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Tax Brief

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Commissioner of Taxation v La Rosa [2003] FCAFC 125 - Deductions for Drug Dealers

In the decision of Commissioner of Taxation v La Rosa [2003] FCAFC 125 (5 June 2003), the Full Federal Court of Australia (per Carr, Merkel and Hely JJ) dismissed the appeal by the Commissioner against the allowance of a deduction in respect of money stolen from Francesco Domenico La Rosa (the "taxpayer"), a convicted drug dealer. The Court also dismissed a cross-appeal by the taxpayer that he was denied procedural fairness by the Administrative Appeals Tribunal ("AAT") by its decision not to issue summons to two Australian Federal Police ("AFP") officers to give evidence in support of the taxpayer's contention that the stolen monies were not his but those of the AFP.

Background

The decision was an appeal and cross-appeal from the decision in the Federal Court of Australia of Nicholson J in Commissioner of Taxation v La Rosa (2002) 50 ATR 450. That case was an appeal from the decision in the AAT of Deputy President Barnett and Senior Member Fayle in Case [2000] AATA 625.

In the years leading up to his conviction, the taxpayer had been in the businesses of running a mechanical workshop and drug dealing. In 1996, the taxpayer was sentenced to an effective term of 12 years and four and half months imprisonment after pleading guilty to charges relating to the importation and possession of drugs including heroin: La Rosa v The Queen (1999) 105 ACrimR 362. Also in that year, the taxpayer forfeited property to the value of $264,610 under the Proceeds of Crime Act 1987 (Cth).

What interested the Commissioner in the taxpayer was that he had not lodged income tax returns for the years ended 30 June 1990, 1991, 1992, 1993, 1994, 1995 and 1996. The Commissioner therefore issued default notices of assessment on the taxpayer pursuant to s167 of the Income Tax Assessment Act 1936 (the "1936 Act") for those income years. Relevantly for the purposes of discussing the decision of the Full Federal Court, the Commissioner included in the assessable income of the taxpayer $220,000 that was accumulated from drug dealings for use in the business and had been buried in the taxpayer's backyard and dug up for an intended drug deal in May 1995 but had been stolen from the taxpayer during that intended drug purchase.

The taxpayer lodged objections to these income tax assessments claiming that they overstated his income for those income years. However, the Commissioner disallowed the taxpayer's objection, so the taxpayer appealed the decision to the AAT.

AAT Decision

The taxpayer objected to the assessments of the Commissioner on various issues that were considered by the AAT in its decision. However, for the purposes of this discussion of the Full Federal Court's decision, the issues will be limited to the assessability of the $220,000 accumulated by the taxpayer from drug dealing proceeds and the deductibility of the $220,000 stolen from the taxpayer during the intended drug purchase in May 1995.

Was the $220,000 Assessable?

Although the taxpayer, representing himself, argued that the $220,000 was not assessable on the basis that the money had been provided to him in his role as agent provocateur for the AFP, the Tribunal found that the taxpayer's evidence was unreliable and preferred the evidence of the son-in-law. The son-in-law stated that this money was the accumulation of proceeds received by the taxpayer in the course of his drug dealing business.

In considering the assessability of the income derived from illegal business activities, the Tribunal considered various overseas authorities and concluded that the 1936 Act does not differentiate as potentially assessable income between income that is derived from legal or illegal activities. In this regard, it is noted that the Commissioner has expressed his views on the assessability of proceeds from illegal activities and the treatment of amounts recovered in Taxation Ruling TR 93/25. In that Ruling, the Commissioner considered that, inter alia, receipts from a systematic activity where the elements of a business are present are income irrespective of whether the activities are legal or illegal (at para 5). Therefore, based on the facts, the Tribunal found that the taxpayer was, at material times, a resident of Australia carrying on an illicit business of trading drugs with a view to profit. On this basis, the Tribunal found that the $220,000 had been correctly included in the assessable income of the taxpayer under s25(1) of the 1936 Act by the Commissioner.

Was the $220,000 Deductible?

Although the taxpayer had not made it a ground for his objection to the assessments made by the Commissioner under s167, as a matter of procedural fairness as the taxpayer had little tax knowledge and was representing himself, the Tribunal considered whether the taxpayer should be entitled to a deduction for the stolen funds under ss51(1) or 71 of the 1936 Act.

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Up to the 1997/98 income year, broadly s71 allowed a deduction where a loss was incurred by a taxpayer through embezzlement, larceny, defalcation or misappropriation by a person employed by the taxpayer not being a person employed solely for private or domestic purposes. Although the money was stolen from the taxpayer (ie larceny), this was not done by a person employed by the taxpayer. Section 71 would therefore not entitle the taxpayer to a deduction.

Up to the 1997/98 income year, s51(1) allowed a deduction for losses or outgoings incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing such income, except, inter alia, to the extent that the loss or outgoing is of capital or of a capital nature.

The Tribunal found that there was clearly a loss to the taxpayer as the money had been stolen from the taxpayer. The issue therefore became whether the amount stolen was a loss on revenue account incurred in the course of carrying on the drug dealing business or whether the loss was a loss of capital.

The Tribunal relied heavily on the Full Court of the High Court's decision in Charles Moore (WA) Pty Ltd v Commissioner of Taxation (1956) 95 CLR 344. In that case, the Court considered the deductibility of a sum of money stolen at pistol point whilst the previous day's takings of a retail store were being taken to a nearby bank for depositing. In holding that the amount was an allowable deduction under s51(1), Dixon CJ, Williams, Webb, Fullagar and Kitto JJ made the following observations (at 350-1):

> *"Banking the takings is a necessary part of the operations that are directed to the gaining or producing day by day of what will form at the end of the accounting period the assessable income. Without this, or some equivalent financial procedure, hitherto undevised, the replenishment of stock in trade and the payment of wages and other essential outgoings would stop and that would mean that the gaining or producing of the assessable income would be suspended…"*

Furthermore, the Tribunal considered the decision of Rich J in Commissioner of Taxation (NSW) v Ash (1938) 61 CLR 263. In that case, Rich J stated:

> *"There is no difficulty in understanding the view that involuntary outgoings and unforeseen or unavoidable losses should be allowed as deductions when they represent that kind of casualty, mischance or misfortune which is a natural or recognized incident of a particular trade or business the profits of which are in question. These are characteristic incidents of the systematic exercise of a trade or the pursuit of a vocation."*

In applying these cases, the Tribunal did not consider that the illegality of the drug dealing business was an important issue in determining whether a deduction should be allowed under s51(1). Strangely, the Tribunal found comfort in the fact that the business was illegal as, applying Ash, the members considered that this would increase the chances that the taxpayer would be robbed as they would be

less inclined to report such a theft to the authorities. Rather, the Tribunal considered that the important issue was whether the robbery during the intended drug purchase was directly connected with the gaining or production of the taxpayer's assessable income. Based on the facts of the case, the Tribunal found that there was such a connection.

The Commissioner argued that even if these authorities applied, the taxpayer would not be entitled to a deduction under s51(1) as it formed part of the capital of the taxpayer. However, the Tribunal found that the acquisition of the drugs was done as part of the replenishment of trading stock rather than the acquisition of an enduring benefit (eg securing a future supply of drugs). On this basis and applying Charles Moore, the Tribunal found that the loss of the stolen money was not on capital account.

The Tribunal therefore allowed a deduction pursuant to s51(1) for the $220,000 in the year ended 30 June 1995 for the money stolen from the taxpayer during the intended drug purchase.

Federal Court – at First Instance

For the purposes of discussing the decision of the Full Federal Court, the comments below will be confined to the Commissioner's appeal against the Tribunal's decision to allow the taxpayer to deduct the stolen funds on the basis that the Tribunal had erred in law in finding that the stolen amount as the Commissioner argued that deductions pursuant to s51(1) are confined to legitimate activities. Also, the Commissioner amended his claim to argue that the stolen funds were not deductible on public policy grounds.

Did the Tribunal Err in Law?

The Commissioner contended that deductions under s51(1) are only allowable for losses and outgoings arising out of "legitimate activity" to gain or produce assessable income. The Commissioner sought to find support in the long established principle that fines and penalties are non-deductible on the basis that their very nature severs them from the expenses of trading as it is inflicted on the offender as a personal deterrent and it is not incurred by them in the character of a trader (see, for example, The Herald and Weekly Times Ltd v Commissioner of Taxation (1932) 48 CLR 113).

However, Nicholson J found that it was not open to him to draw a wider analogy from the fines and penalties cases to deny a deduction for the monies stolen in the course of acquiring the drugs of his business (at para 58). In support of this finding, his Honour referred to various cases, including the decision of Dixon J in Commissioner of Taxation v Snowden & Willson Proprietary Limited (1958) 99 CLR 431. In that case, the issue was whether monies expended by a company on advertising in the press to counter the effect of press reports concerning

allegations against it and legal costs in respect of a royal commission were deductible, and Dixon J stated (at 437):

> *"There is no analogy here to cases in which fines or penalties are incurred. There the character of the expenditure and the reasons why the law imposes a fine or penalty separate the expenditure from the conduct of the business. It is not the point that the conduct penalized found its motive in business consideration. Nothing of the kind can be said of the expenditure now under consideration…"*

Counsel for the Commissioner also made submissions that the Victorian Supreme Court's decision in Mayne Nickless Ltd v FCT (1984) 15 ATR 752 stood for the principle that the courts will not allow a person to benefit from their own wrongdoing. However, Nicholson J distinguished this case on the basis that Mayne Nickless involved the deductibility of fines incurred by employees in respect of traffic offences that were paid by the employer. Indeed, counsel for the Commissioner accepted that the allowance of a deduction for the stolen monies would not frustrate the enforcement of the criminal law (at para 95), unlike where the effect of a fine or penalty would be reduced by the allowance of an income tax deduction.

Moreover, with regard to the submissions by the counsel for the Commissioner that deductions pursuant to s51(1) should be only be available for legitimate business activities, Nicholson J stated (at para 59):

> *"To adopt the use of legitimacy would seem to introduce a measure of subjectivism which would give rise to uncertainty in the application in the law. More fundamentally, the contentions for it do not disclose any foundation either in case law or in the wording of the ITAA upon which such a concept could be approached. In my view, it is essential to adhere to application of the words of the ITAA in s51(1)."*

For these reasons, Nicholson J dismissed this ground of appeal.

Public Policy Considerations

Counsel for the Commissioner contended that to allow a deduction pursuant to s51(1) for funds stolen in the course of criminal activity was contrary to public policy. In this regard, it was submitted that there is recognition in Australian taxation law that expenditure in connection with breaches of the law was in a separate category from other expenditure incurred in carrying on a business and that the weight of judicial authority denies a deduction to a taxpayer who incurs expenditure with respect to a breach of the criminal law. On this basis, counsel for the Commissioner submitted that s51(1) may be limited by public policy considerations, referring to several authorities including the following comments from the decision of Deane and Fisher JJ in Magna Alloys &Research Pty Ltd v Commissioner of Taxation (1980) 49 FLR 183 (at 214-215):

> *"It is somewhat difficult to understand how it can be maintained, as an unqualified position, that the nature of a penalty severs it from the expenses of trading. Recurrent penalties for parking infringements incurred by a delivery man and per diem penalties for unlawfully using premises for business or commercial purposes in contravention of zoning requirements are not, for example, logically severed from the expenses of trading. The same can be said of fines imposed for actually engaging in some unlawful activities, such as illegal bookmaking or soliciting, for the purpose of earning assessable income. If, when the matter directly arises for decision in the Australian course, it is to be held that all fines and penalties are to be denied deductibility under the Act, it would seem preferable that it be on the basis of some perceived overriding consideration of public policy which precludes deductibility."*

As stated above, although public policy was applied in Mayne Nickless to disallow the deductibility of fines and penalties and so prevent frustration of the legislative intent to punish and so avoid the diminishment or lightening of that punishment (at para 95), that case was confined to fines and penalties imposed by parliament. It was therefore submitted by counsel for the Commissioner that to allow a deduction would act as an incentive and not a deterrent or additional penalty against criminal activity. However, Nicholson J stated as follows (at para 97):

> *"Once the circumstances in issue are removed from frustration of a legislatively defined penalty, the scope for intervention lacks clear boundaries of principle. The allowance of a deduction for moneys expended on a criminal business, in circumstances where the income of that business is taxable, is consistent in principle and with the ITAA 1936. Present authority supporting the imposition of a public policy limitation does not extend beyond instances of fines and penalties. No basis of principle is readily apparent to extend that basis. Courts should not do so in the absence of such apparent principle because to do so would arguably attract the aura of the function of legislation. There is no basis for doing so where there is no frustration of criminal enforcement. Such encouragement to criminal activity as a deduction may provide is not a frustration to criminal enforcement: it is arguably an anomaly to which Parliament should give attention."*

For these reasons, Nicholson J found that the public policy argument made for the Commissioner could not succeed.

Full Federal Court

The Commissioner appealed the decision of Nicholson J to the Full Federal Court and contended that the deductions should not have been allowed on various grounds. However, the main issue considered by the Court was whether expenses incurred in the conduct of an unlawful business were deductible, particularly on public policy grounds.

Hely J gave the leading judgment of the Full Court of the Federal Court, to which Carr and Merkel JJ essentially concurred. Based on the decision of Burchett J in MacFarlane v Commissioner of Taxation (1986) 13 FCR 356, his Honour concluded that "there is a body of authority which justifies the proposition that the illegal nature of a receipt does not deny its taxability" as "to hold otherwise would be to favour dishonest businesses over honest ones" (at para 21). Carr J concurred with these conclusions, but with some hesitation (at para 5).

Deductions for Losses from Theft

Hely J accepted (at para 28) that the AAT had correctly found that the $220,000 stolen from the taxpayer was incurred in the course of gaining or producing assessable income because it was lost during a robbery connected with a drug purchase operation directly connected with the taxpayer's illicit drug dealing business. However, Hely J considered in more detail whether the deduction for this loss should be denied on the basis that it was capital.

His Honour considered the decision of the High Court in Guinea Airways Ltd v Federal Commissioner of Taxation (1949) 83 CLR 584. In that case, it was considered whether the difference between the cost price of the goods destroyed when Japan invaded New Guinea and the amount received by way of compensation for stock destroyed were a deductible loss under s51(1). The Commissioner had denied the deduction for this loss on the basis that it was capital. In deciding this case, the Court distinguished between stock in trade (for which a loss would be deductible) and a permanent stock of spare parts which would form part of the profit yielding subject (for which a loss would not be deductible). The Court found that the reserves were of such a large size that they were "beyond any requirements for prospectively immediate use" (at 590) and were therefore regarded as capital.

Hely J also stated (at para 32) that whether money is held as a revenue asset or as a capital asset or on private account depends on the circumstances of the holding. Therefore, where a taxpayer stores money, that money may be capital if it is part of the structure of the business or if it is held for use when needed in the business and is in the nature of a capital reserve. However, Hely J stated that Professor Parsons in Income Taxation in Australia Parsons RW (1985), Income Taxation in Australia, The Law Book Company. at [6.62] stated that "provided money is not held in the bank account in such an amount that it may be regarded as stored…it should be regarded as a revenue asset and not a capital asset."

Based on the AAT's findings, the stolen cash was, at the point of loss, earmarked for use in connection with the acquisition of drugs as trading stock. As the cash had been earmarked for use in the derivation of income, Hely J found that it was circulating capital. Therefore, ignoring the illegality of the activities, Hely J found that the AAT was correct in allowing a deduction for the $220,000 stolen from the taxpayer.

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Would Public Policy Disallow the $220,000 Deduction?

The Commissioner's main submission was that the policy of the law is not served by allowing a deduction to the taxpayer for the stolen money. As stated by his Honour , the Commissioner's argument was that "if allowed, the deduction will be given for an outgoing or loss that is clearly and sharply prohibited by the declared criminal law" (at para 48).

Hely J accepted (at para 54) that if an unlawful business was assessed on its income and not permitted a deduction for its expenses, that persons would be deterred from engaging in unlawful business rather than in one which is lawful. However, his Honour also considered that the allowance of a deduction for expenses incurred or losses sustained in the conduct of the drug dealing business does not frustrate the operation of the criminal law, nor will any sanction imposed by that law be diluted by the allowance of a deduction for business expenses or losses (unlike the result that would occur if a deduction was allowed for fines and penalties imposed by parliament or the courts). Rather, his Honour stated that (at para 55):

> *"[T]he purpose of the ITAA is to tax taxable income, not punish wrongdoing. The language of ss17, 25, 48 and 51 of the ITAA is indifferent as to whether the income , loss or outgoing in question has its source in lawful or unlawful activity. Tax is imposed upon taxable income, not upon assessable income. There should not be a higher burden of taxation imposed on those whose business activities are unlawful than that imposed in relation to lawful business activities. Punishment of those who engage in unlawful activities is imposed by the criminal law, and not by the laws in relation to income tax."*

It is noted that Carr J agreed that "punishment of those who engage in unlawful activities is imposed by the criminal law and not by laws in relation to income tax" (at para 9).

Hely J also stated that it was the role of the legislature, not the Courts, to determine whether a loss or outgoing otherwise falling within s51(1) should not be deductible on public policy grounds or otherwise.

Recognising that the submissions of counsel for the Commissioner stemmed from decisions of the courts in the US regarding deductibility and public policy, his Honour considered those authorities in relation to the deductibility of penalties and fines or losses incurred as a result of forfeitures occurring by operation or force of law. However, his Honour concluded that these authorities went beyond the position reached in Australian case law (at para 58).

With Carr and Merkel JJ agreeing with Hely J, the Full Federal Court therefore unanimously rejected the Commissioner's public policy submission.

Comments

Carr J stated in La Rosa that he considered the application of the tax laws to the activities of drug dealers, as a matter of public perception, amounts to condonation of those activities, although it is fortunate that such cases rarely reach the courts with this case being the first of its type in Australia (at para 8). Furthermore, his Honour agreed with the comments of Nicholson J at first instance where he stated that "the result may be an anomaly to which Parliament should give attention" (at para 10).

In response to the Full Federal Court's decision in La Rosa, the Assistant Treasurer has announced in Press Release No C053/03, 10 June 2003, that the Federal Government will consider changing the law to ensure that tax deductions related to income gained from illegal activities are disallowed. If such measures are introduced, taxpayers engaged in illicit business activities would be treated extremely harshly as they would effectively be taxed at their marginal tax rates on the gross proceeds of that business. But perhaps that is the whole point of introducing such provisions.

The concept of treating different classes of taxpayers in different ways so as to discourage particular behaviour is well established in the income tax legislation. For example, the net income of a trust under Division 6 of Part III of the 1936 Act is taxed at the highest marginal tax rate plus Medicare levy pursuant to s99 of the 1936 Act where there is net income to which no beneficiary is presently entitled to discourage the accumulation of funds within trust structures. Other examples include s26-5 which denies deductions for amounts payable by way of penalty under any Australia or foreign law or ordered to be paid on the conviction of an entity for an offence against an Australian or foreign law, and ss26-52 and 26-53 of the 1997 Act which deny deductions for losses or outgoings incurred in bribing public officials.

Peter Hill in "Morality and tax" (2003) 32 AT Rev 069, and Carr and Hely JJ in the Full Federal Court decision in La Rosa,have expressed the opinion that the income tax legislation should tax income and not punish wrongdoing, as punishing wrongdoing is the role of the criminal laws. As discussed by Hill, La Rosa is a perfect example of a case where the criminal laws have punished the taxpayer sufficiently without the need to revert to the income tax legislation for further punishment. Hill points out that the taxpayer in La Rosa was convicted and sentenced to more than 12 years imprisonment, was abused in prison on account of his perceived previous role as a police informant, and his possessions were confiscated under the Proceeds of Crimes Act 1987 (Cth).

However, rather than viewing the denial of deductions for illicit activities as being a penal measure, the parliament may consider that further discouragement is necessary. The deterrent effect that denying deductions for illicit business activities was discussed by Hely J in the Full Federal Court decision of La Rosa at 54:

> *"It may well be that if an unlawful business was assessed on its income, and not permitted a deduction for its expenses, that persons would be deterred from engaging in an unlawful business, rather than in one which is lawful (although there is an element of unreality inherent in this proposition)."*

Should the harshness of an outright denial of all deductions for losses and outgoings incurred in illicit activities prove to be unduly harsh, the Federal Government might instead consider introducing a system for quarantining losses from illicit business activities to prevent such losses from being used to offset other assessable income, similar to the provisions in Div 35 that deal with non-commercial losses.

At the end of the day, as stated by Carr J in his judgment in the Full Federal Court hearing of La Rosa (at para 8):

> *"There is a degree of unreality in a statutory expectation that drug dealers will file returns of their income."*

One suspects that the response to date was mainly designed to combat outraged headlines rather than reflecting hard thinking about the matter. What level of illegality will be enough? Will someone who carries on a business in breach of licensing or regulatory provisions be caught if there is an offence committed in doing so? Perhaps the Government would be better leaving the matter alone. Nothing has been done to date about the decision in Zobory (1995) 30 ATR 412 that embezzlers are not taxable on the interest earned on their ill-gotten gains, despite a recommendation of the Ralph Committee to deal with the matter.

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