.⁶⁷ But where one is a suspect or arrested, one cannot be compelled to give information that can incriminate him or her. Tax returns on illegal income can lead to prosecution in non-tax related hence need to separate the two. If one files tax returns and it reveals tax evasion or non-payment of tax, when one is prosecuted, the right against self-incrimination does not arise as discussed in the first chapter. However, it becomes an issue where one is being prosecuted for non-tax offences and one is being investigated for criminal offences whether arrested or deemed a suspect.

⁶⁴ Leonard Levy, ‘The Right Against Self-Incrimination: History and Judicial History’(1969) Political Science Quarterly 84, no. 1,1-29

⁶⁵ Ibid

⁶⁶ Mike Redmayne, ‘Rethinking the Privilege Against Self Incrimination,’ (2007) 27 Oxford Journal of Legal Studies, page 210

⁶⁷Ibid

The taxation legal framework requires taxpayers to disclose all their income through filing returns.⁶⁸ The legal framework governing tax inadequately protects the right against self-incrimination. The right against self-incrimination is a constituent right of an arrested person and fair trial.⁶⁹ With regards to the right against self-incrimination as a right against an arrested person, it arises when one is arrested. The police cannot compel one to give information that will incriminate him or her. One has the right to remain silent. As a right to a fair trial, Article 50 provides one can refuse to give self-incriminating evidence. Right to a fair trial does not begin in court but at the moment one is suspected to have committed a crime.⁷⁰ This means where one is being investigated for criminal offences, whether tax related or not can refuse to give information. This means that under Section 58 and 59, a tax payer can refuse to answer a question if it can self-incriminate him. Illegal income automatically involves criminal acts. Therefore, questions on illegal incomes can be self-incriminating if answered.

In analyzing this right, it is important to note that it does not begin when one is charged but once one is treated as a suspect.⁷¹ Right against self-incrimination arises both at the pre trial and trial stages.⁷² Information derived at the pre-trial stages form evidence at the trial stages. If a question, records, or evidence sought can incriminate, then one can raise this privilege while under criminal investigations..

⁶⁸Tax Procedure Act, Section 24

⁶⁹Constitution of Kenya, Article 49 and 50

⁷⁰ Kayatire Frank, 'Respect of the Right to a Fair Trial in Indigenous Africa Criminal Justice Systems: The Case of Rwanda and South Africa,' LLM Thesis, University of Pretoria 2004 page 22

⁷¹Kayatire Frank, 'Respect of the Right to a Fair Trial in Indigenous Africa Criminal Justice Systems: The Case of Rwanda and South Africa,' (LLM Thesis, University of Pretoria 2004) page 22

⁷²Livio Lizzi, 'Children's Right to A Fair Trial Under International Law,' (2002) 5 Trinity College Law Review page 237

2.2 Constitutional Protection in Illegal Income Disclosure

The Constitution being supreme over all laws of the land invalidates all other laws that are inconsistent to its provisions.⁷³ The disclosure of income earned from illegal activities may lead to an individual's conviction in a non-tax criminal prosecution. Justice Majanja in the case of *Dickson Ogendo vs. Attorney General* stated that the government ought to labour to get any evidence rather than compelling it from an accused person.⁷⁴

The CoK, 2010 provides for the bill of rights. It guarantees the rights to every individual.⁷⁵ The CoK, 2010 mandates the state to respect, promote, observe and observe the rights. The state is the duty bearer when it comes to the issue of protection of human rights. The goal of defending and upholding human rights is in order to uphold human dignity, promote social justice and realize the human potential.⁷⁶ Limitation on the fundamental rights and freedoms can only be limited on principles set in the Constitution.⁷⁷

There are those of the school of thought that the right against self-incrimination shelters the guilty and reduces the possibility of finding their culpability.⁷⁸ This is because it tremendously increases the burden on government in proving culpability.⁷⁹ It is arguable that the innocent person cannot incriminate himself.⁸⁰ Those who subscribe to this school of thought are of the idea that the guilty ones are most of the time silent while the innocent are more likely to testify.⁸¹

⁷³ Article 2(1) of the Constitution.

⁷⁴[2014] eKLR

⁷⁵ Constitution of Kenya, Article 19

⁷⁶ Ibid

⁷⁷Ibid ,Article 24

⁷⁸Ronald Allen, 'Theorizing About Self-Incrimination,' (2009) 30 Cardozo Law Review page 730

⁷⁹Ibid

⁸⁰Ibid

⁸¹Ibid

However, these notions may not be genuine since in certain occasions the guilty ones may confess.⁸²

The right to self-incrimination is a limited right to an arrested person.⁸³ However, the right to fair trial is a non-derogable right.⁸⁴ The right is unlimited since it aids in ensuring that each court makes its decision entirely on merit.⁸⁵ The right against self-incrimination is however not a non-derogable right since it is also a constituent right of an arrested person. The right to fair trial requires utmost respect of the fundamental rights of an accused person.⁸⁶

The right to self-incrimination does not cover a taxpayer from criminal tax malpractices.⁸⁷ One cannot claim the right when it comes to records that the law requires him to preserve.⁸⁸ In the collection of revenue, information that a taxpayer submits is solely to determine the correct tax liability of taxpayers. Information from tax returns that point to criminality and not crucial to the assessment of tax liability should be withheld from non-tax criminality. An arrested person can also waive the right by making a confession. Section 25A of the Evidence Act provides that one can confess before a judge, a magistrate or a police officer who is of the minimum rank of an inspector of police.

A person cannot decline to submit tax returns on the ground that certain disclosures in the return would tend to incriminate him. If answers to specific questions in the return might incriminate the taxpayer, he could plead the entitlement of the privilege against self-incrimination and refuse to answer those questions. Since a taxpayer must file an income tax return, he has only three

⁸²Ibid

⁸³Constitution of Kenya, Article 49

⁸⁴Ibid

⁸⁵Morris Mbondenyi, 'International Human Rights and Their Enforcement in Africa,' (Law Africa 2011) page 174

⁸⁶Black's Law Dictionary page 676 9th edition

⁸⁷Donald Eckhart, 'Illegal Income as Defense in Criminal Tax Prosecution,' (1955) 38 Marquette Law Review page 263

⁸⁸ Ibid

practical choices with regard to incriminating questions in the return: decline to answer or say he is entitled to the freedom against self-incrimination and decline to answer. If the practical effect of all the alternatives is the implication of the taxpayer in the commission of a crime, the requirement that he must file a return may be constitutionally suspect.

The taxpayer also enjoys other rights beside the right against self-incrimination concerning tax returns. This include the right to privacy under Article 31, access to information under Article 35, right to fair administrative action under Article 47. With regards to privacy, one's records and information given to the tax authority should not be released to another person unless very necessary. On access to information, one should be informed of the purpose of further information apart from the annual tax returns. One should be informed that the information sought is solely for the tax authorities to meet their mandate in tax collection.

These rights can however be limited under Article 24. The provision requires that the degree of limitation have to be reasonable and justifiable. It outlines the aspects considered in imposing a limitation. These aspects include the nature of the right or fundamental freedom, significance of the purpose of the limitation, nature and degree of the limitation, the necessity of protecting the rights of others and relation between the limitation and its purpose and if there are less limiting means to achieve the ends. The right to fair trial is a right that cannot be limited as per the provisions of Article 25. Therefore, the right to refuse to give self-incriminating evidence cannot be limited. Under Article 49, the right against self-incrimination can be limited. These limitations can exist under the Tax Procedures Act, Income Tax Act, Value-Added Tax Act, Customs, and Excise Act.

In jurisdictions such as USA, the law requiring full disclosure of illegal income does not infringe the right against self-incrimination⁸⁹. The right is only be affected when used in a non-tax criminal prosecution.⁹⁰ This is similar to the United Kingdom jurisdiction.⁹¹ Kenya protects the right both under the right of arrested person and the right to fair trial. Under fair trial, where one is a suspect, he or she can refuse to give self-incriminating evidence. These allows one not to give information or evidence where under criminal investigations. The tax returns should not be used in non-tax offences as they have not been submitted for that purpose. Where illegal income is disclosed, the power of tax authorities to compel any information should not be used to force one to give self-incriminating evidence. Information disclosed should be solely for tax collection purposes.

2.3 Tax Laws

Tax Procedures Act (TPA Act)

The Tax Procedures Act provides rules for administration of tax. It provides a number of provisions with regard to tax collection. Under Section 24 of the TPA Act requires every taxpayer to submit returns. It creates a number of penalties for failure to provide information on tax required by the Kenya Revenue Authority. Section 82 provides for sanction on failure to keep records required by the Authority. Section 84 provides for penalties if one makes a false statement. This two provisions require full disclosure and failure to do so attracts penalties.

From the determination of the court in the *Yaya Towers Case*, if one does not disclose all his income, whether legal or illegal, it attracts liability under Section 97. The Section provides that

⁸⁹Amendment 5 to the Constitution of the United States of America, an equivalent of our section 35 (1) (c).

⁹⁰*United States v Josephberg* 459 F.3d 350 (2d Cir. 2009); *United States v Sullivan* 274 U.S. 259 (1927) at 264; *Garner v United States* 424 U.S. 648 (1976) at 666; SA Berson *Federal Tax Litigation* (2003) at 13-42.

⁹¹*The DPP v Michael Collins*. Unreported Circuit Court judgment delivered on 27 September 2007.

omitting any income in a tax return is an offence. Such an action can be termed as providing false information to the Kenya Revenue Authority as provided under Article 96.

Under Section 6, the Act provides for confidentiality. However, it lists a lot of exception to confidentiality. Among the exceptions, is that the tax officer can disclose the information received to any other government institutions. This means that it can release such information to the prosecuting and investigating authorities. Section 7 provides that the taxing officer will have the power of a police officer. This means that a tax officer can enter and search, seize evidence, interrogate and present the evidence in court. Section 58 and 59 gives the tax officer the power to access building and ask any questions. The inquiry under the provision is open meaning also it can be inquiry under criminal investigations. The information established can be passed to prosecuting and investigating authorities. Section 60(6) compels an owner of a building to give assistance to the tax officer. This compels one to give self-incriminating evidence. Section 98 makes an offence for one to refuse to submit documents required by a tax-payer or fails to answer questions asked by a commissioner or a tax officer. This amounts to compulsion. The tax officer has been given the power of a police officer, such a provision means that they can force information from a tax payer that is self-incriminating.

Income Tax Act

Everyone subject to pay income tax must file a return regardless of the source of income⁹². A refusal to file is thus not a practical alternative for a person wishing to conceal the source of income derived from illegal activities. However, once a taxpayer engaging in illegal activities is required to file, the protection from self-incrimination may be lost entirely as the information may be used as evidence.

⁹² Sec 52B of the Income Tax Act

Section 109 of the Act provides for a number of offences on failure to file tax returns. The effect of such provision is that it compels disclosure of illegal income. The provision makes it an offence if a taxpayer does not furnish a full and true return. It also requires the taxpayer to give any information that is required from him and answer any question asked lawfully. This provision gives the Kenya Revenue Authority all powers to require any person to disclose information that can be self-incriminating. To have such a provision, which does not provide for protection against self-incrimination, infringes the right.

Value-Added Tax Act (VAT Act)

The statute also requires full disclosure in tax returns.⁹³ Failure to submit attracts a penalty.⁹⁴ This demonstrates the obligation of disclosure and the possibility of self-incrimination. The Act provides widely for the taxation of supply of goods and services. It provides under Section 6 that this tax operates in any business. Subsection 4 of the provision puts liability on the person who is supplying the goods and services. The *Yaya Case* only leads to a conclusion that it does not matter whether the supply of those goods are legal or illegal. Tax liability will accrue to the supplier.

Section 13 of the Act provides for when the tax is due. The tax has to be paid by the twentieth day of the due month. The Act under Section gives the Commissioner for tax powers to require production of books and record. This Section makes it compulsory that one must submit his records when required to do so. Even though a record is self-incriminating, one is obliged to submit it to the Commissioner. The Act does not prevent the Commissioner from submitting those records to criminal enforcement authorities if he/she finds incriminating evidence. The Act

⁹³ Value Added Tax, Section 44

⁹⁴ibid

also allows the Commissioner to enter one's premises without warrant and seize records. This can expose a tax payer to prosecution as a result of tax returns.

Customs and Excise Act

Section 187 of the Act requires full and true disclosure. One can be imprisoned for three years or fined for not more than one million five hundred thousand shillings if he contravenes the provision. This can be through a number of actions including making a false entry, refusing to answer questions asked by a customs officer and making false statement. These provisions require full disclosure in making returns. Legalization of illegal income makes it mandatory on a taxpayer to disclose it.

2.4 Case Laws

The Income Tax Act does not expressly provide for taxation of earnings of illegal activities. It has resulted from a court's interpretation. This was in the case of *Kenya Revenue Authority vs Yaya Towers Ltd* that held that proceeds from unlawful activities are taxable. The case began in the High Court in 2006. The case involved one, Mr. David Peter Saunder, who was under unlawful employment. The applicant, Yaya Towers argued that since he was in unlawful employment, his income was not amenable to tax. KRA on the other hand argued that the income paid to Mr. Saunder was taxable. The judge, Justice Joseph Nyamu held that illegal income could not be taxed. The court saw taxation of such income was against public policy. The judge was of the view that it was improper for the taxing authority to derive revenue from an illegality.

The tax authority appealed the case. The Court of Appeal disagreed with the High Court. It held that as per the provisions of the Income Tax Act on income, it mattered not if income was legal or illegal. The case allowed Kenya Revenue Authority to tax all illegal incomes. Court from other jurisdiction have widely discussed on this issue. In the case of *Southern Inspector of Texas*

*vs. A.B*⁹⁵ the court stated that although business carried out is unlawful, they constitute trade within the meaning of the income tax. In the case of *Garner vs. United States*⁹⁶, the supreme court overturned the decision of the trial court where it had stated that filing tax returns was not a waiver of the right against self-incrimination. The court stated that as far it concerned tax related matters, one could not raise the fifth amendment privilege but where it was used in non-tax prosecution, it infringed on the right. The appellate court was of the view that the one could raise the defense if compelled to produce information or documents that is self-incriminating.

In the case of *Miranda vs Arizona*⁹⁷ the court stated that that statements that an accused makes in custody are admissible as evidence only if the law enforcement informed the accused that he had the right to remain silent or speak to an attorney and the right was waived. As argued through the research, one cannot raise the right to avoid filing returns. The right is raised where there are investigations for criminal acts. In the case of *United States vs. Troescher*⁹⁸ the court stated that the privilege against self-incrimination arises where there is an appreciable possibility of prosecution for a non-tax related crime . In analyzing the right, there must be an aspect of compulsion for one to say that their right to self-incrimination was infringed as stated in the case of *United States vs. Monia*⁹⁹. However, one cannot say that he has the right from self-incrimination if he has not assert it as stated in the case of *United States vs. Kordell*¹⁰⁰

⁹⁵ [1933] 1 K.B 713

⁹⁶ [1976] 424 US 648.

⁹⁷ [1966] 384 USA

⁹⁸ [1995] 75 2118

⁹⁹ [1975] USA ,424

¹⁰⁰ [1970] USA 397

2.5 Self Incrimination: Confidentiality Clause

There are some confidentiality clauses that have been provided in statutes. Section 6 of the Tax Procedure Act KRA from divulging any information on the tax affairs of a taxpayer¹⁰¹. The purpose of the provision is to ensure that taxpayers make full disclosures. The provision guarantees a taxpayer from consequences of such a disclosure. However, the provision does not provide adequately for the right against self-incrimination.

The provision does not protect one from non-tax criminal prosecution. This is because such information is available to other government authorities. Section 6(2) of the Tax Procedure Act provides that KRA can submit information to other authorities including the court, Auditor General, Ethics and Anti-Corruption Commission and any other government institution that the information might be relevant due to the function they carry out. This only that information obtained from the disclosure can end up in the Office of the Director of Prosecution or the National Police. This can lead to criminal prosecution due to the disclosure.

2.6 Conclusion

The legal framework as discussed above does not provide enough measures that ensure protection against self-incrimination after disclosure of illegal income. This infringes on the right of an arrested person and the right to a fair trial. The CoK, 2010 provides for the right of an arrested person and the right to a fair trial. The rights of an arrested person include the right from self-incrimination and the right to a fair trial includes the right not to be compelled to give self-incriminating evidence.

The criminal judicial system in Kenya is adversarial hence it should not operate in favour of the state. The officers of KRA have been given the power of a police man which allows them to

¹⁰¹ Sec 6 Act 29 of 2015

interrogate and give evidence in court. The Act requires the information sourced to be related to the tax but gives the officer wide access to the premises of the tax payer, goods and documents. While the access is necessary, the tax officer can compel information from a tax payer, an information that can be used to prosecute the tax payer even for non-tax related offences. The Act allows the tax officer to pass the information he has received to the prosecuting and investigation authorities. The element of compelling comes on the basis that if a tax officer requires a record or information and the tax payer does not do as required, it amounts to an offence. The Act does not provide if the taxpayer can assert his right against self-incrimination of to give self-incriminating evidence. This gives the prosecuting and investigating officers a loophole to use this channel to obtain self-incriminating evidence for non-tax related offences.

CHAPTER 3:

DEDUCTION OF EXPENDITURE RESULTING FROM ILLEGAL ACTIVITIES

3.1 Introduction

Deduction of expenses of an illegal business for tax assessment is an equivocal issue in Kenya. The Appellate Court in *KRA v Yaya Towers Limited* did not decide on the question of deductions. The parties did not raise the issue of deductions hence the court was denied a crucial opportunity to determine it.¹⁰² This leaves a loophole in law that requires an immediate attention.

Different jurisdictions across the world, which tax illegal income, have varied approaches to this issue. United States of America for instance allows legal expenses from illegal income but disallow illegal expenses.¹⁰³ The court in the case of *Accardo vs. Commissioner* held that where there is no statute denying deductions of legal expenses in a business, then such expenses are allowable deductions.¹⁰⁴ Illegal expenses USA are disallowable even in legal businesses.¹⁰⁵ In Kenya, treatment of expenses in illegal businesses is uncertain. Clarity on this issue under the tax legal framework has to be established.

Imposition of income tax is an exclusive role of the national government.¹⁰⁶ Any variation or waiver has to arise from a statute.¹⁰⁷ Matters of deduction in many jurisdictions across the world are creatures of statutes.¹⁰⁸ In jurisdictions such as USA, the court has determined on the question on allowable deductions through interpretation of statutes.¹⁰⁹ Legislators thus have the

¹⁰²KRA vs Yaya towers [2016] eKLR

¹⁰³Douglas Khan, 'The Tax Provisions Denying a Deduction for Illegal Expenses; Business Should be Repealed,' (2016) University of Michigan Law School Scholarship Repository page 214

¹⁰⁴942 F.2d 444 (7th Cir.1991).

¹⁰⁵Douglas (n2) page 212

¹⁰⁶ Constitution of Kenya, 2010, Article 209

¹⁰⁷Ibid, Article 210

¹⁰⁸Sharp, 'Tax accounting for illegal activities' (2003) *The National Public Accountant* 1.

¹⁰⁹Melville Locker, 'Public Policy in the Taxation of Illegal Income,' (1941) 29 *Georgetown Law Journal* 360

power, but not the obligation, to enact laws that allow for deductions¹¹⁰. In the American case of *New Colonial Ice Company v Helverin*¹¹¹, the court opined that matters of allowable deductions entirely relied on legislative grace. It stated that Congress was the only body with power to provide any exclusion and deduction. Kenya is not an exception to this. It is only the parliament, specifically the National Assembly can determine whether to allow deductions of illegal income or not. The court only interprets the intention of the National Assembly.

As discussed in previous chapters, taxation of illegal income is highly influenced by public policy. Every decision that affects the interest of the society has to look at public policy.¹¹² This only means that the question of allowing or disallowing deductions of expenses on illegal income, whether legal or not, will be determined under a public policy doctrine. This doctrine is a key ingredient in every legal system.¹¹³ This doctrine as discussed the first chapter, comprises of three components. These are public interest, public security, and public morality.¹¹⁴ The public interest involves balancing private interest and public interest.¹¹⁵ Public security seeks to protect the citizen and public morality looks at the maintenance and shape of a society.¹¹⁶

3.1 The Rationale of Deductions

Deductions of expenses in Kenya is based on the purpose of the expense. The main form of deductible expenses are those spent exclusively in generating income.¹¹⁷ The state allows the taxpayer to deduct such expenses in order to assess tax entirely on a gain. Income tax is levied on the net income hence it only operates after a business has deducted its expenses. The U.S.A

¹¹⁰JW Colliton, 'The tax treatment of criminal and disapproved payments' (1989) 9 *Virginia Tax Review* 280.

¹¹¹*New Colonial Ice Company v Helvering* 292 U.S. 435 (1934).

¹¹²Lawaree Valentin, 'Public Policy in English and American Law,' University of Gent (2014) page 8

¹¹³Farshad Ghodoosi, 'The Concept of Public Policy in Law :Revisiting the Role of the Public Policy Doctrine in the Enforcement of Private Legal Arrangement,' (2016) 94 *Nebraska Law Review* 687

¹¹⁴ *Ibid*

¹¹⁵ *Ibid*

¹¹⁶ *Ibid*

¹¹⁷ Income Tax Act, Section 15(1)

Supreme Court in the case of *Commissioner vs. Tellier*¹¹⁸ stated that the tax authority ought to treat illegal income similarly to the legal income. This means that illegal income should enjoy deductions similarly to the legal income. It can be argued that if the government decides to derive revenue from an illegal enterprise, then it ought to extend the same favor to those who earn income from it by allowing them to deduct expenses.

The concept of equity is a vital concept in tax law.¹¹⁹ Equity in tax law can be vertical or horizontal. The concept states that those earning similar incomes should be subjected to a similar taxation system and those with different income should be subjected to different tax system. Thus, it can be argued that if illegal income is subjected to tax, then it should enjoy the benefit of deductions. However, when it comes to taxation of illegal income, it can be argued that equity cannot benefit an illegality. This is under the maxim that he who comes to equity must come with clean hands. The government may impose harsh taxes on illegal tax in order for it to act as a deterrence or use it to reinforce criminal law.¹²⁰

The question of deductions on income from illegal businesses can also be determined looking at the purpose of taxation. Tax is levied on profits. Profits are only determined after deduction of expenses. It does not matter whether the expenses are legal or illegal or the income is illegal. In the case of *Inspector of Taxes vs. J.P Harrison*,¹²¹ matters of legality were held to be non-essential when talking of trade under tax law. Many court authorities opine that the source is irrelevant. Deman J in *Partridge vs. Melladine* stated that a taxpayer cannot refuse to remit tax just because his business is illegal. Scott J said that illegality does not change what can be termed

¹¹⁸ [1966] 383 U.S 687

¹¹⁹ Nicole Wilson & Dale Pinto, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes,' (2009) 7 e-Journal of Tax Research page 74

¹²⁰Ranjana Gupta, 'Taxation of Illegal Activities in New Zealand and Australia,' (2008) 3 Journal of Australian Tax Teachers Association page 107

¹²¹[1963] AC 1 at 20

as income.¹²² A profit is only a profit after the expenses have been deducted. Those in this school of thought argue that the tax is on profits hence deductions should be allowed.

The USA jurisdiction requires expenses to be ordinary and necessary for them to be allowable for deductions.¹²³ This came to be discussed in the case of *Welch vs Helving* where the court termed ordinary to be an expense that is not unique by the customs of a business. The federal government allows deductions of legal expenses but disallows for legal expenses. This approach has enjoyed both support and critic. The Kenyan approach needs to be determined and made clear.

3.2 Deduction Formula in Kenya

Deductions of expenses from total income provides the taxable income. The guiding provisions are laid out under Section 15 to 28 of the Income Tax Act. The taxing authority uses the provision to compute the formulae for taxable income and ascertain the total tax payable. The authority taxes any income and allows deductions so long as it is within the provisions of the Act.

In the case of *Hancock vs. General Reversionary and Investment Company*,¹²⁴ the court stated that the test applicable in determining allowable deduction was that one which was incurred in order for a business to meet the demands of the business.¹²⁵ It was also stated in the case of *Income Tax vs. T Ltd*¹²⁶ that an expenditure could only be deductible if it had been used directly to generate profits. The same was held by Lawrence J in the case *Southier vs Borax Consolidated*

¹²²itc 1545

¹²³Income Tax Assessment Act, Section 162

¹²⁴ [1919] 1KB.25

¹²⁵ Ibid

¹²⁶ EA (1971) 569

*Ltd*¹²⁷. The dicta in these cases can be seen in Section 15(1) of the Income Tax Act. It points out the first rule in determining allowable deductions.

Every expenditure has to meet at least one of the provisions set in part IV of the act for it to be deducted to ascertaining taxable income. In case of any ambiguity in matters of deductions, the provisions will be interpreted in a way that favors the taxpayer. The court in the case of *Commissioner of Income Tax vs. Westmont Power (k) ltd*¹²⁸ held that when a provision in tax law is equivocal, the law would only be interpreted in a way that favors the taxpayer. It was also held in the case of *Ramsay Ltd vs Inland Revenue Commissioner*¹²⁹ that tax is only imposed where there is clarity.

As per the provisions of Section 15, the expense has to be exclusively purposed for generation of income for it to be an allowable deduction. Section 16 disqualifies any expense that is not wholly channeled in generating returns for the business. The expenses that are listed in this part are all legal expenses. However, the question is whether by a business being illegal, invalidates all the expenses as well. In the case of *Heininger vs, Commissioner*¹³⁰ the court stated that an expense is not barred from deduction simply because it is related to an illegal business. It is vital to analyze Kenya's legal framework to establish if it holds the same provision.

ALLOWABLE EXPENSES

Section 15(1)¹³¹ provides the general rule. An expense has to be solely incurred to generate income for the business. The allowable deductions relies highly on the nature of the business.

The nature of the business is very important in determining the expenditure. The court in the case

¹²⁷ 23 T.C 597

¹²⁸ Income Tax Appeal No 626 of 2002

¹²⁹ [1991] AC 300

¹³⁰ [1952]

¹³¹ Income Tax Act 1973

of *CIR vs. Gen & Co (Pty) Ltd*¹³² stated that the expense has to be attached to the business performance. This means that if the aim of spending on an item is not towards profit, then it is not an expense for the purpose of taxation.

Sec 15(2) lists the expenditure that are allowed for deductions. The list is not exhaustive as there are other provisions that provide for deductions. The allowable deductions provided for include bad debts generated from production of income. However, the Commissioner has to be satisfied that the debts has become bad. Other expenses include those expenses

The second schedule of the act provides for allowable deduction from capital expenditure. One type of such an expenditure is one that has been incurred in the construction of an industrial building. It provides also for wear and tear deductions¹³³ mining operation deductions, capital expenditure on agricultural land and investment deductions such as purchase of a machinery. The Petroleum industry has its special deductions as provided in the ninth schedule.

Other expenses include on scientific research, legal costs, lease of business premises, donation to registered charitable organizations, interest paid on borrowings for the generation of investment income costs incurred in issuing shares or debentures¹³⁴. The nature of this cost among others provided for in the Act is that they are exclusive for the purpose of profit generation.

3.3 Dis-Allowable Expenses

The Act provides for a list of expenses, which cannot be deducted in ascertainment of taxable income.¹³⁵ Any expenditure that is not wholly channeled towards generating income cannot be

¹³² [1924] AD 516

¹³³Section 7 of the Second Schedule

¹³⁴Section 15(2), as analysed by Deloitte and Touche, "*Income Tax in East Africa*," p. 8, (June 2012) http://www.deloitte.com/assets/DcomKenya/Local%20Assets/Documents/Budget%202012/Deloitte_IncomeTax2012.pdf. (Accessed October 29, 2012).

¹³⁵Income Tax Act Section 16

allowed for deduction. Other expenses include personal entertainment; hotel expenses other than those incurred for business trip and training courses, premium paid in annuity contract and expenditure that is recoverable under insurance

3.3 Tax Treatment of Losses

The loss that a business incurs does affect the ascertainment of tax. This is provided for under Section 15(4) of Income Tax Act. It states that if there is a deficit after the computation of taxable income, it will be an allowable deduction for that year and the subsequent four years. The Income Tax Act under the eighth schedule and section 15 (3(f)) provide that capital losses cannot be deductible or set off against trading income.

Expenditure and loss are distinct. Watermeyer CJ in the case of *Joffe & Co (Pty) Ltd vs. CIR*¹³⁶ distinguished between expenditure and loss. He stated that loss entailed an involuntary deprivation while expenditure was a voluntary payment. Findlay J in the case of *Allen vs. Farquharson Brothers*¹³⁷ stated that a loss was an involuntary spending that arose out of misfortune while expenditure was a voluntary and designed.

3.4 Deductibility of Other Expenses

Persons involved in the illegal activities of prostitution, fraud or theft may incur a number of other expenses in relation to their illegal trades that would not qualify for deduction as per the provisions of the act.

Deduction Of Fines

Fines and penalties are not allowable deduction by virtue of Section 16 of the Act. If fines for criminal conduct would qualify as a deduction, there would be no public policy barrier against

¹³⁶[1946] ad 157

¹³⁷1965 (1) SA 59

allowing such deduction. Criminal sanctions are not imposed on the taxpayer as a trader but as a personal punishment. In the House of Lords case of McKnight v. Sheppard¹³⁸ the court stated

“But the reason (for fines being disallowed) in my opinion is much more specific and relates to the particular character of a fine or penalty. Its purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by a deduction for the purposes of tax... By parity of reasoning, I think that the Special Commissioner and the judge were quite right in not allowing the fines to be deducted.”

A fine is a personal punishment not a cost of performing business operations. Deduction of fines incurred is disallowed on the grounds that the section that provides for deductions only provides for the deduction of commercial losses and a loss that results from a breach of law is not a commercial loss¹³⁹. Persons involved in illegal activities would frequently have to pay fines or penalties for so doing and it is clear that these expenses would not be deductible.

Deduction of Legal Fees

Legal cost can be allowable expenses depending on its purpose. For legal expenses to be an allowable expense, it must be towards the performance of the business as required by section 15. This can be on aspects such as legal fees for registration and compliance. It can also be in defending the business in suits or litigation. However, legal fees will not be allowable deductions for defense against any criminal act, for tax appeals and any other tax matter and for breach of trade agreements.

¹³⁸[1999]71 TC 419.

¹³⁹Jacobson *The tax treatment of illegal transactions* (1986) 25

Costs of appeal against a tax assessment

It has been established that legal and accountancy expenses incurred in an appeal against a tax assessment are not allowed because they cannot be said to have been incurred wholly and exclusively in the generating income. The authority on this position is the case of *Allen v. Farquharson & Bros Co* (1932) 17 TC 59. In the case, the company sought allowance to deduct legal expenses incurred in connection with an appeal against an assessment. The High Court held that it could not amount to an allowable expense simply because it related to the business. It stated that the expense had to be for profit generation. Justice Finlay reasoned that this was an application of profits earned rather than an expense to earn those profits.

3.5 Conclusion

The income tax act does not provide on treatment of expenses that violate the laws of the state. An expense incurred exclusively for generating income may have illegalities. Other jurisdictions such as USA as shall be seen in the following chapter have expressly provided on treatment of illegal expenses.¹⁴⁰ If such a question comes before court, should the court make a decision based on the doctrine of public policy or should it just interpret the act as it did in the *Yaya Case*. The court's rationale was that tax knew no morality. Its view was that tax only recognized what amounted to income. It strictly and literally interpreted the provisions of the Income Tax Act. In the case of *Tank Truck Rentals vs. Commissioner*,¹⁴¹ the court stated that a court of law has to measure how a deduction will affect a government policy. The determination of whether to allow deductions in illegal expenses has to consider public policy.

Even though the court stated that illegal income is taxable, the same cannot be said of its expenses. Involvement in illegal activities is accompanied by the risk of imprisonment or a civil

¹⁴⁰Tax provisions page 208

¹⁴¹356 U.S 27 (1958)

action. Expenses associated with these risks can be said to be purposely for generating income. In a legal business, the law has provided for payment of income tax from the profits and value added tax. It is unclear if the illegal businesses can be allowed to deduct expenses.

CHAPTER 4

JURISDICTIONS THAT PROVIDE TAX LIABILITY ON ILLEGAL INCOMES.

4.1 Introduction

Up to this point, the thesis has dealt with the legal position under Kenyan law, on deductibility of expenses and protection against self-incrimination of persons deriving income from illegal activities. This chapter focuses on a brief comparison between the tax systems of the United States of America and South Africa on deductibility of expenses and protection against self-incrimination. The aim is to compare and contrast the three tax systems, in order to address the third objective of the research.

4.2 Freedom Against Self Incrimination

The disclosure of illegal income as required in income tax regulations may lead to an individual's conviction in a non-tax criminal prosecution. United States of America (USA) and the Republic of South Africa (SA) operate under a written constitution regime where the constitution is the supreme law.¹⁴² . The constitution of the two states expressly provide for the right against self-incrimination. Since Kenya provides the same under its constitution, South Africa and USA are a good selection for comparative analysis.

United States of America (USA)

The right against self-incrimination operates under the bill of rights. The American Taxation system has been successful in charging tax liability from illegal income without infringing on the right against self-incrimination¹⁴³. This forms a basis why it is a case study in this thesis. The right to a fair trial has its own uniqueness. It is a right that comprises a group of rights under it.

¹⁴²Melville Locker, 'Public Policy in the Taxation of Illegal Income,' (1941) 29 Georgetown Law Journal page 361

¹⁴³ Amy Bucci, "Taxation of illegal narcotics: a violation of the Fifth Amendment rights or an innovative tool in the war against drugs?"(2012)3 Journal of Civil Rights and Economic Development 11, 22

Article 8 of the American Convention on Human Rights of 1978¹⁴⁴ provides for the rights that make up the right to a fair trial. This includes the right of presumption of innocence until proved guilty, the right to remain silent and the right against self-incrimination and the right to legal representation.¹⁴⁵

USA tax legal framework operates under the Internal Revenue Code of 1986. The code obliges total disclosure of income not only legal income but also illegal income¹⁴⁶. It makes it an offence if one does not file tax return, fails to pay tax or keep records of his income. Such offences attract a fine, imprisonment or both.¹⁴⁷

The right against self- incrimination operates under the Fifth Amendment.¹⁴⁸ It does not exclusively operate in criminal proceeding but also in civil proceedings as well.¹⁴⁹ There are however few exceptions. One exception is that one cannot plead the right when he has obtained immunity from prosecution in exchange for evidence that is self-incriminating.¹⁵⁰ If one pleads for immunity in order to testify, he cannot plead the Fifth Amendment. Immunity assures one that whatever self-incriminating evidence he will give, will not attract criminal prosecution. The Fifth Amendment does not operate as an excuse to prevent one from carrying out a legal obligation such as filing tax returns.¹⁵¹

¹⁴⁴Available at http://www.wunrn.com/reference/pdf/American_convention_Human_Rights.PDF (accessed 22 June 2017)

¹⁴⁵Art 8(2) (g) American Convention on Human Rights of 1978.

¹⁴⁶ Boris Bittker, "Constitutional Limits on the Taxing Power of the Federal Government" (1987) *The Tax Lawyer* 3

¹⁴⁷ Internal Revenue Code,s 7203

¹⁴⁸ Boris(n132)

¹⁴⁹ibid

¹⁵⁰ ibid

¹⁵¹ Boris Bittker, 'Federal Income Tax Returns-Confidentiality vs. Public Disclosure' (1980) *Washburn LJ* 20,479.

The balance between the obligation to disclose all income, whether legal or illegal, and the right against self-incrimination is widely discussed in USA courts.¹⁵² One such case is *Garner v United States*.¹⁵³ The appellant in this case challenged the use of his tax returns in a case involving violation of gambling laws. He argued that the trial court should not have admitted his tax returns as evidence since it infringed upon his right against self-incrimination. The appellate court agreed with his argument and held that it was a violation of his right against self-incrimination. The decision suggests that a taxpayer can get sufficient protection against self-incrimination even though he is required to disclose incriminating information. Consequently, the court held that the Government had to prove its case without using the defendant's income tax returns as evidence. The Government, however, can use the returns in further tax-related prosecutions; therefore, these returns would still remain a valuable tool in the enforcement of the internal revenue laws.

The words of the Fifth Amendment contain no criteria upon which to define accurately the scope of the protection of the right. The Court has interpreted the standards for application of the privilege. The court has to consider two factors. One factor is the history and purpose of the right and the second factor is urgency and character of the other public interests involved¹⁵⁴. These criteria imply that at some point the policies of the privilege against self-incrimination is subordinate to the requirements placed upon law enforcement agencies to satisfy societal needs for order.

The privilege is not, therefore, all-encompassing, and the United States Supreme Court has accordingly placed limitations on its use. In the first place, the exercise of the privilege has been

¹⁵²E.g. *Garner v United States* and *United States v Barnes*.

¹⁵³ *ibid*

¹⁵⁴Justice Harlan's concurring opinion in *California v. Byers*, 402 U.S. 424, 449 (1971)

limited to natural persons¹⁵⁵, and thus is unavailable to corporations¹⁵⁶, labour unions¹⁵⁷ and partnerships¹⁵⁸. This limitation flows from the concept that the Fifth Amendment privilege is a personal privilege which seeks to ensure that the judicial process will respect the human dignity of the accused. Secondly, the privilege applies only when the compelled disclosure is of a testimonial or communicative nature¹⁵⁹. Thus, self-incriminatory evidence disclosed by an accused under compulsion may not violate the Fifth Amendment, if not disclosed through the accused's testimony nor through evidence relating to some communicative act of the accused. Finally, even when the information sought by the tax man is of a testimonial nature and such information concerns a natural person, the privilege protects only that information obtained under compulsion from the accused person himself¹⁶⁰. This means that the Fifth Amendment protects an individual from self-incrimination, not from incrimination.

Everyone subject to pay income tax must file a return¹⁶¹ regardless of the source of income. A refusal to file is thus not a practical alternative for a person wishing to conceal the source of income derived from illegal activities. A doctrine espoused by the Supreme Court's decision in *Shapiro v. United States* exemplifies the extent to which the privilege is abrogable. Courts have been moving towards the recognition of the so-called "required records" doctrine in the tax area¹⁶². The required records doctrine of *Shapiro* asserts that records kept under governmental regulations are not susceptible to claims of privacy. The implications of this position would be

¹⁵⁵United States v. White, 322 U.S. 694, 698 (1944).

¹⁵⁶Wilson v. United States, 221 U.S. 361, 382 f1911); Hale v. Henkel, 201 U.S. 43, 74(1906).

¹⁵⁷United States v. White, 322 U.S. 694, 704 (1944).

¹⁵⁸United States v. Silverstein, 314 F.2d 789,191-92 (2d Cir. 1963).

¹⁵⁹Schmerber v. California, 384 U.S. 757 (1966).

¹⁶⁰Johnson v. United States, 228 U.S. 457, 458 (1913).

¹⁶¹Section 6011 of the Internal Revenue Code of 1954 requires the making of a return, and section **7203** makes it a crime to fail to file any return. The Supreme Court has sustained this filing requirement even where the reporting of illegal gains tends to incriminate the taxpayer. United States v. Sullivan, 274 U.S. 259 (1927).

¹⁶²Edgar, Tax Records, The Fifth Amendment and the Required Records Doctrine, 9 St. Louis L.J. 502 (1965); Comment, 12 B.C. Ind. & Coin. L. Rev. 1176 (1971); Comment, 65 Colum. L. Rev. 681 (1965); C. McCormick, Evidence § 142 (2d ed. 1972); 8 J. Wigmore, Evidence § 2259 (J. McNaughton rev. 1961).

that all financial records that bear on tax liability would be within the public domain, and therefore the privilege against self-incrimination would be unavailable to taxpayers.

The formulation of the doctrine was in order that needed information about the operation of maximum price legislation is obtainable¹⁶³. However, on occasion it applies to income tax records that tax payers must keep. In addition to those records, the doctrine may apply to reports that require mandatory filing, *e.g.*, income tax returns. Indeed, from the time of the doctrine's inception, it has been felt that the Government could completely destroy the privilege against self-incrimination by simply designating reports as being required¹⁶⁴. The Supreme Court has not applied the required records *Shapiro* doctrine per se to tax cases. However, a number of lower federal courts have applied the doctrine to tax cases. Other lower federal courts and legal commentators have supported the proposition that the required records doctrine should be inapplicable in this area¹⁶⁵.

There are several convincing reasons to support the contention that the *Shapiro* doctrine should be inapplicable in tax cases. In the first place, *Shapiro* involved an emergency measure and the national interest required strict enforcement. Secondly, notwithstanding emergency conditions, *Shapiro* decision was a five to four vote. Thirdly, in *Shapiro* the Supreme Court did not cite the Internal Revenue Code among the twenty-six regulatory statutes to which the required records doctrine might apply. Fourthly, the record-keeping requirements of the tax regulations are

¹⁶³Emergency Price Control Act of 1942, **50 U.S.C. § 901 et seq. (1970)**.

¹⁶⁴Mr. Justice Jackson in his dissent in *Shapiro* felt that Congress might have the tendency to extend the requirements even more, thereby narrowing the privilege against self-incrimination considerably. If the doctrine is extended to its fullest reach, it is capable of entirely destroying the privilege. **335 U.S. at 70** (Jackson, **J.**, dissenting).

¹⁶⁵*Blumberg v. United States*, 222 F.2d 496 (5th Cir. 1955); *United States v. Remolif*, 227 F. Supp. 420 (D. Nev. 1964); *In re Daniels*, 140 F. Supp. 322 (S.D.N.Y. 1956). Also Lipton, *Constitutional Rights in Criminal Tax Fraud Investigations*, 45 F.R.D. 323 (1968); Comment, *The Relationship Between Civil and Criminal Tax Fraud and Its Effect on the Taxpayer's Constitutional Rights*, 12 B.C. Ind. & Corn. L. Rev. 1176 (1971).

extremely broad and general. Practically every record related to taxable income is possibly a record required by the tax laws.

Under the *Shapiro* doctrine taxpayers could be compelled to disclose the entire range of their financial affairs, regardless of the incriminatory nature of the item demanded. This could potentially affect tens of millions of individual citizen taxpayers, for unlike the limited investigatory powers of many agencies which have less extensive jurisdiction, a majority of adult citizens are potential targets for IRS investigation. Recognition of this doctrine in the tax area would have the formidable effect of nullifying every taxpayer's expectation of privacy and Fifth Amendment privileges in IRS investigations. Yet, in spite of severe criticism, the doctrine has not been overruled¹⁶⁶.

Although the "required records" doctrine and its abrogation of the freedom against self-incrimination seem inapplicable to income disclosure situations, the protection against self-incrimination may nevertheless be inadequate. A leading case illustrating this inadequacy is *United States vs. Sullivan* which dealt with the connexion between the Fifth Amendment and the income tax reporting statute. Sullivan made his living selling moonshine whiskey and, rather than risk prosecution, did not file an income tax return. The Court held that a person could not decline to file returns on the excuse that certain disclosures in the return would tend to incriminate him. If answers to specific questions in the return might incriminate the taxpayer, he could claim the privilege against self-incrimination and refuse to answer those questions. The Court, however, failed to enumerate the particular questions which might tend to be incriminating.

¹⁶⁶*United States v. Remolif*, 227 F. Supp. 420 (D. Nev. 1964); *In re Daniels*, 140 F. Supp. 322 (S.D.N.Y. 1956).

Until recently most courts, under various rationales, have refused to find this Fifth Amendment protection in income disclosure cases. Some courts have failed to reach the question of protection by saying that the disclosures are not in fact sufficiently incriminating¹⁶⁷. Others facing the issue have nevertheless held that governmental needs were more important than those of the individual or that the taxpayer waived his privilege against self-incrimination by complying with the income tax filing requirements.

South Africa

The right against self-incrimination is a fundamental right under the Constitution of South Africa. The Constitution of South Africa provides for Bill of rights under chapter 2.¹⁶⁸ The bill of rights provides for the right of an arrested person and right to fair trial. Section 35(3) provides that every person has a right to a fair trial. This also entails the freedom against giving self-incriminating evidence.¹⁶⁹ The case of *S v Lottering*¹⁷⁰ is one of the cases in South Africa that demonstrate the operation of the right. The accused person argued that he made an admission without having told his rights to remain silent and the right to legal representation. The court however held that since there were no threats or intimidation and no force used, he acted voluntarily.

Evidence obtained through duress or undue influence is inadmissible in court.¹⁷¹ Such evidence, however incriminating, is illegal evidence. However, if an accused person makes a confession willingly he cannot fall back to rely on this right. But the information given by a taxpayer is not in the intention of confession. Where a taxpayer gives such information, his sole intention is to

¹⁶⁷*Albertson v. Subversive Activities Control Bd.*, 382 U.S. 70 (1965); *United States v. Sullivan*, 274 U.S. 259 (1927).

¹⁶⁸The Constitution 1996, Sec 7(1)

¹⁶⁹The Constitution 1996, Sec 35(3) (j)

¹⁷⁰*S v Lottering* 1999 12 BCLR 1478.

¹⁷¹

fulfil a legal obligation of declaring his total annual income. The aim of the South African Revenue Service (SARS) in requiring disclosure is for determination of tax liability.

Sections 75, 76 and 104 of the Income Tax Act¹⁷² makes it mandatory for one to file returns. It makes it an offence if one exceeds 24 months without filing returns. Filing of returns requires full and complete disclosure. Since South Africa and Kenya can tax illegal income, it means that in South Africa, disclosure illegal income is mandatory. Disclosure of illegal income will definitely invite investigations if such information gets to the relevant authorities. There is no legal provision that prevents the authorities from submitting before a court of law ones tax returns as proof of one engaging in illegal activities. This hence makes filing of tax returns as a self-incriminating exercise.

Section 28 of the VAT Act¹⁷³ mandates those in business to submit returns. This has to be done within twenty-five days after tax period ends. Section 58 makes it an offence if one does not file those returns. The effect of this section is the pressure of disclosure on a taxpayer and the possible acts of self-incrimination.

Levying of estate duty is as per the provisions of the Estate Duty Act¹⁷⁴. The Act provides under Section 7 for filing of tax returns. Section 28 under the same Act makes it an offence if one fails to do so. It attracts a fine, imprisonment or both. This provisions can expose one to criminal prosecution. It makes one to self-incriminate oneself without the possibility of immunity.

The legal framework governing tax in South Africa compels disclosure. This as seen in the above analysis is through disclosure provisions. South Africa however has provisions that safeguard the

¹⁷²Act 58 of 1962

¹⁷³Act 89 of 1991.

¹⁷⁴Act 45 of 1955.

confidentiality of a taxpayer. This provisions prohibits disclosure of information to third parties. Section 4 of the Income Tax Act states that a tax authority should not disclose a taxpayer's information. Section 6 of the VAT Act provides the same.¹⁷⁵

The confidentiality provisions of the Income Tax Act protect the freedoms provided under the Constitution of South Africa. Section 35(3) (h) and (j) of the Constitution provide for the right to a fair trial including the right to remain silent and against self-incrimination. Although the act provides clauses on confidentiality, it contains a lot of inadequacies. The confidentiality is limited under Section 4(1B) of the Income Tax Act. This provisions allows the Commissioner to apply *ex parte* to a judge in chambers to get permission to make disclosures to investigating authority which is the National Commissioner of the South African Police Services (SAPS) or to the prosecutorial authority being the National Director of Public Prosecutions (NDPP). The provision also allows the National Commissioner of the SAPS or NDPP to obtain such information during investigations. This makes filing of returns of illegal act as a direct act of self-incrimination.

4.3 Deductibility of Expenses

United States of America

In the United States, gross income for taxation purposes refers to all income received whatever its source. The taxing statute empowers the Commissioner of Taxes; to levy tax on all income received by taxpayers regardless of its source. The mere fact that income is from an illegal source does not exempt such a receipt from tax. Taxation of illegal income ensures that they cannot derive the full benefit of their misdeeds without paying what is due.

¹⁷⁵Sec 6 Act 89 of 1991

The United States Constitution provides for the levy of tax on all income but does not make any provision for the allowance of deductions¹⁷⁶. It was thus left to the judiciary to decide on the deductions to be allowed and for many years this decision was taken on public policy considerations. In other words, a deduction was only allowed if it did not contravene public policy. Under this regime, expenditure arising in the production of illegal income is disallowable for deduction because allowing it would be inconsistent with public policy. Relying on public policy lead to inconsistency and uncertainty in law and Congress decided to enact a deduction section to avoid having to rely directly on public policy.

The Internal Revenue Code under Section 162(a) allows taxpayers to deduct the expenses they incur in generating their income. All ordinary expenses incurred, whether lawful or unlawful, are allowable deductions as they are inherent in all commercial enterprises¹⁷⁷. The act however illegal expenses such as bribes, kickbacks.¹⁷⁸ It also disallows expenditure incurred in paid lobbying and political expenditures such as influencing legislation, political campaigns and general public ¹⁷⁹

Equipment and salaries are deductible even if the taxpayer is carrying on an illegal trade. Although revenue laws allow for the deduction of certain expenses incurred in the production of income, other deductions are disallowed on public policy grounds. For an expense to be deductible it does not .only need to be an economic cost of earning income but it must not be against public policy¹⁸⁰. In *Sam Mesi*¹⁸¹ it was held that salaries paid to employees by an

¹⁷⁶Boris Bittker, "Churches, Taxes and the Constitution"(1969) The Yale Law Journal 78 no. 8 ,1285-1310.

¹⁷⁷ Arthur Fleischer Jr, "The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment"(1958) *Tax L. Rev.* 14, 567.

¹⁷⁸Subsections 162 (c) of the IRC

¹⁷⁹Subsection 162(e) of the IRC

¹⁸⁰Colliton 'The Tax Treatment of Criminal and Disapproved Payments' (Fall, 1989) 9 *Virginia Tax Review* 273 at 274

¹⁸¹*Sam Mesi*25 T.C. 513 (1955)

employer engaged in illegal activities were not allowable business expense deductions. Denying a delinquent taxpayer his deductions is based on the view of taxation as moral barometer, while allowing such deductions entails a view of taxation as a mechanism for revenue collection, dependent on accurate methods of computation. In *Commissioner v Sullivan*¹⁸², the court allowed the deduction of rent and wages paid by an illegal bookmaking operation. However, In *Tank Truck Rentals, Inc. v. Commissioner*, the courts held that the payment of an expense which is against public policy does not represent a necessary expense. In *G.A. Comeaux*¹⁸³ a deduction for salaries was allowed and emphasis was placed on the fact that these were expenses incurred in earning the income reported by the taxpayer. The law allows the deduction of a legitimate expense incurred by a taxpayer carrying on an illegal business¹⁸⁴. The *Tank Truck Rentals* case held that fines are not deductible while the *Sullivan* and the *Sam Mesic* cases held that other expenses incurred in the production of income generated in an illegal manner are deductible. This means that taxpayers may be involved in illegal activities and the expenditure of one taxpayer will be allowed as a deduction and the expenditure of another taxpayer will be denied.

Fines and penalties on the other hand are not deductible, even if they were used in the production of income. In *Tank Truck Rentals Inc. v Commissioner*¹⁸⁵, the taxpayer intentionally violated the weight limitations that applied to the trucking services and incurred a fine. In denying the deduction of the fine the court held that allowance of such fines as a deduction would encourage continued violation of state law and also because such a fine was not necessary for the operation of the trucking business. The Internal Revenue Code provides for the

¹⁸²*Commissioner v Sullivan* 356 U.S. 30 (1958)

¹⁸³*G.A. Comeaux* 10 T.c. 201 (1948) at 207

¹⁸⁴DeMattei, "The Use of Taxation to Control Organized Crime" (1951) *California Law Review*, 39 (2): 226-234 228

¹⁸⁵*Tank Truck Rentals Inc. v Commissioner* 356 US. 30 (1958)

disallowance. If a taxpayer violates a law leading to imposition of a fine, that fine is not deductible even if such a violation occurred in the process of furtherance of the taxpayer's business or trade.

The taxing statute in the United States empowers the Commissioner to tax income earned and does not make any provision for the exclusion of income from illegal activities. It would appear that all ordinary and necessary expenses spent during a tax year in carrying on an illegal trade or business would be deductible, other than those specifically denied under the public policy denial sections. Expenditure on fines and penalties is also not deductible. The situation in the United States with regard to the deduction of expenses incurred in carrying on an illegal trade is very certain.

South Africa

The Income Tax Act does not explicitly provide for taxation of illegal income. Taxation of such income can only be determined by first making an analysis on the general deduction formula. There a number of provisions that provide for illegal expenses. Section 11(a) and Section 23(g) provide for expenditure and losses from illegal activities such embezzlement. Section 23(o) provides for expenditure on corrupt activities and deduction of fines from unlawful activities. This creates ambiguity relating to the normal income tax treatment of illegal activities in South African.

The South African Revenue Service has provided for a draft interpretation on the consequences of tax in embezzlement and theft of money for both the victim as well as the offender during 2013. The draft provides for the normal tax consequences of illegal income. However, this does not provide clarity on deduction on illegal income provided. Section 11(a) allows deductions provided they are not of capital nature. Section 23(g) of the Act provides that an expenditure can

only be claimed as a deduction depending on the extent is spent for the purpose of generating income.

Section 11 (a), section 23(f) and section 23(g) of the Income Tax Act provide for the deduction formulae. For expenditure or a loss to be deductible it must meet all the requirements laid down in the preamble to section 11 and section 11(a) and not be prohibited by section 23 of the Income Tax Act. Failure to meet anyone requirement results in disallowing part of or the whole deduction claimed¹⁸⁶.

Section 11(a) of the Act provide that a business must first before there could be a deduction in terms of the general deduction formula. For an expense to be deductible it must be incurred. Expenditure is actually incurred when it has been paid and when the taxpayer is under an unconditional obligation to pay the amount in question¹⁸⁷ In *Caltex Oil (SA) Ltd v SIR*¹⁸⁸ it was held that the expression "actually incurred" means all expenditure for which liability has arisen even if that liability has not yet been paid. Expenditure, other than refunds, restitution or the payment of compensation, incurred by thieves, perpetrators of fraud and those earning their income directly or indirectly through prostitution, or the payment of salaries and wages for the services of others involved in the illegal trade, is expenditure actually incurred when the obligation to pay has arisen, with no conditions attached. When the existence of a liability is conditional and reliant on an event, the liability is not incurred until the event happens¹⁸⁹.

Income is generated first in an illegal business before the application of the general deduction formulae. Since an allowable deduction is one wholly incurred in generating income, a scrutiny

¹⁸⁶Huxham and Haupt, 'Notes on South African Income Tax' (2006) 25th edition, 63

¹⁸⁷Williams, *Income Tax and Capital Gains Tax In South Africa Law and Practice* 278

¹⁸⁸*Caltex Oil (SA) Ltd v SIR* 25 SATe 67

¹⁸⁹*Edgars Stores Ltd v CIR* 50 SATe 81

is required when it comes to an illegal expenditure or loss. The provisions on general deduction formula does not mention that the deductions and allowances is prohibited if they result from illegal activities.

There are quite a few case is South Africa that have addressed matters of deduction in illegal income. Inthe case of *COT v Rendle* the Commissioner permitted the deduction of expenses on legal fees spent on investigating fraud by an employee.¹⁹⁰. The expense was allowable since it was wholly spent towards the operations of the taxpayer's business. The taxpayer was part of a partnership of attorneys. One of the partners stole funds from the partnership and the taxpayer deducted the stolen funds¹⁹¹. The court ruled that it was not an inherent risk and hence not deductible.

The only provision in the Income Tax Act that deals directly with illegal activities is section 23(0) which provides that there are no allowable deductions on any expenditure for any activity under Chapter 2 of the Prevention and Combating of Corrupt Activities Act. It also includes payments that constitute a fine from unlawful activity. Section 3 of the Combating of Corrupt Activities Act describes the general offence of corruption, which relates to accepting or giving a gratification in order to influence another to act in a manner that amounts to the abuse of a power, a breach of trust, breaching of a duty or a set of rules. This includes the giving of a gratification to or acceptance by persons occupying public office, parties in an employment relationship and a list of other activities, including sporting events and gambling. The prohibition in section 23(0) would not, therefore, relate directly to the offences forming the basis of this research, except with regard to fines or penalties incurred in respect of the illegal activities,

¹⁹⁰COT v Rendle 26 SATC 326 1965 (1) SA 59 (SR AD)

¹⁹¹Orlando Christian Streicher, "An analysis of the taxability of illegal activities in South Africa" (PhD diss., 2015)

which would not be deductible. It is also likely that persons engaging in illegal activities would pay bribes or gratifications to persons in authority to promote the success of their activities. Such payments would be disallowed in terms of section 23(0)¹⁹²

The Commissioner makes fines resulting from unlawful activities disallowable for deductions. Criminal penalties are not deductible¹⁹³. In *ITC 1199*¹⁹⁴ it was held that if fines for criminal conduct would qualify as a deduction there would be no public policy barrier against allowing such deduction. These fines are not deductible even if the crime was committed in the course of income-earning operations. This non-deductibility is based on public policy and supports the legislature's intention to decrease crime.

Another type of expense that persons involved in illegal activities would, sooner or later, have to incur is legal expenses. These expenses may not fall within general deduction formula, but might fall under section 11 (c) of the Income Tax Act. This section provides for the deduction of any legal expenses (of the nature described in the section) "actually incurred during the year of assessment in respect of any claim, dispute or action at law arising in the course of or by reason of the ordinary operations undertaken by him in the carrying on of his trade ". The expenses need not, therefore, be incurred "in the production of income", but by reason of the ordinary business operations. Though not deductible in terms of section 11(a) of the Income Tax Act, the expenses would qualify in terms of section 11 (c), unless the legal expenses are of a capital nature, which are also excluded in terms of the paragraph. Persons involved in prostitution or profiting from the activities of prostitution, who incur legal costs to prevent imprisonment and ensure the ability to

¹⁹²*Income Tax Act 58 of 1962*

¹⁹³*Williams Income Tax and Capital Gains Tax In South Africa Law and Practice 337*

¹⁹⁴*ITC 1199 36 SATC 16 19*

"Continue earning income, would (all else being equal) be able to deduct the costs in terms of section 11(c) as non-capital expenses closely connected with their normal business activities.

Conclusion

An analysis of the two jurisdiction shows that Kenya needs to do more on taxation of illegal income. Declaration by the court that illegal income is taxable has its own consequences. As seen in the two jurisdictions, taxation of illegal income has led to conflict between the aim of government to maximize revenue and to uphold public policy. The use of tax law for criminal enforcement is as an aspect that is not in line with the principles of taxation. Writers from all the two jurisdictions agree that the right against self-incrimination is a fundamental right requires protection. The state has the obligation to protect constitutional rights of its citizens. Kenya needs to ensure that even if one discloses illegal income, it does not lead to self-incrimination.

On the aspect of deductions, the Kenya legal framework can borrow from USA. Legal expenses can be allowed while illegal expenses be disallowed. This will make all ordinary and necessary expenses paid or incurred during a tax year in carrying on an illegal trade or business deductible. United States of America law provides more certainty in relation to deductions, than the South African law provides. Kenya needs to take the USA model in order to have clarity.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

Introduction

The research from the onset laid out several objectives. The objectives were to analyse the deductibility of expenses from illegal activities, examine how mandatory disclosure of illegal income affects the right to self-incrimination and make a comparative analysis with other jurisdictions such as USA and South Africa. The research sought to provide answers to whether Kenya should allow deductions in illegal income, whether mandatory disclosure affects the right to self-incrimination and which measures other jurisdictions had taken with regards to allowable deductions and the right to self-incrimination.

These issues have been extensively discussed in the preceding chapters. In these analysis the factor that has been widely considered and has been critical in all chapters is self-assessment of tax. Kenya has a self-assessment tax system which requires each tax payer to file his or her tax returns. The questions analyzed consider the essence of this self-assessment system and how critical it is to tax collection. Efficiency of tax collection is of essence. For any government to be able to fund its programmes such as providing quality healthcare, education, security, administration, general welfare of its citizens among other programmes, it requires funding. A government that has a good system of taxation can meet its revenue targets. The self-assessment of tax is critical in achieving this.

The first chapter laid out the structure of the thesis. It discussed on the objectives, theoretical framework, conceptual framework, justification, literature review and the areas of discussions on the thesis. This chapter, especially through the hypothesis, literature review and theoretical framework established an area that required discussion. It laid out the flow of thoughts that the research was going to follow.

The second and third chapter discussed on the framework governing taxation of illegal income in the areas of self-incrimination and matters of deductions in such income. In its analysis, it examined how Kenya has constantly made efforts to broaden its tax base in order to meet the expenses of both the National and county governments. The two chapters looked into the legal framework and judicial precedents.

In chapter four, the thesis looked into USA and South African jurisdictions. In USA it established that the state had already provided for a taxation system on illegal income and matters of self-incrimination. Through the Internal Revenue Code under Section 162(a), deductions on illegal income is allowable. The section allows deduction of expenses but with a qualification. It provides that the expense needs to be necessary. Illegal expenses are not allowable deductions.

The thesis discussed the reasoning behind the determination in the case of *Republic vs. Kenya Revenue Authority ex-parte Yaya Towers*. Judicial decisions can result to consequences that the court might not anticipate. The decision which held that illegal income is taxable resulted in two issues as per the discussion in this thesis. The resulting issues were on the effect on the right to self-incrimination and the determination of allowable and disallowable deductions of illegal income.

The research was not focused on the reasonability of the decision but the effect that the decision has on self-incrimination and deductions. It analyzed the two issues and drew conclusions and made recommendations. The recommendations highly recommend a legislative approach in addressing the issues of taxation of illegal income.

Conclusion

From the analysis of this thesis, the research has made a number of conclusions. The conclusion arrived are on the research questions set in the first chapter. From the comparative analysis of USA and South Africa, it can be determined that Kenya has a lot to do on taxation of illegal income. In analysing the two jurisdictions, it can be seen that the determination on taxation of illegal income has been between the between the aim maximizing government revenue and upholding public policy. In USA, a legislative approach has been taken with regards matters of illegal taxation. USA has dealt with the issue of illegal taxation for a long period of time. Its legislative approach has addressed the issues raised in this research hence applicable to Kenya. This research highly advocates for a legislative approach.

The Constitution of Kenya puts public policy above all. The Constitution focusses on the power belonging to the people and values. The first conclusion that can be made is that there is no explicit legislative mandate that allows Kenya Revenue Authority to collect taxes from illegal income. The court in its interpretation took quite a literal approach in stating that income under the Act included illegal income. Without a legislative approach, there are a lot of ambiguities that arise in the question of deductions and use of information and evidence from disclosure of illegal income in criminal prosecutions.

Since the Income Tax Act does not explicitly provide on taxation of illegal income. If income is income as per the *Yaya Tower* case, it means that it enjoys the same deductions as legal incomes.

This therefore signifies that there is need for reforms to specifically state that where illegal income is taxed, there are no allowable deductions. USA through the Internal Revenue Code do not allow deductions on illegal income. It is only a legislative approach that can correct this in Kenya.

The denial of allowing deductions is on a public policy basis in order to deter one from engaging in illegal activities. The denial of deductions for illegal businesses is meant to constitute a punishment. USA has in some laws allowed deductions of legal expenses and disallowed deductions in illegal expenses.

Illegal income can have both illegal expenses and legal expenses. In assessing such tax, if the government is considering public policy, it can either disallow any expense, either legal or illegal or allow illegal and legal income. However, this can go against the principle that all expenses that are wholly incurred in generating income be deducted to determine taxable income.

The legal framework in Kenya governing tax does not provide on how illegal income is to be treated. Though taxing illegal income is allowed, the taxing authority does not have a recognized and a legally provided guideline on how it should assess tax on such income. USA jurisdiction has provided on how such tax should be treated. Since its legal framework is highly developed, it has addressed matters of deductions and self-incrimination. This has been seen in a number of court cases and statutes. South Africa is also slightly ahead compared to Kenya in addressing the two issues. Kenya has a lot to borrow from the two jurisdictions.

Consideration of public policy is highly essential in the determination of the two issues especially on the question of deductions. Kenya has laid out in Article 10 of its Constitution, its national values and principles. These principles guide any decision that is to be made on matters of taxation. If the issue of illegal taxation comes before the Parliament, the Parliament can decide

on the grounds of public policy to exclude illegal income from taxation in order to discourage such activities.

On self-incrimination, the right is provided under the Constitution and it is protected. Under tax law, the right cannot be pleaded if one is statutory required to produce certain documents. This research is of the conclusion that every person must file tax returns. One cannot refuse to file tax returns by pleading the right against self-incrimination.

The determination that illegal income is taxable means that one has to disclose illegal income. Lack of disclosure attracts penalties and even criminal sanctions. The requirement for disclosure in the Kenyan legal framework does not provide adequate protection against self-incrimination. The aspect of self-incrimination comes out of the power of tax officers to compel for information from a tax payer and lack of confidentiality of that information. The Income Tax Act gives tax officers the power of a police officer. This means that a police officers can search, interrogate and produce evidence in court. This can go beyond the purpose of tax collection. Self-incrimination arises from the aspect that the information compelled from a tax payer can be used in both ta and non-tax criminal prosecution. If one refuses to answer questions of a taxation officer, the Act has made it an offence. The information collected can be used against him in tax related criminal prosecution. The Act allows the tax payer to pass the information to the police or Office of the Prosecutor. This leads to criminal prosecution in non-tax offences.

Self-incrimination is a right is provided under Article 49 and 50 of Constitution of Kenya,2010. As a constituent tight under the right to a fair trial, it cannot be limited as provided under Article 25. This means that the tax authority is under strict obligation not to release any information of a tax payer to investigative and prosecutorial authorities. This however is not provided for under

the current tax regime hence it can lead to abuse of this right when the tax payer discloses his illegal tax information.

Using tax law to prohibit and punish illegal activities goes against the purpose of tax. The court in the case of *Yaya* held that tax law was not concerned on whether income was legal or illegal. Its focus was on what amounted to income. If the tax authorities use the requirement of disclosure to nab those earning illegal income and present them before relevant authorities for prosecution, it will go against the purpose of taxation.

Recommendations

Having analysed the taxation of illegal income in Kenya, the suggestions for reforms from the analysis and conclusion made in this research are as follows:

- a) The Income Tax Act should be amended in order to capture the effects of the decision in *Yaya Tower* case. There is need to provide clarity on the aspect of deductions. Kenya should not adopt a practise of allowing deductions on illegal income. The common law doctrine of public policy should be applied in it. In consideration of public policy, those who benefit from illegal tax should not enjoy similar benefits to those who derive legal income. Illegal income should incur a heavier tax burden. This can be done by either disallowing deductions or only allowing legal expenses. USA in its Tax Law amended the tax laws to disallow deductions of expenses from illegal businesses.
- b) The Income Tax Act will need to define what can be termed as an illegal income. Illegal income can arise from both legal and illegal business. In *Yaya Tower* case, it arose from a legal business. Therefore, there is need to state if illegal income arising from a legal business and income arising from illegal business should be treated the same. This can

only come from definition. Both should not enjoy deductions. Illegal income should be defined as an income arising from an illegal business, contract or the income itself.

- c) Tax laws should provide stringent rules to prevent taxing authorities from disclosing information they get from tax payers as a result of disclosure of illegal income. Such information should only be used in matters of tax offences such as evasions and tax fraud. The prosecution should not use such information in court to prosecute against cases such as working without permit or license or activities such as smuggling. The Tax officers are limited to tax matters and should not compel tax payers to give them information while they are investigating them for criminal offences. The State should also not use this loophole to source for evidence for non-tax offences.
- d) The Tax authorities should assure every tax payer's information will be strictly confidential. When a tax payer discloses illegal income, the tax payer should not compel further information to establish the illegal income other than the tax obligations. Section 6 should be amended to only allow for disclosure of information for taxation on tax related matters to the Office of the Prosecutor. Kenya Revenue Authority has no mandate to investigate non tax offences or seek and pass information on matter unrelated to tax.
- e) On Section 58 and 59 of Tax Procedure Act, Tax officers should only seize documents for purposes of tax collection matters and not for prosecution of non-tax related matters. If one is arrested for tax offences, he should not be compelled to give information or evidence as provided under these provisions. If one is under criminal investigations, he should have a right to plead the right and refuse to give information without the threat of being persecuted for not coordinating with tax officers.

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