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**IFA 2016**

**Seminar B – Taxation of Illegal Activities  
26 September 2016**



# Seminar Participants

## Chair

- Colin Campbell, Western University (Canada)

## Panelists

- Peter Blessing, KPMG (USA)
- Mariana Eguiarte Morett, Sánchez Devanny (Mexico)
- Jacques Malherbe, Liedekerke (Belgium)
- Andrea Parolini, Maisto e Associati (Italy)
- John Prebble QC, Victoria University of Wellington (New Zealand)

## Secretary

- Kim Maguire, Borden Ladner Gervais (Canada)



# Overview

- General Rules – Common law approach
- General Rules – Civil law approaches
- General Rules – VAT
- Specific Issues
  - Proceeds of Theft and Fraud
  - Fines, Penalties, Restitution and Bribes
  - Confiscation
  - Relationship to Criminal Law
- Treaty-related Issues



# Relevant Themes and General Rules – Common Law Approach

John Prebble QC

Victoria University of Wellington (New Zealand)



## Scope of Seminar B

- Receipts that are caught as income (or as consumption for VAT purposes)
- No need to explore the meaning of “income” or consumption
- Issue: Does illegality make income or consumption non taxable?



# Default or unreformed law vs. Codified law

- Default position under judge-made law of taxation
- Law as reformed by statute



# General Rule


- Income of illegal activities just as taxable as income of legal activities
- *Minister of National Revenue (Canada) v Smith* governs in most Commonwealth countries that follow the common law
- Privy Council held that a bootlegger was taxable on his profits



# US Legislative Approach

- 1913 Revenue Act: tax on “lawful” income
- 1916 “Lawful” deleted





# US Constitutional Issue: Tax returns and self-incrimination

- Fifth amendment 1791, interpreted in
  - *Brushaber v Union Pacific Railroad* 240 U.S. 1 (1916)
  - *United States v Sullivan* 274 U.S. 259 (1927)
  - *Garner v United States* 424 U.S. 648 (1976).



# Islamic Law

- Illegal activities are “haram”
- All proceeds forfeited to the state
- Taxation does not arise



# Fundamentally Illegal vs. Illegal Manner

- Any difference between activities that are fundamentally illegal and legal activities carried on in an illegal manner?
  - Fundamentally illegal
  - Legal activities carried on in an illegal manner



# Examples of Fundamentally Illegal

- Drug dealing
- Burglary
- Kidnapping



# Examples of legal activities carried on in illegal manner

- Usury
- Rack renting in contravention of housing laws
- Manufacturing in contravention of labour laws
- Courier services that breach parking regulations



# Income Inclusions

- In most jurisdictions, income from both categories treated the same



# Limits on Deductions

- Any difference between the two categories?



# Deductibility of Penalties

- Any difference between the two categories?
- Rationale for non-deductibility





# Confiscations and Forfeitures

- Treated the same as penalties?



# Deductibility of costs of prosecution awarded against taxpayer

- In context of prosecutions by
  - the state and regulatory authorities, or
  - professional organisations



# Deductibility of expenses reimbursed to employees

- Where employees are reimbursed
- Deductibility by employer of penalties, prosecution costs, and defence costs
- Is the reimbursement taxable to the employee?



# Bribes

- Assessability
- Deductibility



# Proceeds of theft and fraud where property in the proceeds has not passed?

- Does failure of property to pass affect whether the receipt is income?



# Embezzlement

- Are there special rules for embezzlement?



# Embezzlement by Proprietors and Directors

- Is corporate veil breached?
- Embezzlement by directors - sometimes subsumed to the rules for proprietors even where directors are not major shareholder/proprietors



# Cross-border Issues: Semble

- If receipt is income in both countries: DTAs and unilateral relief would seem to operate as usual
- If receipt is not income in either country: DTAs and unilateral relief is irrelevant and may be ignored





## Cross-border Issues: Semble (cont.)

- If there is a conflict between the jurisdictions involved (taxable in one, not in the other) credit and exemption issues appear to be irrelevant, because there can be no double taxation



# General Rules – Civil Law Approaches in Europe

Jacques Malherbe, Liedekerke (Brussels)

Andrea Parolini, Maisto e Associati (Italy)



# General rules – Civil law approach

“The optimal rule is to tax the net income from any unlawful activity”

- Prof. Boris I. Bittker (Yale Law School): “Taxing Income from Unlawful Activities” (1974)



# General rules – Civil law approach

- The product of illicit actions (“*praetium sceleris*”) may never undergo income taxation as the delinquent
  - Has an obligation to retribute
  - Never had the legal disposal of the income
    - Oscar Díaz (Argentina), referring to B. Ribeiro de Moraes (Brazil)



# Belgium: Is there a taxable income?

- Is income arising from criminal offences never legally an asset of the offender because offender had an obligation to return it?
  - “Fruits” under civil law go only to possessor in good faith (Civil Code, art. 549-550)



# Belgium: Is there a taxable income? (cont.)

- No → on the basis of the principle of reality
- Tax law must be applied to licit and illicit activities



## Belgium: Is there a taxable income? (cont.)

- Example: Army colonel sells state secrets to foreign country
- 20 year jail sentence; money confiscated
- Taxed as miscellaneous income; wife jointly liable
- Claims husband was never owner of corruption money: rejected

Brussels, 12.10.2000, TFR, 2001, p. 61



# Income from illegal activities

- Which type of income is it?
- Business income?
- Illicit activity is part of a business?

E.g. sale of alcohol by an unlicensed café





# Income of separate business or profit raising activity

## Examples

- Corruption of civil servant
- Renting of premises used for prostitution



# Remuneration

- Causal relationship between income and employment examples
  - Civil servant who claims remuneration for services which must be supplied at no cost
  - Company director who embezzles money of the company



## Remuneration (cont.)

- Bank employee embezzles money of clients over years
  - Sentenced criminally
  - Taxed as "remuneration"
  - Supreme Court: not remuneration; not product of work (ICT, art. 31)
  - May be other type of income

Cass., 28.04.2016



# France

- Special presumption of income
- Property, instruments, money resulting from certain offences
  - Drug trafficking
  - Counterfeiting
  - Arms, alcohol, tobacco

CGI, art. 1649quater



# France

- Unnamed income
- Example: proceeds of bank robbery may not be considered as bank loan (defendent)?

CAA Nancy, 11.04.1996



# Income deductions

- Are expenses deductible?
  - E.g. damages paid to victim
- Courts have held that such expenses are not connected with the professional activity but arise in the private sphere if the offence is intentional
- Criticized: illogical



# Denial of deduction

Example: lawyer receiver of bankruptcy

- embezzles bankruptcy money
- he reimburses; but he is taxed
- Reimbursement not deductible because activity of embezzlement does not belong to activity as receiver and is even incompatible

Cass., 14.12.2007, RGCF, 2008, p. 397



# Acceptance of deduction

- The second Court of Appeal holds that deductible because obligation to reimburse incurred by reason of unlawful acts committed in the course of his professional activity
- Supreme Court agrees this time and reverses its previous decision

Cass., 22.11.2013, JDF, 2013, p. 321





# Acceptance of deduction

- Fines → Not deductible (ITC, art. 53, 6°)



# General principles - Italy

- Taxable under the schedular system
  - Usury: income from capital
  - Criminal activities: business/  
professional income
  - Extortion, bribery, theft: miscellaneous  
income (2006)
- Exception: income seized before year-end
- Computation taxable base follows character



# Case law - Italy

- Wrong characterization by TA does not exclude taxation
- Miscellaneous income
  - Bribes
  - Misappropriation of funds by professional
  - Illegal betting



# Deductions - Italy

- Application of general principles (character)
- Deduction of Anti-trust penalties
- Debate
  - Scholars and lower Courts
- Supreme Court: deduction disallowed
  - Non-business related
  - Need to keep the punitive ratio of penalties



# General Rules – Civil Law Approaches in Latin America

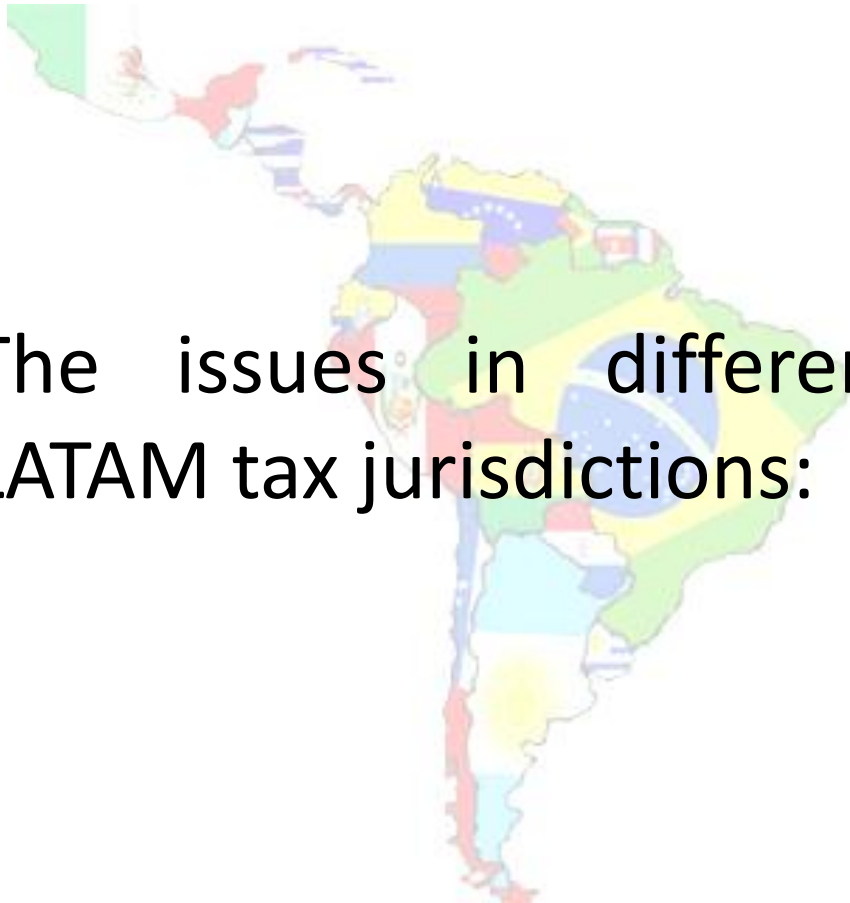
Mariana Eguiarte Morett  
Sánchez Devanny (Mexico)

# Outlining the issue in LATAM

- Should illegal income be taxed, such as the profits of crime or the gains of illegality? Arguments in favor and against taxation of illegal activities
- Assuming the illegal income is taxable, should the costs of those crimes and illegalities be deductible / should losses be allowed to offset legal income?



The issues in different  
LATAM tax jurisdictions:



ARGENTINA

BRAZIL

CHILE

MEXICO

PERU

# Arguments in favor of and against taxation

<b>In favor of taxation</b>	<b>Against taxation</b>
Legality of an activity should not be a condition to tax	Taxation of illegal activities is immoral
Tax law is independent	A single legal system
Equal treatment, self-determination, “pecunia non olet”	Self-incrimination principle



# Arguments in favor of and against taxation (Cont.)

In favor of taxation	Against taxation
Economic capacity	No enrichment / Fictitious economic capacity
Confiscation and taxation should exclude each other	Confiscation so no need to tax
Each case must be analyzed to avoid contradictory results affecting the victim.	Taxation could conduct to absurd results affecting the victim.

# LATAM tax laws

<b>LATAM Country</b>	<b>Rule</b>
Argentina	Income is taxed (obligation), but deductions or offset of losses are not allowed (right)
Brazil	Income from illegal activities is subject to tax, regardless of any other sanctions that might apply

# LATAM tax laws (Cont.)

LATAM Country	Rule
Chile and Mexico	Tax on all income, regardless of its origin
Peru	Income whose origin cannot be justified will be considered as an unjustified increase of assets. Income arising from illegal activities cannot be used to justify an increase of assets



# Latam judicial criteria

1. Illegality of activity irrelevant (no ethics in tax)
2. The taxed activity cannot be the performance of an illegal activity *per se*
3. Confiscation should exclude taxation
4. *Non bis in idem* (double jeopardy) does not exist if accused of tax crime and crime generating the illegal income



# EU VAT

Andrea Parolini

Maisto e Associati (Italy)



# EU VAT

- No explicit reference in VAT Law
  - Art. 9 (1) VAT Directive
- Several CJEU cases on illegal activities
  - Illegal activities *per se* → Non-VAT relevant
  - Activities *lato sensu* “legal” → VAT relevant
- Level playing field (competition)



# CJEU Landmark cases

- Illegal activities *per se*
  - Case 240/81 (*Einberger*)
  - Case 269/86 (*Moll*)
  - Case 289/86 (*Happy Family*)
- Activities *lato sensu* “legal”
  - Case C-158/98 (*Coffeeshop "Siberië"*)
  - Case C-3/97 (*Goodwin + Unstead*)
  - Case C-283/95 (*Fischer*)



# Domestic law

- Principle rarely implemented
  - Exceptions: e.g. Germany/Austria
    - Reference to “public morality”
- Similar approach in non-EU Law
  - E.g. Australia





# Application of VAT to illegal activities

- Need to apply the specific VAT regime
- Supply may be either taxed or exempt
- Scope of exemptions
  - Objective vs. subjective
  - Example: betting vs. medical care
- Right of deduction?
  - Case C-104/12 (*Becker*)
- Compliance obligation



# National courts

- Illegal medical profession (NL-F)
- Prostitution (IT-UK-NL-M-S) and procuring (F)
- Selling products to raise/produce drugs (NL)
- Alienation of anabolic steroids (UK)
- Renting windows in the red light district (guess where?)



# EU Custom code

- Absence of custom debt for introduction in EU of
  - counterfeit currency (if unlawful)
  - certain narcotic drugs and psychotropic substances



# Conceptual Difficulties Arising From Nature of Illegal Activities

John Prebble QC

Victoria University of Wellington (New Zealand)



# Conceptual problem is tension between...

- Regular tax law, and
- Policy: should illegal activities receive special treatment?
- Several examples
- E.g. penalties and forfeitures
- Other panellists



## Other areas

- Structural problems of the law
- Create automatic incoherencies
- Without referring to policy



# Extreme contrast

- Most western law
- Illegal business taxed in the ordinary way
- Islamic law
- State confiscates gross proceeds
- Tax is irrelevant



# Proceeds of theft and fraud

- Issue: *are the proceeds of theft and fraud taxable as income?*





# Default and modified rule

- What is the default rule?
- Problem
- Statutory modification



# US position

- Contrast: USA IRS Publication #17 Your Federal Income Tax for Individuals 2006 Catalog Number 10311G
  - If you steal property, report fair market value in income in the year you stole it
  - Unless in the same year you return it to its rightful owner.



# Commonwealth position

- In Commonwealth, e.g. NZ. takes a more formal approach
  - Stolen property not income
  - Because title has not passed



# Reversed by Income Tax Act 2007 s CB 32

- (1) If a person obtains possession or control of property
  - without claim of right
  - an amount equal to the market value of the property is income of the person.



# Deductions of expenses

- Automatic when calculating profits
- But what about drug dealer
- Buying trading stock?



# La Rosa [2003] CAFC 125

- Confirms no issue
- Even the standard rule on theft is available to drug dealers
- That is, dealer can deduct loss of takings
- When stolen by a thief



# La Rosa statutory reversal

- Income Tax Assessment Act 1997 s 26-54
- Paraphrase
- Cannot deduct outgoing
- Incurred in relation to a [serious] offence
- If convicted



# Fines, Penalties, Restitution and Bribes – US Perspective

Peter Blessing  
KPMG (USA)





# Some US Statutory Rules Denying Deductions—Relevant Law for Illegality

- Distinguish:
  - Illegal Payments, or fines or penalties for illegal conduct, vs
  - Ordinary course payments in connection with illegal activities



# Some US Statutory Rules Denying Deductions—Relevant Law for Illegality

- Bribes/kickbacks to domestic Govt personnel (IRC §162(c)(1))—test per Federal law.
- Payments to foreign Govt personnel if violates FCPA (IRC §162(c)(1))—Federal law but foreign law can be defense.
- Any other illegal payment (IRC §162(c)(2))—Federal law or-if generally enforced-State law.



## Some US Code Provisions Disallowing Deductions for Illegal Activities (Cont.)

- In each above case, parallel provision for “earnings and profits” of CFCs. IRC §964(a).
- Fines, etc. (IRC §162(f))—if illegality was under either Federal or foreign law.
- Antitrust treble damages for violation of (IRC §162(k): 2/3 of amount not deductible.



# US Federalism Issue in Certain Cases

- IRC §280E: No deduction or credit if trafficking in controlled substances prohibited by Federal or State law.
  - Marijuana production—illegal under Federal law, but States may deem legal
  - Statute enforced. E.g. *Feinberg* (2015)
- Also relevant to an organization's tax exempt status; Fed law governs. *PLR 201615018*.




# Certain General Principles Applied by US Courts to Cases Involving Illegal Activities

- Absent a statute, public policy considerations are often critical.
- Deduction permitted for compensatory amounts--payments to make victim whole (*not* for penalties/punitive damages).
  - E.g., PLR 201528026 (restitution to US Government deductible)



# Certain General Principles Applied by US Courts to Cases Involving Illegal Activities

- Settlements have the same treatment as if an actual decision were rendered.
  - TAM 200629030-settlement of anticipated Clean Air Act violation “analogous to a fine”
- Legal fees and related amounts to defend against claims of illegality are deductible.



# Commercial Transactions Involving Effect of Illegality on Deductions

- CAFE (Corporate Average Fuel Economy) penalties on auto manufacturer
  - Nondeductible fine under IRC §162(f). FSA 1459 (1994).
- Oil spills/environmental damage
  - BP Deepwater Horizon oil spill; compare Exxon Valdez oil spill.



# Commercial Transactions Involving Effect of Illegality on Deductions (Cont.)

- 2008 financial crisis – Settlements by large banks
  - Payments to FINRA (self-regulatory organization of securities industry) are nondeductible fines on theory that FINRA is an agency or instrumentality of the US Govt for this purpose. CCA 201623006.





# Commercial Transactions Involving Effect of Illegality on Deductions (Cont.)

- Antitrust settlements
  - Portion of civil settlement was deductible *to extent* allocable to sales/locations not covered in criminal case. PLR 201124004.



# Restitution can be Deducible

- Insider trading
  - Restitution required by securities laws could allow a loss deduction if taxpayer believed it had unrestricted right to the income. *Nacchio v. US* (Fed. Cl. 2014)



# Issue of Settlement Allocation Between Fine and Deductible Other Amount

- False Claims Act
  - Fresenius Medical Care Holdings Inc. (1<sup>st</sup> Cir. 2014) - taxpayer minimized amount allocable to nondeductible fine.
- See Public Interest Research Group report (Dec. 2015)
  - Classifying US agencies based on extent to which attempts made to limit deductibility.



# Public Policy Used to Deny Deduction of Loss where No Statutory Rule

- Freon smuggling (off the books transactions) to avoid excise tax
  - Funds forfeited in connection with a plea agreement reached in a criminal matter not deductible or allowed as loss as policy matter. *Wood v. US* (2003).



# Illegal Activity Conducted Offshore

- FCPA prohibition of foreign Govt bribes
- Amount disgorged under FCPA is nondeductible fine per §162(f). CCA 201619008
- Payments to foreign non-Govt individuals to obtain military contracts.
  - Deductible, as they were not themselves illegal, though taxpayer illegally hid them (mail fraud/false tax return). FSA 200128004.



# Public Policy Disallowed Statutory Exclusion from Income for Offshore Activity

- IRC §911 partial exclusion for income earned by US citizens offshore
  - Denied as a matter of policy for income derived in violation of US law. GCM 34213.



# Confiscation – European Perspective

Jacques Malherbe  
Liedekerke (Brussels)



# Confiscation

- Applies to
  - Economic benefits generated by the offence
  - Property substituted for such benefits
  - Income from those benefits (Crim. Code, art. 42, 3°)
- If benefits were spent or have disappeared, confiscation of an equivalent amount (Crim. Code, art. 43bis, § 2)





# Confiscation - example

- Example: Income received from a French company to corrupt a civil servant granting authorization to build a gazoduc
- Put in a Luxembourg account; confiscated
- Non bis in idem » No double jeopardy (art. 14.7, International Pact relating to civil and political rights)



# Confiscation - example (cont.)

- Taxation is no penalty
- Sanctions for two different offences:
  - Corruption
  - Non reporting of income



# Confiscation

- But what if confiscation pronounced for wilful unreporting of income?
- Unlawful benefit is non payment of tax

## 1. What if tax was paid before criminal judgment ?

- Same answer:
  - Tax is no penalty
  - Confiscation is a penalty



# Confiscation

## 2. What if tax increase imposed after criminal judgment ?

- Supreme Court - A country may impose two types of sanctions: Criminal or Administrative (even if repressive in nature)
- Court of Human Rights - no second penalty for "substantially the same offence"  
(10.02.2009 Zolotoukhine v Russia, Ghent, 3 March 2015)



# France

- Act contrary to the interest of the business or taking manifestly excessive risk?
- Unlawful expense is deductible if made in the interest of the business
  - E.g. amounts paid to the mayor of St-Tropez to obtain construction permits  
CE, 24.05.2006
  - E.g. payments of damages to victims of swindling in the profession



# France

Act of abnormal management?

- Conform with long term interest of business?
- Cour de Cassation
  - abuse of company property by active corruption
  - exposes author to criminal sanctions
  - *in se* contrary to reputation of business

Cass. crim., 27.10.1997



# France

- Consequences
  - A company cannot deduct amounts embezzled by a director but may deduct if embezzlement by an officer if the directors did not know, even though negligent CE, 5.10.2007
  - E.g. trader of Société générale: €1 billion loss accepted (2008)



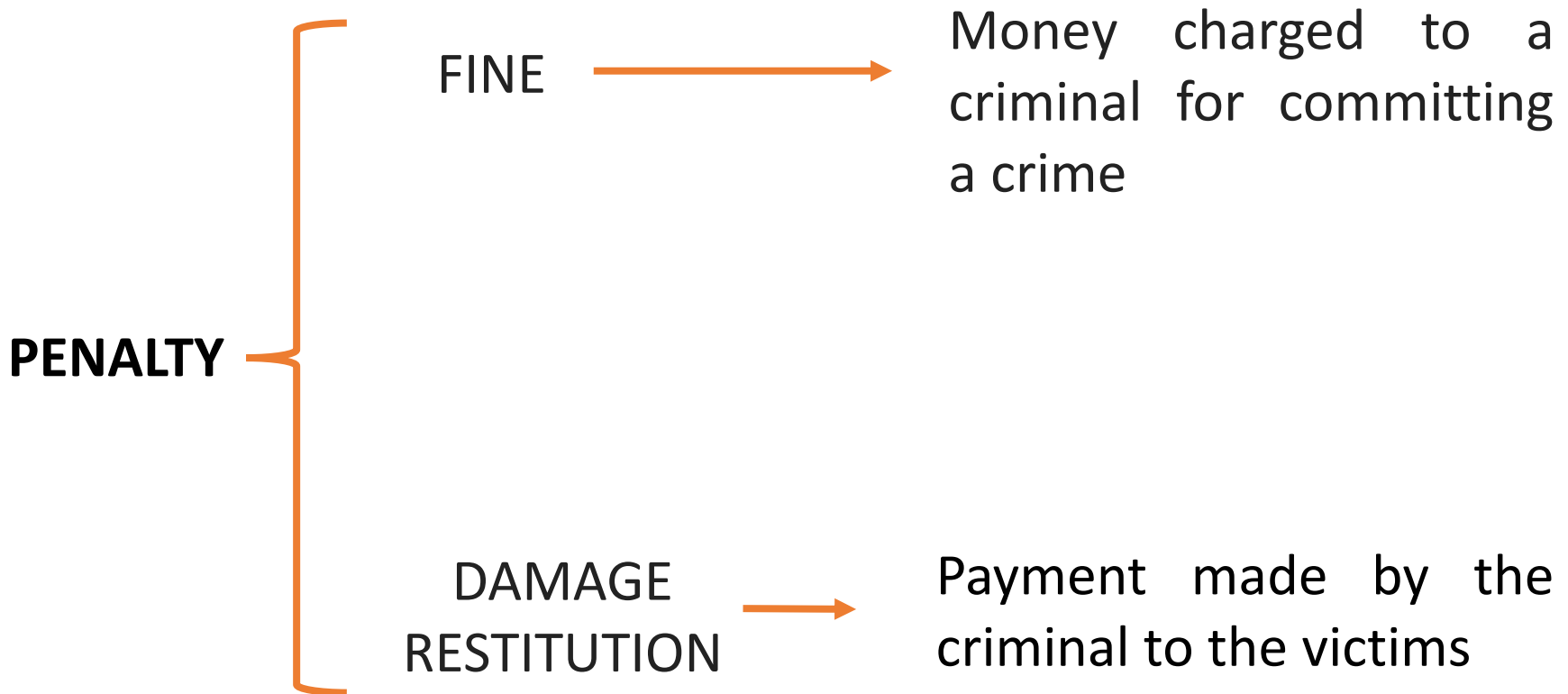
# Criminal Law and Taxation of Illegal Activities – Mexican Perspective

Mariana Eguiarte Morett  
Sánchez Devanny (Mexico)





# Criminal law financial disciplinary actions





# Restitution – criminal law and taxation of illegal activities

## Scope of Restitution?



Restitution is part of a judgement in a criminal case, ordering a defendant to compensate the victim for losses suffered as a result of the crime.

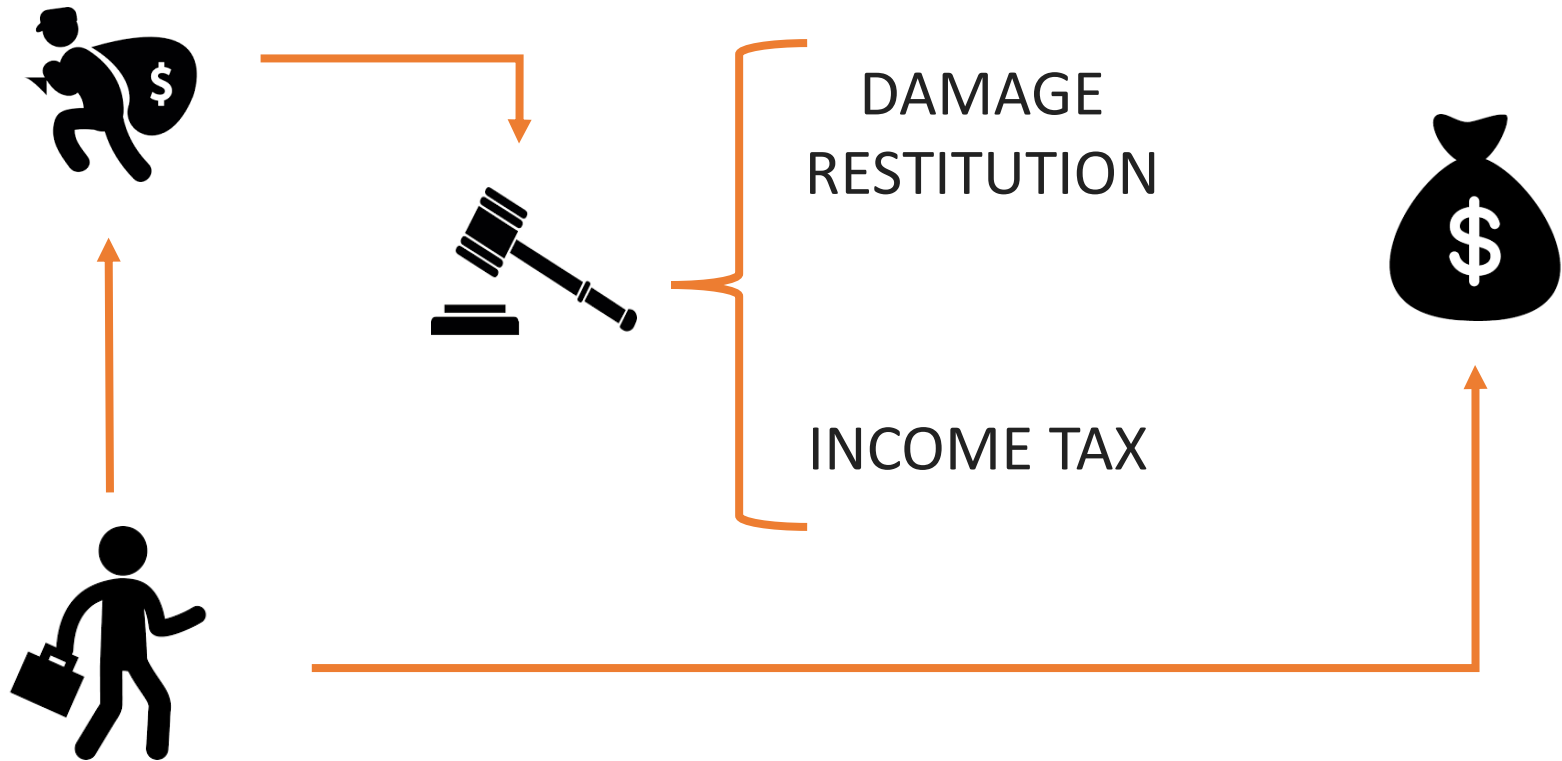


Victim suffered financial damages



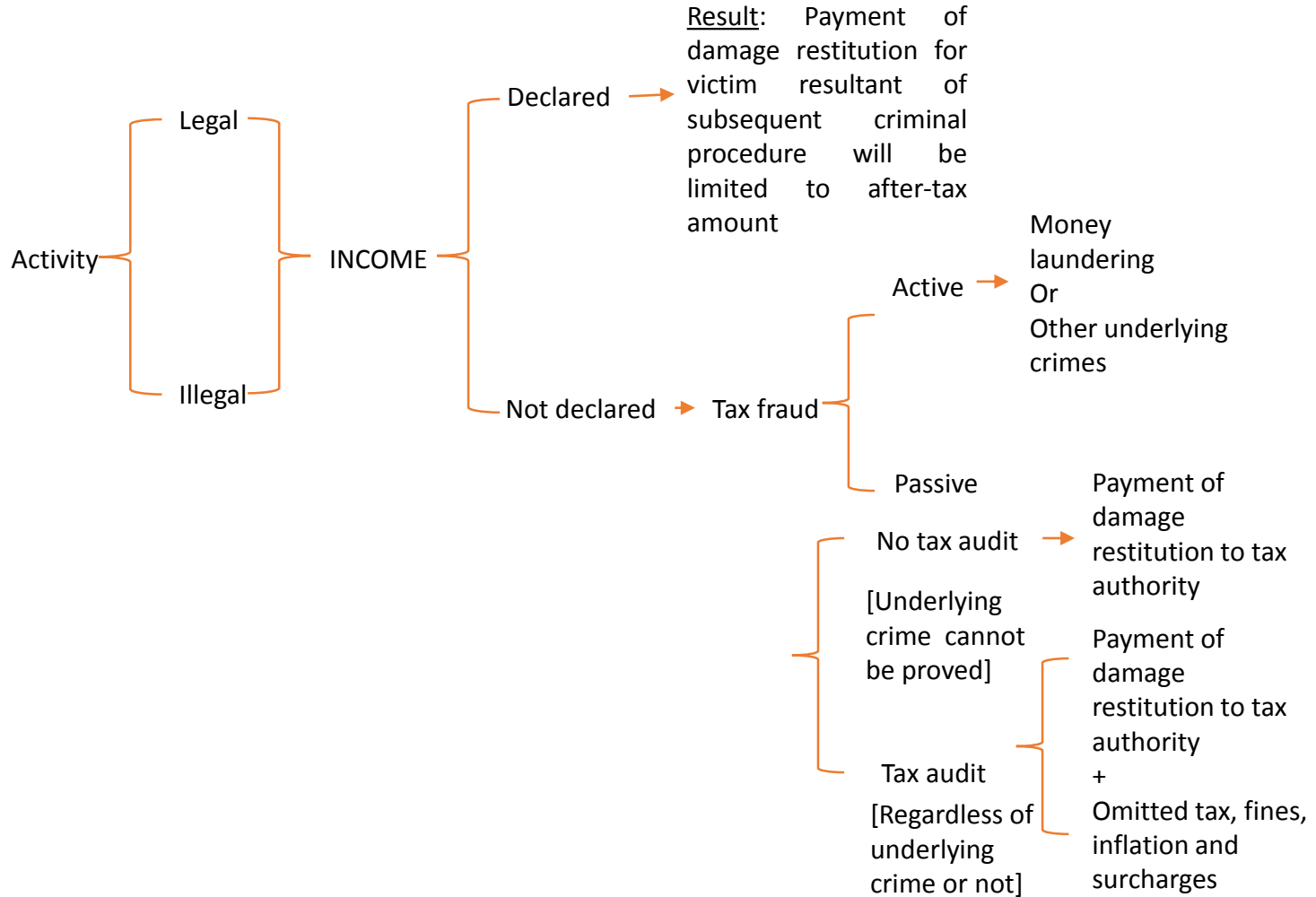
Restore a person to financial condition prior the crime

# Criminal law application consequences





# Taxation of illegal activities (Mexico)





# Treaty-related Issues

Peter Blessing  
KPMG (USA)



# Treaty Aspects of Illegal Activity: How Do Treaties Address Currently?

- No provision in Models or most treaties.
- But 1973 USSR-US (now CIS-US) treaty Art. VIII
  - “This Convention shall apply only to the taxation of income from activity conducted in a Contracting State in accordance with the laws and regulations in force in such Contracting State.”



# Treaty Aspects of Illegal Activity: : How Do Treaties Address Currently? (Cont.)

- Effectively saying Source Country may deny Treaty benefits, and arguably access to MAP, with respect to income from activity not “in accordance with” its laws.
- Included at request of USSR.
- Still in certain US treaties with former Soviet Republics (CIS countries)
  - E.g., Armenia, Azerbaijan, Uzbekistan



# Treaty Aspects of Illegal Activity – What Should Be the Approach?

- Should the OECD Model treaty specifically deny benefits for illegal activities?
- Or should it be agnostic on legality or even reject its relevance?
- Absence of precedents may indicate something





# Treaty Aspects of Illegal Activity – Access to MAPS?

- Should illegality be relevant to MAP access?
  - 2008 addition of par. 26 to the Commentaries on Art. 25:
    - In the context of “abusive transactions” or “serious violations of domestic laws resulting in significant penalties,” certain States may wish to deny MAP access.



# Treaty Aspects of Illegal Activity –MAPS Access? (Cont.)

- But BEPS Final Report Action 14 p. 15 and Manual on Effective Mutual Agreement Procedure p. 22 (with reference to abusive transactions, *open access policy*).
- Chance to have dialogue on what is “abusive.”



# Treaty Aspects of Illegal Activity—Which Law?

- Issue of differing views of legality/tax abuse.
  - Issue of fundamental illegality vs. regulatory infraction
- What if the activity is legal in Source Country but not in Residence Country, or vice versa (classification/qualification conflict)?
  - Source Country's own rules apply re its allocable taxing rights? Compare Art. 3(2)



# Treaty Aspects of Illegal Activity—Which Law? (Cont.)

- Residence Country's own rules apply re Double Tax Relief-
  - If any limitation, should legality under foreign law be relevant? Compare FCPA, supra
- E.g., OECD Anti-Bribery Convention strives for common standard.



# How Would Courts React under Current Law?

- Importance of public policy considerations
  - Compare concepts of treaty abuse or *fraus legis*.
- Art 7 available if Country A resident carries on an illegal business in Country B w/o a PE?
- W/H tax relief available for illegal income?



# How Would Courts React under Current Law? (Cont.)

- Treaty tiebreaker rule to claim non-US residence and treaty protection?
  - US v Kaushanksy (WD Pa. 2007) (judge allowed Russian residence per treaty as defense in taxation of illegal activity).
- Double tax relief available?
  - Why require double taxation?



# Treaty Provisions Used Aggressively in Tax Cases if Illegal Activities

- Affirmative use of treaties against violations of non-tax (or tax) law
  - Pasquantino case re collection of tax despite revenue rule (RICO/wire fraud)
  - Former Swiss info exchange standard: fraud
  - US v Phillips: info obtained per treaty usable in US tax evasion case even if would be suppressed if accessed domestically. Cf. MLAT



# Panel Discussion on Treaty-related Issues





# Treaty issues

## Residence State

COMPANY X  
Construction company

## Source State



### FACTUAL BACKGROUND

Company X has a building site in S State (7 months)  
Activity in breach of national legislation (S State)  
Company X subject to tax in R state  
S State domestic law: PE if more than 6 months  
R-S Treaty: PE if more than 12 months

**Can S State deny treaty benefits?**



**Questions?**



**Thank you, gracias, grazie, merci!**