UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

TAXATION OF DERIVATIVE FINANCIAL INSTRUMENTS:

NATURE AND TIMING OF INCOME AND EXPENDITURE

Mini dissertation by

JABULANI STEVEN MASONDO

(Student number 25447450)

submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII (TAXATION)

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

Study leader: Adv RD (Redge) de Swardt

March 2009

CONTENTS PAGE

ABSTRACT

TAXATION OF DERIVATIVE FINANCIAL INSTRUMENTS:

NATURE AND TIMING OF INCOME AND EXPENDITURE

by

JABULANI STEVEN MASONDO

STUDY LEADER	:	ADV RD (REDGE) DE SWARDT
DEPARTMENT	:	TAXATION
DEGREE	:	MAGISTER COMMERCII (TAXATION)

The purpose or objective of this dissertation was to analyse the current income tax treatment of derivative financial instruments in South Africa. In the context of financial markets, derivative financial instruments are mainly used for hedging and speculation.

The dissertation considers whether the current South African Income Tax Act deals with the income taxation of derivatives with respect to gains and losses and the timing of those gains and losses.

With regards to the nature of gains and losses arising from derivative transactions, the aspect which was considered is whether gains and losses were of a capital or revenue nature in the context of speculation or hedging. With regards to the timing of gains or losses, the dissertation considers when gains and losses should be brought into taxable income of a taxpayer.

The following examples of derivative financial instruments were analysed: cross currency swaps, index options, credit default swaps and contracts for differences (CFDs). These derivatives were analysed with respect to the nature and timing of the gains or losses when hedging or speculating.

The impact of the provisions of the Eighth Schedule is also considered with respect to the derivatives mentioned above.

OPSOMMING

BELASTING OP AFGELEIDE FINANSIËLE INSTRUMENTE:

AARD EN TYDSBEREKENING VAN INKOMSTE EN UITGAWES

deur

JABULANI STEVEN MASONDO

STUDIELEIER	:	ADV RD (REDGE) DE SWARDT
DEPARTEMENT	:	BELASTING
GRAAD	:	MAGISTER COMMERCII (BELASTING)

Die doel van hierdie verhandeling was om die huidige belastinghantering van afgeleide finansiële instrumente in Suid-Afrika te ontleed. In die konteks van finansiële markte word afgeleide finansiële instrumente hoofsaaklik vir verskansing en spekulasie gebruik.

Die verhandeling oorweeg of die huidige Suid-Afrikaanse Inkomstebelastingwet aandag skenk aan inkomstebelasting op afgeleide instrumente ten opsigte van wins en verlies, en die tydsberekening van daardie wins en verlies.

Met betrekking tot die aard van wins en verlies voortspruitend uit afgeleide transaksies is die aspek wat oorweeg is of wins en verlies in die konteks van spekulasie of verskansing van ’n kapitale of inkomsteaard is. Wat die tydsberekening van wins of verlies betref, oorweeg die verhandeling wanneer wins en verlies by ’n belastingbetaler se belasbare inkomste ingesluit behoort te word.

Die volgende voorbeelde van afgeleide finansiële instrumente is ontleed: kruisvalutaruiltransaksies, indeksopsies, kredietverstekruiltransaksies en prysverskilkontrakte. Hierdie afgeleide instrumente is ten opsigte van die aard en tydsberekening van die wins of verlies op verskansing of spekulasie ontleed.

Die impak van die Agste Bylae se bepalings is ook met verwysing na bogenoemde afgeleide instrumente oorweeg.

GLOSSARY

Financial Instrument:	a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity
Derivative:	A financial instrument that relies on another underlying asset to derive its value
Hedge:	To take a position that offsets an existing position in order to reduce price risk in the open position
Over-the-counter:	This refers to any transaction that is made outside a regulated and organised organisation
Short position:	A short position in an instrument is being the seller of that instrument as opposed to a long position
Long position:	A long position in an instrument is being the owner of that instrument as opposed to a short position
Open position:	The net long or short position in instruments, held by an investor
Initial margin:	The security margin that is required by an exchange to be paid in by the buyers and/or sellers of a financial instrument
Mark to market:	the process of recalculating the net profit or loss on each client's open positions at the end of each trading day
Equity Settled:	settlement of a derivative by physical delivery of underlying equities
Cash settled:	settlement of a derivative is made in cash
Close out:	to terminate a derivative position in the market before expiry date
Call option:	an option which gives the holder of the option the right, but not the obligation to buy an asset specified in the contract
Put option:	an option which gives the holder of the option the right, but not the obligation to sell an asset specified in the contract
Strike price:	the pre-agreed price at which the option buyer can exercise
Exercise date:	the last date on which the rights attached to an option may be exercised
Fixed for floating rate:	a swap in terms of which cash flows of a fixed rate are exchanged for floating rate on an agreed notional amount

Chapter 1

INTRODUCTION AND RESEARCH PROBLEM

1.1 INTRODUCTION AND BACKGROUND

Even a casual observer of capital markets would have noted that the past 25 years have witnessed an explosion in the development of new financial instruments. Indeed, this awareness is so widespread that the idea of explosive financial innovation, presumably in response to the increasing volatility of interest rates and exchange rates, is almost as trite at this point as the idea of globalisation (Edgar 2000:1).

Derivatives are broadly defined as financial arrangements between two parties whose payments are based on, or "derived" from, the performance of some agreed-upon benchmark (Bodie, Cane & Marcus 1998: 6).

For accounting purposes, a derivative is defined in Accounting Statement AC133 (SAICA 1999: para 09) as a financial instrument or other contract with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

Bodie *et al* (1998:6) explained that although derivatives can be powerful speculative instruments, they are used most often by businesses as hedges. As an example of a hedge, companies often use forwards and exchange-listed futures to protect against fluctuations in currency or commodity prices. In doing so companies are able to manage import and raw materials costs. Other examples of derivatives used for hedging are options. Interest rate options such as caps and floors help companies control financing costs in much the same way that caps on adjustable-rate mortgages do for homeowners."

Examples of derivatives includes cross currency swaps, index options, credit default swaps and contracts for differences (CFDs).

A cross currency swap is an arrangement under which two parties agree to exchange specified amounts of two different currencies for a defined period. At the end of the period the arrangement specifies the re-exchange of the same amounts of the currencies regardless of the exchange rate ruling at the time. Typically, during the period of the swap the parties exchange a series of interest payments based on the amounts exchanged (Van Wyk and Engelbrecht 1999:103).

The essential characteristics of a an index option is the grant of a right to the option holder to receive a payment on the date that the option is exercised, equal to the difference between the base value of the index, that is the value of the index at the time of entering into the contract and the exercise price, that is, the strike price (Van Wyk and Rudnicki 2000:310).

A credit default swap is a contract under which one of the parties (the protection seller), in exchange for a premium, is obliged to make a payment to the other party (protection buyer) if a credit event of a third entity (the reference entity which is not party to the credit default swap agreement) occurs. Some of the most common credit default events are bankruptcy, insolvency, payment default on obligations, failure to meet financial obligations or covenants or a rating down-grade below an agreed threshold (Van Wyk and Engelbrecht 1999:193).

In the broadest sense, contract for differences (CFDs) are traditionally an over-the-counter derivative whereby both parties agree on the reference price of the underlying reference instrument and further agree that, should the underlying reference instrument increase in value, then the party that is long in respect of the CFD gets compensated and similarly the party that is short in respect of the CFD would pay this compensation (Watson 2007:18).

When trading on contract for difference, investors are asked to deposit a small percentage of the overall cost (initial margin) that would be required if they were to purchase the equivalent shares in the physical market. If a position moves against the CFD investor and reduces the cash balance so that the investor's initial margin is below the required margin level on a particular trade, the investor would be subject to a margin call and will have to pay additional money into his account to keep the position open or he may be forced to close his position.

The use of derivatives in managing financial risk, currency risk and for speculative purposes, coupled by the fact that derivatives derive their values from some other underlying arrangement, potentially complicates the tax consequences arising from the use of derivatives.

Thuronyi (2001:2) in his paper to the United Nations states that for each type of income under a financial instrument, there are broadly three issues to consider from a taxation perspective:

a) The type or character of the income (i.e., ordinary income, capital gain etc.).
b) The time when the income or deduction is taken into account.
c) Whether the income is domestic or foreign source and is subject to withholding at source.

Van Wyk and Engelbrecht (1999:195) point out that the South African Income Tax Act, No. 58 of 1962 ("The Act") deals specifically with interest bearing arrangements (i.e. section 24J), interest rate swaps (section 24K) and some aspects of foreign exchange derivatives (section 24I), but generally a combination of general and specific legislative provisions, court cases and current practice of the South African

Revenue Service ("the SARS") need to be considered in determining the tax consequences arising from a specific derivative.

In 1994 the Tax Advisory Committee in South Africa (TAC) released a document entitled: Consultative document on the tax treatment of financial arrangements. The document was prepared by a sub-committee of the TAC which consisted of members of from TAC, the Council of Southern African Bankers and the Inland Revenue branch of the Department of Finance. Sections 24J, 24K and 24L were introduced into the Act subsequent to the release of the TAC document. (The TAC document is annexed as Annexure "A" to this dissertation.)

Thuronyi (2001:5) argues that financial instruments are likely to pose the greatest problem for countries which do not tax capital gains of companies or which subject such gains to a favourable tax rate. This is because one of the typical uses of financial instruments is to convert income that would otherwise be taxable as ordinary income into capital gain. For countries that provide favourable treatment for corporate capital gains, financial instruments pose a problem.

Thuronyi (2001:5) furthermore deals with the difficulties facing tax authorities in dealing with derivatives. He specifically points out that derivatives may be used to change the nature of income (with respect to capital or revenue) and also the type of income (i.e. change taxable interest to non-taxable dividend).

1.2 RESEARCH PROBLEM

The Act has no provision dealing specifically with derivatives. This may result in uncertainty regarding the tax treatment of derivatives and potentially causes inconsistent tax treatment of derivative financial instruments.

The potential uncertainty with regards to derivative financial instruments arises from the following:

(a) Whether a derivative financial instrument generate income or expenditure of a capital nature or revenue nature, or whether such income or expenditure is taxable or deductible.
(b) When such income generated from a derivative would be taxable and when the loss or expenditure incurred on a derivative would be deductible.

This raises the question of whether the Act effectively provides for the income tax treatment of derivative financial instruments. Generally when dealing with income and expenditure, one needs to know the nature of income or expenditure generated. In addition one need to know in which year of assessment the income or expenditure should be accounted for in the taxpayers' records.

1.3 RESEARCH OBJECTIVES AND LIMITATIONS OF THE STUDY

The objective of this study is to assess whether the South African Income Tax legislation effectively provides for the income tax treatment of the following derivative financial instruments: cross currency swaps, index options, credit default swaps and contracts for differences (CFDs). The reason behind the selection of these specific derivatives is that they represent most general characteristics of derivatives.

The study will be limited to the income tax, including possible capital gains tax, consequences arising from these derivative financial instruments. The study will specifically focus on the assessment of the Act in respect of the nature of income and expenditure and the timing of such income and expenditure arising from derivative financial instruments used by taxpayers.

Set out below in tabular format are the objectives of this study in respect of each of the above derivative financial instruments

Derivative Financial Instrument	**Objective**
Cross currency swap	The objective would be to assess the income tax treatment at the following stages of this derivative:

	(i) At inception (ii) On exchange of interest (iii) On re-exchange of principal amounts (iv) At the end of a tax year
Index options	The objective would be to assess the income tax treatment on this derivative in respect of the following: (i) Taxability of the premium received (ii) Deductibility of premium paid (iii) Taxability of the receipt on settlement (iv) Deductibility of settlement payment
Credit default swap	The objective would be to assess the income tax treatment on this derivative in respect of the following: a) Taxability of the premium received by the protection seller b) Deductibility of the premium paid by the protection buyer c) Taxability of the payment received by the protection buyer d) Deductibility of the payment made by the protection seller
Contract for differences	The objective would be to assess the income tax treatment at the following stages of this derivative: (i) Initial margin payment (ii) Interest paid or received on open positions (iii) Interest paid or received in favour of the investor resulting in a gain (iv) Open position on CFD moves against the investor resulting in a loss (v) Value of dividends credited to the holder of a CFD (vi) Value of dividends debited to the holder of a CFD (vii) Closing a CFD position

1.4 RESEARCH METHODOLOGY

A qualitative approach, comprising of a literature review on the taxation of derivative financial instruments, will be used to conduct the research.

Information and data will be gathered from various sources including the following:

a) Websites and publication of the Big 4 Auditing firms i.e. PricewaterhouseCoopers, KPMG, Deloitte & Touche and Ernst & Young.
b) The Consultative document on The Tax treatment of financial arrangements released by the TAC. Although released in 1994, this document has some useful information as it was instrumental to the introduction of section 24J, 24K and 24L of the income tax Act.
c) The University of Pretoria's Academic Information Service. The University has a wealth of information and has links with other Universities and Libraries. Information can be sourced from other places if not available at the University.
d) Income tax legislation and literature which deals with the application and interpretation of such legislation.
e) Case law would be obtained from the PricewaterhouseCoopers' library and the databases which contains case reports.
f) Other documents dealing with the taxation derivative financial instruments would be obtained from the PricewaterhouseCoopers library.
g) The World Wide Web will also be searched for relevant documents on this topic.

1.5 RESEARCH BENEFITS

The following parties will benefit from the study of derivative financial instruments:

The researcher

The researcher has clients in the financial services and deals with derivative financial instruments on a daily basis. The results of the research will improve the researcher's understanding of taxation of derivative financial instruments.

University of Pretoria

The research product will form part of the University's database for future reference and use by the department of taxation and students doing taxation courses if required.

South African Revenue Service

The findings of the research product could be used by the South African Revenue Service in improving legislation which deals with the taxation of derivative financial instruments.

Taxpayers and tax practitioners

The findings of this study could assist taxpayers and tax practitioners and hopefully clear some uncertainties surrounding the taxation of derivative financial instruments. This could improve the level of compliance and improve quality service to taxpayers by tax practitioners.

1.1 CHAPTER OUTLINE

Chapter 2 : Nature of income and expenditure

This chapter deals with the capital or revenue nature of income earned or losses incurred on derivative financial instruments. The nature of the expenditure or loss incurred or a return derived from a derivative financial instrument can either be of a capital or revenue nature. Consideration is given to whether the income or loss would be capital or revenue where a derivative is entered into for speculative or hedging purposes.

When analysing the nature of the expenditure or loss or return from a derivative used as a hedge, an enquiry has to be made as to whether there is a link between the hedged item and the hedging item. Once the link has been established between the hedged item and the hedging derivative, the second consideration is to enquire as to the nature of the position being hedged.

Chapter 3 : Timing of income and expenditure

This chapter deals with the timing of income or expenditure and losses arising from a derivative financial instrument. The analysis considers the specific provisions in the Act and how they apply to specific derivatives. This includes the analysis of how capital gains tax ("CGT") applies to derivative financial instruments. Specific provisions which are analysed include section 24I, 24J, 24K and 24L.

In the absence of specific provisions, the general principles are analysed to determine how they would apply to derivative which are not specifically catered for. The principles of unconditional obligation and entitlement are explored to determine how they would apply derivative financial instruments.

Chapter 4 : Current income tax treatment to specific derivatives

The focus of this chapter is on the income tax treatment of specific derivative financial instruments. The following derivative financial instruments are dealt with: cross currency swaps (CCS), index options, credit default swaps and contract for differences.

With reference to these derivatives, the analysis is on whether the gains or losses arising from derivative financial instruments would be capital or revenue in nature. In addition, the question of timing of those gains and losses are analysed, including the capital gains tax implications.

Where the derivatives are not specifically catered for in the Act, their legal nature is analysed to determine their true form in order to apply the provisions of the Act. The general principles of unconditional entitlement and obligation are analysed with respect to the derivatives in order to determine the income tax treatment.

Chapter 5 : Conclusion and recommendations

This chapter focuses on the overall analysis of the entire document and provides some recommendations based on the conclusions reached. The focus of the recommendation is on derivatives used as a hedge, guidance on specific treatment of derivatives, the timing rules governing derivatives and the CGT implications

Chapter 2

NATURE OF INCOME AND EXPENDITURE OR LOSS DERIVED FROM A DERIVATIVE

2.1 INTRODUCTION

The objective of this chapter is to determine the circumstances under which income derived from a derivative financial instrument is of a revenue or capital nature for purpose of the definition of "gross income" in section 1 of the Act. In addition, the nature of expenditure or loss incurred on a derivative would be explored to determine under which circumstances such a loss would be of a capital or revenue nature.

For income tax purposes, Income is defined in section 1 of the Act as follows:

> *"income means the amount remaining of the gross income of any person for any year or period of assessment after deducting there from any amounts exempt from normal tax under Part I of Chapter II"*

Gross income is in turn defined in section in section 1 of the Act as

(i) *"in the case of any resident, the total amount, in cash or otherwise, received or accrued to or in favour of such person; or*

(ii) *in the case of any person other than a resident, the total amount in cash or otherwise, received by or accrued to or in favour of such a person from a source within or deemed to be within the Republic,*

during a year or period of assessment, excluding receipt or accruals of a capital nature".

If the income derived from a derivative complies with the definition of gross income, such income would be subjected to income tax at the normal rate. If, however, the income derived from a derivative financial instrument is of a capital nature, it might constitute taxable capital gain and consequently subject to tax at a lower rate of tax. This is because in terms of paragraph 10 of Eighth Schedule to the Act, fifty per cent

of the capital gain in the case of companies is a taxable capital gain. This taxable capital gain is included in taxable income in terms of section 26A of the Act. In other words, the full amount of capital gain is not included in taxable income. This results in the lower rate of tax being applied to the total capital gain.

Thus the discussion on the nature of income from derivatives hinges around whether or not such income is of a capital or revenue nature.

As far as the nature of income derived from a derivative is concerned, it is important to note that a distinction must be made as to whether a derivative generates a return which is of a capital or revenue nature. This distinction is of paramount importance as a return which is of a capital nature would not form part of gross income. Conversely a return which is not of a capital nature would form part of gross income. It is also important to note that in South Africa different effective rates of income tax apply to capital profits and revenue profits.

2.2 DETERMINATION OF THE NATURE OF INCOME

The distinction between revenue and capital relies to a large extent on the legal rather than economic character of the receipt. In explaining the notion of income/revenue, courts have often relied on the notion of fruit and the tree.

South African Courts have recognised the principle or analogy of tree and the fruit. In **CIR v Visser 1937 TPD 77 (8 SATC 271)**, Maritz J stated: *"if we take the economic meaning of capital and income, the one excludes the other. Income is what capital produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal or tree in the hands of one man may be interest or fruit in the hands of another. Law books in the hands of a lawyer are capital asset; in the hands of a bookseller they are a trading asset. A farm owned by a farmer is a capital asset; in the hands of a land jobber it becomes stock-in-trade".*

2.2.1 THE INTENTION OF THE TAXPAYER: SCHEME OF PROFIT MAKING

The established test in South African case law to determine the capital or revenue nature of receipt is whether there was an "operation of business in carrying out a scheme for profit making". If the answer is in the affirmative, the receipt or accrual will be of a revenue nature. The application of the test presupposes an enquiry into the state of mind or intention of the taxpayer (Van Wyk and Engelbrecht 1999:198).

The above-mentioned test examines the intention with which the taxpayer acquired and held the asset. So for example, if the asset was acquired and held for the purpose of re-sale at a profit, pursuant to a scheme of profit-making, then the proceeds are regarded as being on revenue account. However if the asset was not acquired for re-sale but in order to generate income in the form of rent, interest or dividends then the outcome is arguably different. In such a case, the proceeds from the realisation of the income-generating asset are treated as being of a capital nature.

Some of the objective factors used to test the taxpayer's *ipse dixit* regarding his alleged intention are:

- the fixed versus floating nature of the capital invested or employed (**CIR v George Forest Timber Co Ltd 1924 AD 516 (1 SATC 20)**)
- whether the asset generates income or whether its only economic utility is that it can be turned into cash in **ITC 1525 (54 SATC 209)** the taxpayer acquired Krugerrand coins over a period of time. The court found that the sale of Krugerrands constituted revenue.
- whether the asset was acquired with the original intention of resale at a profit **ITC 1525** *supra* –; and
- evidence of a scheme of profit-making (**CIR v Pick 'n Pay Employees Share Purchase Trust 1992 (4) SA 39 (A)**).

The scheme of profit-making test was formulated and explained as follows in **CIR v Pick 'n Pay Employees Share Purchase Trust,** *supra* (at 56J and 57F):

> *"The appropriate test in a matter such as the present is a well-established one. The receipts accruing to the Trust will be revenue if they constitute a gain made by an operation of business in carrying out a scheme for profit making…"*
>
> and
>
> *"In this respect I agree with what is said in Meyerowitz and Spiro on Income Tax,…*
>
> *'(t)he rather clumsy phrase "operation of business in carrying out a scheme of profit-making" in plain language really means that receipts and accruals bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for.'*
>
> *The application of this test involves a consideration of the objectives of the taxpayer (the Trust) and what its purpose, or if there was more than one, what its dominant purpose was."*

The test was formulated earlier by Corbett JA in **Elandsheuwel Farming (Edms) Bpk v SBI 1978 (1) SA 101 (A) at (118A)** in his minority judgment as follows:

> *"Where a taxpayer sells property, the question as to whether the profits derived from the sale are taxable in his hands…turns on the further enquiry as to whether the sale amounted to the realisation of a capital asset or whether it was the sale of an asset in the course of carrying on a business…"*

The learned Chief Justice went on to say (at 118A) that in considering whether a scheme of profit-making had been entered into it was most appropriate to consider whether:

> *"…(there was an) acquisition of an asset for the purpose of selling it at a profit."*

In an even earlier judgment handed down by Innes CJ in **COT v Booysens Estates Ltd 1918 AD 576 (at 594)** the learned Chief Justice held:

> *"Profit or gain may be made in many ways; men may earn it by labour, by their wits, by their capital…we have to enquire whether profit has resulted from the productive use of capital employed to earn it, or whether it has resulted from the realisation of capital at an enhanced value.*

In **Overseas Trust Corporation Ltd v CIR 1926 AD 444 (2 SATC 71)**, Innes CJ set out the test even more succinctly as follows:

> *"Where an asset is realised at a profit as a mere change of investment there is no difference in character between the amount of enhancement and the balance of the proceeds. But where the profit is, in the words of an eminent Scotch (sic) Judge, see Californian Copper Syndicate v Inland Revenue (41 SC LR 694), 'a gain made by an operation of business in carrying out a scheme for profit-making', then it is revenue derived from capital productively employed, and must be income."*

From the above case law it can be submitted that if a return from a derivative was derived in an operation of business in carrying out a scheme for profit making, such return would be of a revenue nature and would thus form part of gross income.

2.2.2 THE NATURE OF RETURN DERIVED FROM A DERIVATE WITH SPECIFIC REFERENCE TO HEDGING

From the outset it must be stated that South Africa has no legislation governing the tax implication of hedging transactions. Before proceeding to determine what the nature of income derived from a derivative is, it is pivotal to have an understanding of what hedging is. The rationale behind ascertaining the meaning of hedging (or a hedge), is to ensure that an appropriate tax method is applied

One of the uses of derivatives is hedging. In finance, a hedge is an investment that is taken out specifically to reduce or cancel out the risk in another investment. Bodie *et al* (1999:115, fn1) defines 'hedge' as follows:

> *"To hedge means to mitigate a financial risk, a possible loss from a decline in the value of an asset. The return on the hedging asset will be higher when*

> *losses from the risk in question are greater. In other words, the return on the hedge asset offsets the risk in question – its returns are inversely related to the exposure from that risk. The greater the negative correlation between the returns on the hedge asset and the risk, the better the hedge. For example, an insurance policy against a specified risk is a perfect hedge, since it is designed precisely to cover a potential loss; its correlation is perfectly negative."*

Hedging is defined in AC133 (SAICA 1999: para.11) developed from the International Accounting Standard, 39, as follows:

> *"Hedging for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item."*

A hedging instrument is defined in AC 133 (SAICA 1999: para. 11) as follows:

> *"A hedging instrument, for hedge accounting purposes, is a designated derivative or another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item."*

A hedged item is also defined in AC 133 (SAICA 1999: para. 11) as follows:

> *"A hedged item is an asset, liability, firm commitment or forecasted future transaction that:*
>
> > *(a) exposes the enterprise to risk of changes in fair value or changes in future cash flows, and*
> > *(b) for hedge accounting purposes is designated as being a hedge."*

Hedging is a procedure used to offset or counterbalance risk associated with the underlying transaction. For a risk to be managed with a hedge there must be an instrument whose value displays a high degree of inverse correlation with the value

of the position to be hedged. Generally, hedging transactions will be entered into to manage interest rate risk, foreign exchange risk or price risk (TAC 1994: 63).

What is apparent from the definition of hedging is that the taxpayer has an existing position or transaction which could result in the taxpayer suffering a financial loss.

A hedging item if used effectively (i.e. if there is a total inverse correlation between the existing transaction and the derivative used to hedge such transaction) could reduce such possible loss that could be incurred on an existing position. Consider this example. A taxpayer has a loan denominated in dollars and incurs foreign exchange loss of R100 million. The same taxpayer enters into a Forward exchange contract to hedge the risk of a loss on its foreign loan and makes an exchange profit of R100 million. The taxpayer would have succeeded in reducing the entire loss from the foreign loan. The taxpayer would therefore have effectively hedged his existing transaction or position.

The question which arises here is the nature of the return from a derivative that is used as a hedging item, i.e., whether the return is of a capital or a revenue nature.

In **CIR v Illovo Sugar Estates Limited 1951 (1) SA 306 (N)** the issue at hand was whether compensation paid to the taxpayer for loss of sugar cane destroyed by virtue of the requisitioning of cane fields by the military and naval authorities was of a capital or revenue nature. It was held that the compensation paid constituted compensation for the loss of portion of the company's income producing machine and so constituted receipts of a capital nature. Reference in this case was also made to the question raised in **Burma Steam Ship Co LTD v IRC (1930) 16 TC 67 (Court Session), 1931 SC 156)**, *viz:* which hole was the receipt to fill, a hole in the profits or a hole in the assets?

In **WJ Fourie Beleggings CC v CSARS (70 SATC 8)**, the taxpayer close corporation had been the lessee of a certain hotel which had provided accommodation and meals for overseas students who were to be trained locally. The students, in breach of the contractual undertaking entered into by the taxpayer with their local trainer had left the hotel prematurely without any reason. The local trainer agreeing to settle the

matter out of court on certain terms and conditions. The taxpayer having been paid specified amount in full and final settlement of any claims it may have had irrespective of same flowing from contract or in accordance with the common law. The question before the court was whether the amount was a capital or revenue receipt and whether settlement amount was a surrogatum for future profits surrendered. The court held (at 10) that:

> "*the agreement between the taxpayer and the local trainer was not an essential of the taxpayer's profit making machine or structure but was a normal contract incidental to the normal course of the taxpayer's trade.*"

and that:

> "*[t]he taxpayer had been compensated for the loss of profit that it would have made had the students not moved out and it was compensated to help with its cash flow problems.*"

and accordingly that:

> *"the taxpayer had not succeeded in proving on balance of probabilities that the compensation was of a capital nature but it was rather in respect of costs incidental to the performance of the taxpayer's income-producing operations and was of revenue and not a capital nature."*

In **ITC 1498 (53 SATC 260)**, the appellant imported a printing press to form part of its income earning structure. In order to hedge itself against currency devaluation, it hedged itself by entering into a forward exchange contract. In this case, the Commissioner contended that the taxpayer had a profit motive in entering into the forward exchange contract and therefore the forward exchange contract independently should be judged as a profit making venture. It was held that the taxpayer was not trafficking in foreign exchange contracts and held that the exchange gains should assume the same character as that of the underlying capital transaction.

According to Brincker (2008:W-18-1), one should be careful of relying on **ITC 1498** in support of an argument that the hedging of a capital asset will always result in the proceeds of the derivative being deemed to be capital in nature. The ultimate question is the intention of the taxpayer in hedging the underlying asset or position and whether the intention is in itself of a capital nature and is consistent with the holding of the underlying capital asset.

This enquiry is consistent with legal precedent when dealing with the capital and or revenue nature of receipts. In other words, the question would always have to be answered as far as the intention of the taxpayer is concerned with respect to receipts or proceeds from a derivative.

Special hedging rules would match the tax treatment of the hedging instrument to that of the underlying transaction, position or asset. This means that if for example an underlying transaction is accounted for on a day-to-day basis, a derivative which was entered into as a hedge of that transaction would also be accounted for on a day-to-day basis. These rules would attempt to achieve a composite tax treatment whereby the hedge and the underlying instrument are taxed as a single unit. If the underlying transaction was taxed on a compounding accrual basis, the hedging instrument would also be taxed on a compounding accrual basis. If the underlying transaction was taxed on a due and receivable basis, the hedging instrument would be taxed on a due and receivable basis. (TAC 1994: 63)

There should be some link between the hedging instrument and the underlying transaction. Without this link, it would be difficult for a taxpayer to prove that the nature of income from a hedging derivative would follow the nature of income from the reference asset or hedged position.

Brincker (2008: W-9) states that the ultimate question is whether a true hedging arrangement is entered into with reference to an underlying asset. The following are some of the requirements which are taken into account to determine the link between the hedging derivative and the underlying asset:

a) Whether the percentage risk reduced by the hedge is acceptable (ranging between 80% to 120%);

b) Whether the price fluctuations of the hedge are directly linked to the underlying asset;
c) The quantity of goods sought to be hedged, as well as the price concerned;
d) Whether the derivative is specifically designated as the hedge;
e) Whether the changes in the value of the derivative and the underlying asset will have a high degree of correlation; and
f) Whether the hedge is assessed on an ongoing basis.

Brincker (2008: W-9) further argues that in the final analysis, the test should be whether a taxpayer has the intention to hedge an underlying capital asset or capital position and whether all surrounding circumstances support such intention. It is submitted that it would not only be sufficient to indicate that a derivative instrument has been entered into in respect of an underlying instrument. There should be a sufficiently close link between the derivative instrument and the underlying asset. In determining such link, the correlation, the extent of risk mitigation and duration of the two transactions may well be determinative.

One of the well established tests to be applied in such cases is the test formulated in **Burmah Steam Ship Co Ltd v IRC (1931 SC 156)** of establishing whether the payment is intended to fill a hole in the taxpayer's profits or to fill a hole in his assets. The former is revenue while the latter is capital. The court, applying the trading stock test, concluded that the trees were floating capital and that the compensation was therefore, of a revenue nature being a payment intended to fill a hole in the taxpayer's profits. It is considered that this decision is correct having regard to the fact that the trees were grown for the purpose of sale (Huxham and Haupt 2008: 44).

One could argue that hedging is no different to insurance contracts. As far as an insurance contract is concerned, there would as a general rule be an insured item and a specified risk. There is without a doubt a link between the insured item and the insurance itself. Basically the insurance contracts cannot exist without an insured item. Unfortunately with hedging such link is not usually apparent. This is because derivatives are mainly used not just for hedging but also for speculation.

2.2.3 THE NATURE OF EXPENDITURE OR LOSS INCURRED ON A DERIVATIVE

In order to determine the taxable income of a taxpayer, all amounts which are allowable for deductions under the Act should be subtracted from the income.

Section 11(a) of the Act provides as follows:

> "*For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived-*
> *(a) expenditure or losses actually incurred in the production of the income, provided such expenditure or losses are not of a capital nature;"*

Essentially, if a loss or expenditure incurred by entering into derivatives is of a capital nature, it would not be allowed as a deduction. Conversely, if the expenditure or loss is not of a capital nature, it would be allowed as a deduction when determining taxable income.

As is the case with the gross income definition, "of a capital nature" as contained in section 11(*a*) of the Act is also not defined and thus guidance is sought from our courts.

In **CIR v George Forest Timber Co Ltd (at 526)** it was held that:

> *"Money spent in creating or acquiring an income producing concern must be capital expenditure. It is invested to yield a future profit, and while the outlay does not recur, the income does. There is a great difference between money spent in creating or acquiring a source of profit and money spent in working it. The one is capital expenditure, the other is not. The reason is plain, in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profits".*

In **CIR v African Oxygen Ltd 1963 (1) SA 681 (A), 25 SATC 67 (at 688)**, Steyn CJ said:

> *"generally speaking, money spent in creating or acquiring an income-producing concern, a source of profit or capital asset, is capital expenditure, while the cost incidental to the performance of the income-producing operations is revenue expenditure".*

It was also stated in **New State Areas Ltd v CIR 1946 AD 610 (at 620)**, that

> "*The problem which arises when deductions are claimed is therefore usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant".*

As is the case with income generated from derivatives, where a derivative is entered into pursuant to a scheme of profit making or for speculative purposes the attendant expenditure or loss arising from such activities would not be of a capital nature. This is because such expenditure or loss would be regarded as part of the cost of performing income-earning operations.

Conversely, expenditure or loss incurred on a derivative entered into as a long-term investment would be of a capital nature. This is because such expenditure or loss would be regarded as part of the cost of establishing or improving or adding to the income-earning plant.

Where a derivative is entered into as a hedge of an underlying position of a capital nature, the expenditure or loss incurred from the derivative would be of a capital nature. This is because the expenditure or loss would have been incurred in order to protect the income producing structure.

Ultimately, the analysis of the case law dictates that the consideration to the nature of the expenditure or loss is whether the derivative activities could be:

a) properly regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant.

b) regarded as money spent in creating or acquiring an income-producing concern, or the cost incurred was incidental to the performance of the income-producing operations.

2.2.4 CGT IMPLICATIONS

The question that needs to be considered is whether the Act deals with the CGT implications arising from the disposal of derivatives. It is important to give consideration to this enquiry as where an income or loss on a derivative is of a capital nature, it would not form part of gross income nor would it be allowed as a deduction in terms of section 11(*a*) of the Act.

As will be discussed in Chapter 3 and 4, where the gain or loss on a derivative contract is of a capital nature, the general provisions of the Eighth Schedule of the Act which deals with CGT would apply to derivatives.

It is important to draw attention to the provisions of section 26A of the Act which provides as follows:

> *"there shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule."*

Section 26A provides for the inclusion of the taxable capital gain into taxable income as determined in terms of the Eighth Schedule of the Act.

Paragraph 3(a) of the Eighth Schedule provides as follows:

> *"A person's capital gain for a year of assessment, in respect of the disposal of an asset-"*

Paragraph 4(a) of the Eighth Schedule provides as follows:

> *"A person's capital loss for a year of assessment, in respect of the disposal of an asset-"*

It is important to note from the above that in order to have a capital gain or loss, it is a pre-requisite to have a disposal of an asset.

A disposal is defined in paragraph 11 of the Eighth Schedule to the Act as follows

> *"a disposal event is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset"*

It is important to note that the CGT arises on the disposal of an asset. An asset is defined in paragraph 1 of the Eighth Schedule as follows;

> *"asset includes-*
>
> *(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and*
>
> *(b) a right or interest of whatever nature to or in such property"*

According to the South African Revenue Service's Comprehensive guide to capital gains tax (2007:31), a contractual right is listed as a an example of an asset.

As discussed in chapter 1, a derivative is merely a contract between two or more parties. This means that under derivative contracts, just like any other contract, rights and obligations are created on entering into those contracts.

It therefore follows that the act of entering into a derivative contract would results in a creation of rights. The rights acquired in terms of derivative would therefore amount to an asset for CGT purposes.

2.3 CONCLUSION

The nature of the expenditure or loss incurred or a return derived from a derivative financial instrument can either be of a capital or revenue nature. Whether such nature is of revenue or capital nature would depend on how the taxpayer employs the use of derivative in his business affairs.

The consistent analysis from the above legal precedent is that the intention of the taxpayer is of critical importance when determining the nature of income derived from a derivative.

So, where a taxpayer is engaged in dealing with derivative financial instruments, an enquiry has to be made as to what his intention was in entering into a derivative contract. If the taxpayer has entered into a derivative transaction in a scheme of profit making, the nature of a return or expenditure or loss would be of revenue.

Where a taxpayer enters into derivative transactions for speculative purposes, such a taxpayer usually does so with a view to make a profit within a short space of time. Under these circumstances (i.e. speculative transactions) the expenditure or loss, income or return earned from these activities will be seen to have arose out of a business in carrying out a scheme of profit making. The taxpayer would find it difficult to prove that the return is nothing else other than of a revenue nature. Conversely, the taxpayer would be able to prove that the expenditure or loss is not of a capital nature.

If the taxpayer can prove that the intention was not that of a scheme of profit making, the return would be of a capital nature.

When analysing the nature of the expenditure or loss or return from a derivative used as a hedge, an enquiry has to be made as to whether there is a link between the hedged item and the hedging item. Once the link has been established between the hedged item and the hedging derivative, the second consideration is to enquire as to the nature of the position being hedged. In other words, is the position being hedged a “tree or fruit”. This enquiry is of critical importance as such finding would influence

or inform the nature of the expenditure or loss or return from such derivative used as a hedge.

As can been noted from the legal precedent, the principle of tree and fruit plays a critical role when dealing with derivatives used as hedging instruments.

So for example, where a taxpayer enters into a derivative to prevent revenue losses, the nature of the gain made from such a derivative would thus be informed by the underlying position and would be of a revenue nature. In other words, the gain would be of revenue nature as the derivative would have been entered into to prevent a revenue loss. Where the taxpayer incurs a loss on such a derivative, the loss would be of a revenue nature and the taxpayer would be able to claim the expense under section 11(*a*) of the Act.

When a taxpayer enters into a derivative contract to prevent a capital loss, any gain made from the derivative used as a hedge would be of a capital nature. Conversely, any losses made on the derivative contract would be of a capital nature as it would have been incurred to protect a capital asset.

Where a gain derived from a derivative is of a capital nature, it would be dealt with in terms of the Eighth Schedule of the Act. The Eighth Schedules deals with the determination of a capital gain derived from an asset. Such capital gains are included into taxable income in terms of section 26A of the Act.

Chapter 3

THE TIMING OF INCOME OR EXPENDITURE OR LOSS FROM A DERIVATIVE

3.1 INTRODUCTION

The focus of this chapter is on the timing of income earned or expenditure and losses incurred on a derivative financial instrument. In other words, it deals with the enquiry as to when should the income earned on a derivative and the loss incurred on a derivative be included or deducted from income.

The Act contains specific sections that deal with the taxation of some derivative financial instruments. These sections also address the question of when income or losses should be brought into account when determining taxable income:

3.1.1. SECTION 24I

Section 24I of the Act deals with the tax treatment of transactions in foreign currency. The relevant provision provides as follows:

> *"In determining the taxable income of any person contemplated in subsection (2), there shall be included in or deducted from the income, as the case may be, of that person-*
>
> *(a) any exchange difference in respect of an exchange item or in relation to that person, subject to subjection (10).*

Section 24I thus brings into taxable income foreign exchange gains or losses whether realised or unrealised during the year in which it arose. It therefore addresses the tax treatment of derivatives like for example foreign option contracts.

3.1.2. SECTION 24J

Section 24J of the Act deals with the incurral, Accrual and timing of interest on interest-bearing arrangements. Section 24J (2) provides as follows:

> *"where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to – "*
>
> *(a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or*
>
> *(b) an amount determined in accordance with the alternative method in relation to such year of assessment in respect of such instrument,*
>
> *Which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of income."*

Section 24J(3) provides as follows:

> *"where any person is the holder in relation to an income instrument during any year of assessment, there shall for the purposes of this Act be deemed to have accrued to that person and must be included in the gross income of that person during that year of assessment (whether or not that amount constitutes a receipt or accrual of a capital nature), an amount of interest which is equal to –*
>
> *(a) the sum of all accrual amounts in relation to all accrual periods falling, whether in part or in whole, within such year of assessment in respect of such income instrument, or*
>
> *(b) an amount determined in accordance with the alternative method in relation to such year of assessment in respect of such income instrument"*

Section 24J therefore provides for the tax treatment of financial instruments which are interest bearing arrangement. It clearly gives guidance on when and how to account for interest income or expenditure.

3.1.3 SECTION 24K

Section 24K deals with the timing of interest rate derivatives. Section 24K (2) provides as follows:

> *"Any amount contemplated in the definition of "interest rate agreement" in subsection (1) shall for the purposes of this Act be deemed to have been incurred or accrued to, as the case may be, a person contemplated in such definition on a day to day basis during the period in respect of which it is calculated.*

Section 24K therefore address the timing of payments made under an interest rate derivative like for example an interest rate swap.

An interest rate swap is a contractual agreement between two parties to exchange a series of payments, calculated by reference to a notional principal amount, over a stated period of time (TAC 1994:73).

3.1.4. SECTION 24L

Section 24L deals with the tax treatment of option contracts. Section 24L (2) provides as follows:

> *"the amount of-*
>
> *(a) any premium or like consideration paid or payable by a person in terms of an option contract; or*
>
> *(b) any consideration paid or payable by a person in respect of the acquisition of an option contract by such person*
>
> *shall for the purposes of this Act be deemed to have been incurred by such person on a day to day basis during the term of such contract.*

Section 24L(2)(*b*) has some exceptions to the effect that where an option is held as trading stock, the day to day rule does not apply, or where the premium includes an intrinsic value, such value is deemed to be incurred on the day the option is exercised.

Furthermore, where the option is exercised prior to the exercise date, the balance of the unamortised portion of the premium is deductible in full on such exercise date.

Section 24L(3) deals with a scenario where a taxpayer has received a premium. It deems such premium to have accrued on a day to day basis. Where the option is exercised or terminated prior to exercise date, the amount is immediately brought into income.

It follows therefore that the Act, does provide for the tax treatment of option contracts in terms of section 24L.

3.2 DETERMINATION OF THE TIMING OF INCOME AND EXPENDITURE

As discussed in the first Chapter, there has been an explosion of derivative over the number of years. The question which arises is how would one deal with the timing of income or expenditure or losses arising from derivatives not specifically catered for in the Act.

The analysis would be therefore, as far as the derivatives not specifically catered for in the Act are concerned, dealt with in terms of the ordinary timing rules contained in the Act.

3.2.1 THE TIMING OF INCOME ON A DERIVATIVE

Gross income is defined in section 1 of the Act as*:*

> *"In the case of any resident, the total amount, in cash or otherwise, received or accrued to or in favour of such person* (Own emphasis)

This portion of the gross income definition deals with when (i.e. timing) an amount should be brought into gross income.

In **Lategan v CIR 1926 CPD 203 (2 SATC 16)**, at 209 Watermeyer J stated the following:

> *"In my opinion the words in the Act, 'has accrued to or in favour of any person' merely mean 'to which he has become entitled'.*

In **CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A)**, the issue was whether an amount accrue to the taxpayer when it is due, in other words, when he becomes entitled to it, or only when it is both due and payable. The court held that an amount accrues in the tax year that the taxpayer becomes entitled to it.

The issue in **Mooi v SIR 1972 (1) SA 675 (A) (34 SATC 1)** was what actually accrued to the taxpayer and when did the accrual take place. It was held by the court that:

> *"[w]hat accrued to the taxpayer was the right, on the fulfilment of certain conditions, to obtain shares at a price of R1.25. This accrual took place when the option to acquire the shares became exercisable, that is on 1 September 1966. At that date, the taxpayer was in the service of the company and there was a causal relationship between the benefit he acquired and his services to the company; hence the benefit fell within the statutory definition of gross income."*

This case actually clarified that income accrues to a taxpayer when such taxpayer becomes unconditionally entitled to the income.

Van Wyk and Engelbrecht (1999:196) state that the principle that emerges from case law is that the amount of assessable income 'accrues' to a taxpayer in the year of

assessment in which the taxpayer acquires the right to claim payment and not in the year of assessment in which the taxpayer is eventually entitled to the payment. The timing of recognition of income and expenses from derivative transactions does not generally follow the accounting treatment. Rather, the usual approach is to recognise either (1) gross income or payments or (2) a net profit or loss on a realisation basis.

It can therefore be concluded from the above that income derived from a derivative contract would be included in gross income when the taxpayer has become unconditionally entitled to such income.

Therefore, if the taxpayer has some outstanding condition or performance before he is entitled to the income, such income would not have accrued and would thus not form part of gross income.

As far as the phrase 'received by' in the gross income definition is concerned, it is unlikely that a receipt from derivative would be received before it accrues to a taxpayer.

3.2.2 THE TIMING OF EXPENDITURE OR LOSS ON A DERIVATIVE

In as far as the timing relates to expenditure or loss, section 11(*a*) of the Act provides as follows:

> *"For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person derived-*
>
> *(a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature".*(Own emphasis)

The analysis of the timing of expenditure or losses would be focused on one aspect of section 11(*a*) being the phrase 'actually incurred'.

The use of the words, 'actually incurred' in section 11(*a*) of the Act prevents the deduction of expenditure or losses that are contingent or uncertain. Moreover, it seems that an obligation which is dependant only upon the performance of a reciprocal obligation will be regarded as a conditional liability for income tax purposes until that reciprocal obligation is performed, even though it may be unconditional in the true legal sense before that time (Hutton S 1998: 185).

In **Nasionale Pers Bpk v KBI 46 SATC 83** it was held that an existing liability to pay an amount is a prerequisite to the deductibility of such an amount as 'expenditure actually incurred' under s 11(*a*) of the Act.

This means that expenditure would only be actually incurred and thus deductible when the taxpayer becomes legally liable to pay, even though no payment has been made by the end of the year of assessment and even if it is not due and payable by that date. In other words, this case interpreted the phrase 'actually incurred' to mean an unconditional liability to make payment.

In **CIR v Golden Dumps (Pty) Ltd 55 SATC 198 (A)**, it was held that a liability is contingent where a claim is disputed. Furthermore, where the outcome of the dispute is undetermined, the liability is not actually incurred.

Where an obligation to pay an amount was genuinely disputed by the debtor, the expense was only 'actually incurred' when it was confirmed that the debtor's obligation existed. (Huxham and Haupt 2009:93).

It can therefore be said from the above that where a loss is generated from a derivative financial instrument, such a loss would be allowed as a deduction during a year of assessment where an unconditional liability for payment is incurred. In other words, all performance under the derivative contract by the parties involved must have happened and there should not be any contingencies.

3.3 CGT IMPLICATIONS ON EXPENDITURE OR LOSS ON A DERIVATIVE

Paragraph 13(1)(a)(vi) of the Eighth Schedule to the Act provides as follows:

> *"the time of disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law is, in the case of the granting, renewal or extension of an option, the date on which the option is granted, renewed or extended."*

There is therefore some clear guidance in the Act as to the disposal event and the timing of that disposal in respect of an option contract.

As far as option contracts which are equity settled are concerned, there is some provision in the Act dealing with the CGT implications. Equity settlement, means that the holder of the options takes delivery of or acquires the underlying shares. If the holder receives cash instead of acquiring the shares this is referred to as cash settled. Paragraph 58 of the Eighth Schedule to the Act provides as follows:

> *"Where, as a result of the exercise by a person of an option, that person acquires or disposes of an asset in respect of which that option was granted, that person must disregard any capital gain or loss determined in respect of the exercise of that option.*

The effect of paragraph 58 of the Eighth Schedule to the Act is that the exercise of an option does not trigger CGT, but that the cost of the option is added to the base cost of the asset acquired. The CGT is therefore delayed until the asset is disposed of.

According to the SARS CGT guide (2007:324), the purpose of paragraph 58 is to defer the gain made on disposal of the option contract until such time that the asset acquired in terms of the option contract is disposed of.

Unfortunately where an option contract is cash settled there is no specific provision in the Act. The same applies to any other derivative financial instrument. Where there is no specific provision dealing with derivatives, the general provision of the Act would apply.

3.4 PROBLEMS WITH APPLYING THE GENERAL TIMING RULES OF THE ACT

As discussed above, income generated from derivative transactions would only be included in gross income when the prerequisite for unconditional entitlement is fulfilled. Also, the losses arising from derivative transactions would be deductible under section 11(a) of the Act, when the prerequisite for unconditional obligation has been fulfilled. These general rules will of course apply to those derivatives which are not specifically provided for in the Act.

To illustrate the difficulties or anomalies created by applying the general timing rules, Brincker (2008:W-12) gives the following example:

> *"For instances, in the context of an interest rate swap agreement, the fixed rate payer would pay a lumpsum amount on day one and so claim a deduction thereof. The accrual of the floating rate payments will only take place over the period of the swap agreement, resulting in the accrual being postponed from such taxpayer's perspective. If the so-called "borrower" receiving the upfront lump sum is in an assessable loss position, obvious tax benefits arise"*

Although the above example illustrates the anomaly of applying the general timing rules, it is submitted that if the swap in the example meets the requirements of an interest rate agreement as defined in section 24K of the Act, the lump sum payment referred to in the example would be allowed as a deduction on a day to day basis and it will also be included in gross income of the recipient on a day to day basis.

The TAC (1994: 21-22) describes the difficulties with applying the general timing rules to derivatives as follows:

"*The general scheme of the tax law brings to account amounts when received or accrued and allows deductions for expenditure and losses when incurred, requiring analysis of each contractual arrangement by which taxpayers earn their income. In addition, there are specific provisions for certain financial transactions, largely to eliminate identified tax avoidance or deferral opportunities. The present system is prone to the following problems:*

a) *it can give rise to an unacceptable degree of uncertainty because traditional tax accounting rules do not appropriately reflect the substance of the and/or there is little by way of judicial precedent as to the correct tax treatment of the transaction.*

b) *Tax planning opportunities arise because of timing mismatches between the deduction of expenditure and losses and the accrual of income, including cases where the tax treatment is different between parties to the same financial transaction.*

c) *Inequality in the tax treatment of arrangements that are economically the same but different in legal form*

d) *The general scheme of law does not comfortably accommodate many new financial products".*

Hutton, S (1998: 185), also expands the problems arising from the application of general timing rules to derivative financial instruments as follows:

a) *"The valuation of open positions held by the taxpayer at year end. The appreciation or depreciation in the market value of a derivative instrument will not be taxed or allowed as a deduction until it is actually incurred or accrued when the instrument matures, is disposed of or otherwise closed out.*
b) *Matching the timing of the recognition of income and losses on a revenue hedging transaction with the correlative income and losses on the underlying hedging transaction. Whereas the hedge and the underlying transaction are treated as a single unit for accounting purposes, they are*

taxed in isolation and the application of the ordinary timing rules can result in the income or loss resulting from a hedging transaction being taxed or allowed at a different time from the income or loss on the underlying transaction. This can leave the taxpayer matched in economic terms but unmatched for income tax purposes which distort the efficacy of the hedge."

The methods of timing rules suggested by the TAC are the following (TAC 1994: 23):

a) Compounding accrual
b) Straight line accrual
c) Market valuation

The TAC (1994:63) recommended the following in respect of derivative used as a hedge:

"Special hedging rules would match the tax treatment of the hedging instrument to that of the underlying transaction. These rules will attempt to achieve a composite tax treatment whereby the hedge and the underlying instrument are taxed as a single unit. If the underlying transaction was taxed on a compounding accrual basis, the hedging instrument would also be taxed on a compounding accrual basis. If the underlying transaction was taxed on a due and receivable basis, the hedging instrument would be taxed on a due and receivable basis. Hedging arrangements that are financial arrangements would be excluded from accrual taxation if the underlying transaction was not taxed on an accrual basis".

One of the complications with trying to match the tax treatment of the underlying and the hedging instrument is the period during which a derivative can be kept open. For example, if a taxpayer holds a portfolio of shares on capital account and wish to enter into a hedge to preserve the capital in the portfolio, it may not always be possible to keep the derivative position open to match the realisation day of the portfolio of shares.

Generally, derivatives are by their very nature held for a very short period, as it becomes very expensive to enter into derivatives for a long period. To the extent that long-term derivatives are entered into, they are continuously rolled-over after every nine to twelve months in order to provide the same result. (Brincker 2008: W-7)

The complications arises because the derivative would have to be closed out and a gain/loss would result from such a close out. If the underlying was on capital account, the question would be whether such realised gain/loss is deferred until such time that the underlying asset is realised.

This might not be a major issue, since there are already provisions in the Act such as section 24I(10) which defers the unrealised gain/loss arising from transactions with connected persons until such time that the foreign exchange open position are realised.

In **CIR v Felix Schuh (SA) (Proprietary) Limited 56 SATC 57**, the court said the following:

> *"as has frequently been pointed out, the court is concerned with the deductions permitted in terms of the Act and not with debits or other provisions made in a taxpayer's accounts, even though these may be regarded as prudent and proper from an accounting point of view".*

The recommendations of the TAC seem to favour the accounting treatment of dealing with derivative transactions. As per the above case, our courts are not willing or prepared to apply the accounting rules to tax problems, even though the accounting treatment may reflect the true economic substance of the derivative transactions.

The introduction of section 24I, 24J, 24K and 24L (these were introduced subsequent to the TAC recommendations) addresses some of the issues identified by the TAC. However, to the extent that derivatives transactions are not covered by the above mentioned sections, the general timing rules would still be applicable.

3.5 CONCLUSION

The timing of income or expenditure and losses arising from a derivative financial instrument to the extent that it is not specifically dealt with in terms of specific provisions of the Act would be governed by the general timing rules contained in the Act (i.e., the definition of 'gross income' and section 11(*a*)).

For example, section 24I of the Act allows the inclusion or deduction of exchange gains or losses whether realised or unrealised into taxable income. This is contrary to the general timing rules which require the taxpayer to have an unconditional entitlement or obligation to income or expenditure and losses. Without this specific legislation, the unrealised gains or losses on foreign exchange transactions would not be brought into taxable income.

In terms of the general timing rules, income of the taxpayer arising from derivative transactions would form part of gross income during the year in which that taxpayer becomes unconditional entitled to such income.

Where for accounting purposes open derivatives positions at year end are marked-to-market and the unrealised gain brought into accounting income, such income would not be included in gross income. This is because the taxpayer is not unconditionally entitled to unrealised gains; the entitlement to such income would only arise at close-out of the derivative transaction.

Expenditure or losses arising from derivative transactions would be allowed as a deduction in terms of section 11(*a*) of the Act during the year of assessment in which an unconditional liability for payment is incurred.

So, where for accounting purposes unrealised derivative losses are brought into account in order to reflect the true economic substance of the taxpayer's financial position, such losses would not be allowed as a deduction. This is because the taxpayer would not have incurred an unconditional obligation to pay an amount.

What gives rise to the unconditional obligation to pay under a derivative contract is the close-out, termination, transfer or sale of the derivative transaction. Until such time as any of these events occurs, the payment on unrealised losses is conditional.

It is important to note at this point that in **CIR v Felix Schuh** *supra*, it was held that the court is concerned with the deductions permitted in terms of the Act and not with debits or other provisions made in a taxpayer's accounts.

This means that the recommendations made by the TAC with respect to the introduction of specific timing rules for derivatives would have to be legislated as the courts are not going to apply accounting rules tax issues.

Furthermore, until such legislative changes are introduced, the problems of using general timing rules to derivative financial instruments identified by the TAC would not be addressed.

Where a derivative contract is of a capital nature, the timing of the income or expenditure would be dealt with in terms of the Eighth Schedule of the Act. In terms of the Eighth Schedule a time of disposal is governed by paragraph 13. A person acquires a personal right on acquisition of the derivative, a time of disposal happens on the contract date in the case of a transfer of ownership, or in the case of the exercise of an option, on the date that the option is exercised.

Chapter 4

THE CURRENT INCOME TAX TREATMENT OF SPECIFIC DERIVATIVES

4.1 INTRODUCTION

The objective of this chapter is to deal with the income tax treatment of specific derivative financial instruments. The following derivative financial instruments would be dealt with: cross currency swaps (CCS), index options, credit default swaps and contract for differences. The purpose of analysing these specific derivatives is to assess whether the Act effectively provides for the income tax and CGT treatment of these derivatives.

4.2 CROSS CURRENCY SWAP

A CCS is an arrangement under which two parties agree to exchange specified amounts of two different currencies for a defined period. At the end of the period the arrangement specifies the re-exchange of the same amounts of the currencies regardless of the exchange rate ruling at the time. Typically, during the period of the swap the parties exchange a series of interest payments based on the amounts exchanged (van Wyk, K and Engelbrecht, H(1999:103))

A taxpayer would for example borrow US$100 million for his capital projects to be repaid in five years time. The taxpayer being concerned about the foreign currency risk may wish to hedge himself against the exchange rate fluctuations. The taxpayer would therefore exchange the $100 million for R1 billion on day one and agree with the counterparty that the amount (i.e. U$100 million) would be returned in 5 years time. By entering into this transaction, the taxpayer would have been able to manage the risk of foreign currency fluctuations as the taxpayer would have the US$100 million to repay the loan.

4.2.1 THE CAPITAL OR REVENUE NATURE OF A CROSS CURRENCY SWAP

The established test in South African case law to determine the capital or revenue nature of receipt is whether there was an "operation of business in carrying out a scheme for profit making". If the answer is in the affirmative, the income item or accrual will be of a revenue nature. The application of the test presupposes an enquiry into the state of mind or intention of the taxpayer (van Wyk, K and Engelbrecht, H 1999:198).

As discussed in Chapter 2, in order to determine whether the gains or losses incurred on a CCS are of a capital or revenue nature, one would have to enquire as to the intention of a taxpayer. If the intention was to deal with the CCS in a scheme of profit making or for speculative purposes or to hedge a revenue asset, the gains or losses would not be of a capital nature. If on the other hand, the CCS was entered into as a hedge of a capital asset, the gain or loss would be of a capital nature.

While the regular payments under a CCS may indicate a revenue character, the recurrence of a payment is not necessarily decisive of the capital or revenue enquiry but is simply an important factor to be taken into consideration in determining the taxpayer's intention in entering into the transaction giving rise to such payments. (Hutton, S 1998:223)

4.2.2 ANALYSIS OF THE WORKINGS OF A CCS

A CCS has the following stages as per the definition above:

a) Inception stage
b) Life stage
c) At termination

4.2.2.1 AT INCEPTION

At inception of the CCS the parties exchange physical currencies, for example Rands for Pulas.

Section 24K of the Act deals with interest rate agreement (for example, interest rate swap) and it governs the timing of payments made under those swaps.

It is important to determine whether a CCS is specifically dealt with in the Act before considering the general principles. In order to determine this, one must first determine the legal status of a CCS. The question that needs to be addressed first is whether a CCS is an interest rate agreement, a loan or a contract of exchange.

Section 24K (1) defines an interest rate agreement *inter alia* as follows:

> *"For the purposes of this section "interest rate agreement" means any agreement in terms of which any person-*
>
> *(a) acquires the right to receive-*
>
> *(i) an amount calculated by applying a rate of interest to a notional principal amount specified or referred to in such agreement;*
>
> *(b) becomes liable to pay*
>
> *(i) an amount calculated by applying any rate of interest to a notional principal amount specified or referred to in such an agreement.* (Own emphasis).

The phrase "notional principal amount" immediately excludes a CCS from qualifying as an interest rate agreement.

From the analysis of section 24K it would appear then that a CCS would not amount to an interest rate agreement, as with a CCS there is an actual 'advance' of an amount when the CCS is entered into and the interest is calculated on such an amount which had been advanced.

A loan for consumption is concluded when one party, called the lender, transfers something which can be consumed by use to another, called the borrower, for a certain period of time or to achieve a certain object and the borrower is then bound to return a thing of the same kind, quality and quantity as the one he receives.

Furthermore, if the party receiving a thing has the right to consume it but is bound to deliver some other thing the contract is one of exchange. Money paid in one currency has to be repaid in another currency according to the law of the place where repayment has to be made is excluded from a contract of exchange.

There is also a contract of exchange where things of the same sort are to be exchanged immediately, since the contract of loan for consumption involves the idea that some time must elapse after the things have been received before the lender is entitled to the return of other similar things. (Joubert, Faris & Harms, 2008: 178-179)

What is interesting with a CCS is that each party to a CCS plays a dual role in that each party is a borrower and also a lender at the same time. There are two possible conclusions to be drawn from this arrangement.

The first conclusion is that this is nothing more than a contract of exchange as one party receives currency and is immediately bound to deliver some other currency.

The second conclusion is that a CCS is nothing more than a loan or debt. This is because although one party receives currency and is immediately required or bound to deliver some other currency, such party is not completely released from its obligation to deliver a thing in the future. Put differently, a contract of exchange is for "keeps". In other words, there is no obligation on the parties to perform anything immediately after such contract of exchange has been concluded.

In terms of a CCS the parties also have a continuous obligation to make periodic payments which are calculated with reference to the amounts received from the other party and at a predetermined rate of interest.

Section 24J defines an instrument as *inter alia "any form of interest-bearing arrangement, whether in writing or not including – (c) any secured or unsecured loan, advance or debt".*

As in the case of a CCS, physical amounts are transferred between parties to the arrangement, the initial amount on the CCS would more likely meet the definition of an instrument as defined in section 24J.

It would therefore appear that a CCS has more characteristics of a loan or debt than that of a contract of exchange. It could also be argued that a CCS amounts to a parallel loan as both parties plays a dual purpose, i.e. that of a lender and a borrower.

Section 24J would therefore apply to a CCS as this amounts to a loan or debt as discussed above.

Without an exchange of principal, section 24J cannot apply to a CCS as it does not apply to payments on a notional amount (van Wyk, K and Engelbrecht, H 1999:104). A notional amount means that there is no physical advance or borrowings and thus one would not have an instrument as defined in section 24J. Without an instrument, section 24J cannot apply.

The initial exchange of principal amounts would amount to a loan or debt as discussed above. There would therefore be no accrual for income tax purposes in the hands of the taxpayer who receives an amount at the inception of a CCS. There would also be no deductions in the hands of a taxpayer who has made a payment in pursuance of a CCS at inception date.

4.2.2.2 LIFE STAGE OF A CCS

During the life of a CCS both parties make interest payments to each other based on a rate agreed at inception and on the initial amount advanced at inception.

In order to determine how interest payments made by the parties would be treated, one needs to consider the application of section 24J of the Act.

Section 24J of the Act defines interest as *inter alia "gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement."*

The periodic interest payments on CCS would therefore meet the definition of interest as defined in section 24J of the Act. This means that the periodic payments under a CCS would be accounted for in terms of section 24J of the Act. Interest would be accounted for on a yield-to-maturity basis over the life of the CCS. The effect of section 24J is that interest is spread evenly and included in taxable income over the period of the CCS

If at the end of the tax year a position in a CCS is still open, then one would have to consider the applicability of section 24I of the Act as a CCS involves an exchange of foreign currency.

Section 24I of the Act applies where there is an exchange item. An exchange item is defined in section 24I(1) as *inter alia "an amount in foreign currency owing by or to that person in respect of a loan advance or a debt incurred by or payable to such person."*

Furthermore section 24I(3) of the Act provides that "*any exchange differences in relation to any exchange item shall be included or deducted from the income of the taxpayer."*

The issue to consider is whether the initial amounts under the CCS would meet the requirements of an exchange item as defined. As discussed above, the initial exchange between the parties to a CCS would amount to a loan advance or debt. The initial amount would therefore meet the definition of an exchange item as such amounts are in foreign currency.

This means that the unrealised gains or losses on the foreign currency advance would be included or deducted from the income of the taxpayer in terms of section 24I(3). The unrealised gains of losses are determined on translation date, which is the end of any year of assessment.

Should the CCS transaction be between connected persons as defined, the provisions of section 24I(10) would apply. Section 24I(10) provides that the unrealised foreign exchange gains or losses should not be included in or deducted from income of the taxpayer if the other party to a transaction is a connected person. The taxpayer would only be taxable once the exchange item is realised.

4.2.2.3 AT TERMINATION

At termination of a CCS, the parties re-exchange the initial principal amount. As discussed above, if the transaction was entered into with a connected party, the unrealised foreign exchange gains or losses would at termination be realised and all deferred amounts in terms of section 24I(10) would be brought into income as inclusions or deductions.

The exchange difference on realisation would be included in or deducted from taxable income. Except for the inclusion or deduction of foreign exchange gains or loss on realisation of the CCS there would be no further income tax implications as the re-exchange would amount to repayment of loans by both parties.

4.2.3 CGT IMPLICATIONS OF A CCS

As discussed above, the capital or revenue nature of a CCS would depend on the intention of the taxpayer. If it could be concluded that the income or loss generated from the CCS is of a capital nature, one would have to deal with the implications for CGT.

The analysis of a CCS above indicates that the CCS is more in the nature of a loan and would therefore be dealt with in terms of section 24J and section 24I of the Act. The gains or losses generated from a CCS are in fact interest income or expenditure and foreign exchange gains or losses.

Section 24I, as discussed above includes exchange gains or losses in taxable income whether such gains or losses are capital or revenue is irrelevant. On the

other hand section 24J is the charging section and provides for the inclusion or deduction of interest income or expenditure on instruments.

This means that even if a CCS is of a capital nature, the interest income or expenditure and the foreign exchange gain or losses would form part of taxable income and will not be dealt with in terms of the Eighth Schedule to the Act.

4.3 INDEX OPTIONS

The essential characteristic of a an index option is the grant of a right to the option holder to receive a payment on the date that the option is exercised, equal to the difference between the base value of the index, that is the value of the index at the time of entering into the contract and the exercise price, that is, the strike price. From a cash flow perspective the holder incurs an option premium and may derive a cash pay-out where the option is in the money. Thus, the maximum loss that could be incurred by the option holder is the premium. From the viewpoint of the writer, the maximum income that will accrue is the premium income (van Wyk, K and Rudnicki,M 2000:310).

An index is a weighted or un-weighted average of the prices of a group of shares, commodities or other instruments. There are many types of indices for sectors, subsectors and entire markets. The Dow Jones, for example is a simple arithmetic average of the daily price of 30 blue chip stocks on the New York Stock Exchange. The Johannesburg Securities Exchange Indices are weighted according to Market capitalisation and exclude the smallest 20% of the quoted companies in the respective sectors (Van den Berg 2006: 265).

A taxpayer who has, for example, a strategy of acquiring shares in the top 40 index of the JSE may wish to protect himself against devaluation of his portfolio of shares in the top 40 index. The taxpayer would buy a top 40 index put option, this would give the taxpayer the right to sell shares to the option seller at a price which is higher than the market price of the overall top 40 index at exercise date. By entering into an

index option, the taxpayer would have managed to protect himself against dropping prices in the top 40 index and thus preserve his portfolio.

Section 24L of the Act defines an option contract as follows:

> *"Option contract means an agreement the effect of which is that any person acquires the option (excluding a foreign currency option contract as defined in section 24I(1)) –*
>
> *(b) that an amount of money will be paid to or received from another person before or on a future date depending on whether the value or price of an asset, index, currency, rate of interest or any other factor is higher or lower before or on that future date than the pre-arranged value or price".*

It would therefore follow from the above that an index option meets the definition of an option contract as defined in the Act. This means that the income tax implications of the index option would be dealt with in terms of section 24L of the Act.

4.3.1 DEDUCTIBILITY OF PREMIUM PAID

In terms of section 24L (2) of the Act, "*the amount of –*

(a) any premium or like consideration paid or payable by a person in terms of an option contract; or

(b) any consideration paid or payable by a person in respect of the acquisition of an option contract by such person,

Shall for the purposes of this Act be deemed to have been incurred by such person on a day to day basis during the term of such option contract: Provided that –

(i) where such option contract is exercised, terminated or disposed of, the portion of the amount attributable to the period from the date of exercise, termination or disposal until the end of the original term of the option contract shall be deemed to have been incurred by such person on the date of exercise, termination or disposal of the option contract;

(ii) the provisions of this section shall not be applied to an option contract held by a person as trading stock;

(iii) where such amount includes an amount representing the intrinsic value in relation to an option contract, so much of such amount so representing the intrinsic value shall for the purposes of this Act be deemed to have been incurred by such person on the date of exercise, termination or disposal of the option contract".

Section 24L does not dictate whether the expenditure incurred (i.e. the premium paid) is a of a capital nature or not. What section 24L deals with is the timing of the premium paid under an option contract. In order to determine the capital or revenue nature of the expenditure incurred by a taxpayer, the intention of the taxpayer must be taken into account.

In **ITC 118 4 (SATC 71)**, the taxpayer in that case had obtained information that a rock in which platinum was deposited was present in the Rustenburg district. The taxpayer raised the necessary capital to acquire options to purchase land in that area and sold them shortly thereafter at a profit. The court found that, as the taxpayer had acquired the options for the purpose of selling them at a profit and had organised himself into carrying out a scheme of profit-making for this purpose, the proceeds on disposal of the option were not of a capital nature.

To the extent that a holder of an option wishes to emphasise his capital intention, the better approach is for the option holder rather to exercise the option, as opposed to selling the option at a profit. In addition, the holder should insist upon physical settlement rather than cash settlement. If the holder is merely paid a cash amount equal to the difference between the strike price and the market price of the underlying asset, appearances at least indicate that there is a revenue intention. (Brincker 2008: Y-5)

As defined above, an index is not an asset that can be purchased. It is therefore not possible to acquire an index and thus an index option would always be cash settled. As Brincker alluded to above, where an option is cash settled 'appearances at least indicate that there is a revenue intention.

It is contended that a taxpayer will find it hard to convince the SARS that an indexed option without protecting any underlying risk position is being held purely for investment purposes due to its general short-term nature (van Wyk, K and Rudnicki, M 2000:312).

If it can be proven that the expenditure incurred to acquire the index option is of a revenue nature, the premium paid would be brought into taxable income on a day to day basis until termination of the option in terms of section 24L.

However, if it can be proven that the index option is held as trading stock, the premium paid would not be dealt with in terms of section 24L but the general deduction section 11(*a*) would be applicable. The premium paid would most likely be deducted when the index option is entered into in terms of section 11(*a*) as the expenditure would have been actually incurred and comply with the 'in the production of income' requirement.

4.3.2 TAXABILITY OF PREMIUM RECEIVED

In terms of section 24L(3),

> *"The amount of any premium or like consideration received or receivable by a person in terms of an option contract shall for the purposes of this Act be deemed to have accrued to such person on a day to day basis during the term of such option contract: Provided that where such option contract is exercised, terminated or disposed of, the portion of the amount attributable to the period from the date of exercise, termination or disposal of such option contract until the end of the original term of the option contract shall be deemed to have accrued to such person on the date of exercise, termination or disposal of the option contract".*

Section 24L does not dictate whether the amount received incurred (i.e. the premium received) is a of a capital nature or not. What section 24L deals with is the timing of the premium received under an option contract. In order to determine the capital or

revenue nature of the expenditure incurred by a taxpayer, the intention of the taxpayer must be taken into account.

In **ITC 321 (8 SATC 236)**, the taxpayer entered into a prospecting and option contract in terms of which she granted a third party the right to prospect for minerals on and an option to purchase the mineral rights over a number of farms owned by her. The court held that as the consideration was received for the disposal by the taxpayer of a portion of her rights of ownership in the farms, namely, her right to prospect for minerals and, in the case of the option, the right to dispose freely of the farms during the option period, consideration was of a capital nature.

In **ITC 721 (17 SATC 485)**, the taxpayer owned a number of immovable properties from which it derived rental income. In consideration for the grant by the taxpayer of an option to lease one of its properties for an agreed rental should the existing tenant vacate the property, the taxpayer received an option premium. The court held that in light of the fact that the taxpayer was in the business of letting properties, the option premium was derived by the taxpayer in the course of its business and, as such was of a revenue nature.

According to van Wyk, K and Rudnicki, M (2000:310), where the taxpayer's business is that of selling (writing) index options, it is most likely that the SARS would found the premium received from these activities to be not of a capital nature. Where the seller of the option enters into an option contract with the intention of protecting the capital (hedging) of his assets, the premium received would most likely be of a capital nature.

Section 24L governs the timing of the premium received under an option contract, whether the option contract is of capital or revenue nature, it would be brought into tax on a day-to-day basis over the period of the option contract.

4.3.3 TAXABILITY OF RECEIPT ON SETTLEMENT

At exercise date of the option, if it is in the money, the holder of the index option would receive a payment from the writer of the index option. The first question is what is the nature of the amount received by the option holder. The second question is when the amount should be included in taxable income.

The capital or revenue nature of the receipt on settlement would depend on the intention of the taxpayer. As discussed above, if the holder entered into the option contract in a scheme of profit making, the amount would be of a revenue nature. If the option contract was entered into as a hedge to protect a capital asset, then the receipt would be of a capital nature.

As discussed above, section 24L deems the option premium paid to have been incurred on a day to day basis over the life of the option contract. It however, does not deal with when the gain made by a holder should be brought into taxable income.

As discussed in chapter 2, where there is no specific section in the Act dealing with a derivative financial instrument, the general principles of the Act would apply. If the receipt is of a revenue nature, it would be dealt with under the gross income definition. The income would most likely be included in gross income on exercise date as the option holder would be unconditionally entitled to the receipt.

4.3.4 TAXABILITY OF PAYMENT ON SETTLEMENT

At exercise date of the option, if it is in the money, the option writer would make a payment to the holder of the index option. The first question is what is the nature of the amount paid by the option writer. The second question is when the amount should be deducted from taxable income.

The capital or revenue nature of the receipt on settlement would depend on the intention of the taxpayer. As discussed above, if the writer entered into the option contract in a scheme of profit making, the amount would be of a revenue nature. If

the option contract was entered into as a hedge to protect a capital asset, then the payment would be of a capital nature.

As discussed above, section 24L deems the option premium received to have accrued on a day to day basis over the life of the option contract. It however, does not deal with when the payment made by a holder should be allowed as a deduction.

As discussed in chapter 2, where there is no specific section in the Act dealing with a derivative financial instrument, the general principles of the Act would apply.

If the payment is of a revenue nature, it would be dealt with in terms of section 11(*a*) of the Act. The expenditure or loss would most likely be deducted from income on exercise date as the option writer would have incurred an unconditionally obligation to pay.

4.3.5 TRADING STOCK PROVISIONS

Section 24L(2) makes the following exceptions to the day to day incurral with regards to premium paid by the option holder.

> *"Provided that –*
>
> *(ii) the provisions of this section shall not be applied to an option contract held by a person as trading stock;"*

It would appear that the legislator concedes that an option contract can be held as trading stock.

Trading stock is defined in section 1 of the Act to include:

> (a) *" anything-*
>
> *(i) produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by him or on his behalf.*

(ii) the proceeds from the disposal of which forms or will form part of his gross income…".

It can be concluded from the above that where a taxpayer acquires an option with the intention or purpose of reselling at a profit, such option contract would meet the definition of trading stock.

Where an option meets the requirements of trading stock, the implications is that the premium paid would no longer be dealt with in terms of section 24L of the Act. The rules applicable to trading stock would be applicable to such an option which meets the definition of trading stock.

Section 22(2) of the Act deals with the value of trading stock held and not disposed of at the end of the taxpayer's year of assessment and provides that this value must be taken into account when determining taxable income.

Although section 22 does not indicate how these values must be taken into account, in practice the value of closing stock is added to, and the value of opening stock deducted from, the taxpayer's taxable income (Hutton, S 1998:208).

Section 22(1) deals with the value of closing stock to be added back to taxable income at the end of the taxpayer's year of assessment and provides as follows:

"The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment, shall be –

(a) in the case of trading stock other trading stock contemplated in (b), the cost price to such person of such trading stock, less such amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, not being shares held by any company in any other company, has been diminished by reason of

damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner; and

(b) in the case of any trading stock which consists of any instrument, interest rate agreement or option contract in respect of which a company has made an election which has taken effect as contemplated in section 24J(9), the market value of such trading stock as contemplated in such section".

The application of section 22(1)(a) to options held as trading stock would have the effect that if the option contract is 'out of the money' and the market value of the option is zero, the value to be included in taxable income would zero, provided that the taxpayer can demonstrate such value to the Commissioner.

Out of the money means a call option which has a strike price above the market price of the underlying asset, or a put option which has a strike price below the asset price (Van den Berg 2006: 269).

This means that the holder of the option would make a loss if he were to exercise the option and would thus not exercise the option.

If however, the option is 'in the money' at the end of the taxpayer and the market value were in excess of the original cost of acquiring the option contract, the value of the closing stock would be limited to the cost of acquiring the option (i.e., the option premium).

In the money means a call option which has a strike price below the market price of the underlying asset, or a put option which has a strike price above the asset price (Van den Berg 2006: 265).

This means that the holder of the option would make a gain if he were to exercise the option.

The overall effect of the application of section 22(1)(a) is that the unrealised losses, which would not normally be allowed as a deduction as they are not actually incurred in terms of section 11(a), would be allowed as a deduction. On the other hand,

unrealised gains would not be included in taxable income as the value to be included is limited to the lower of cost or net realisable value.

The effect of the application of section 22(1)(*b*) would be different to that of section 22(1)(a) due to the provision in section 22(1)(*b*) that market value is included in taxable income and not lower of cost or net realisable value as required in section 22(1)(*a*).

The overall effect of section 22(1)(*b*) is that both unrealised gains and losses would be included or deducted from taxable income. It is important to note that this would not apply to foreign currency option contracts as these are specifically dealt with in section 24I of the Act.

4.3.6 CGT IMPLICATIONS OF AN INDEX OPTION

If it could be proved that the gain made on an index option is of a capital nature, such gain would not form part of gross income. The question which arises is how the gain would be treated for CGT purposes.

As defined above, an index is not an asset that can be purchased. It is therefore not possible to acquire an index and thus an index option would always be cash settled. As discussed in Chapter 3, option contracts to the extent that they are physically settled are dealt with in terms of the Eighth Schedule. Where an option is cash settled, which will always be the case with an index option, there is no specific paragraph in the Eighth Schedule which deals with such a scenario.
Paragraph 11(1)(f) provides as follows:

> *"a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset and includes the granting, renewal, extension or exercise of an option".*

In addition, paragraph 13(1)(*a*)(vi) provides as follows:

> *"the time of disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law is, in the case of the granting, renewal or extension of an option, the date on which the option is granted, renewed or extended."*

There is therefore some clear guidance in the Act as to the disposal event and the timing of that disposal in respect of an option contract. There is however no guidance on the base cost of an option contract which is cash settled.

As discussed in chapter 3, the entering into a derivative contract creates a contractual right and the contractual right meets the definition of an asset according to the South African Revenue Service Guidance of Capital gains tax. It would mean that, the base cost of the index option is according to paragraph 20(1)(*a*) of the Eighth Schedule to the Act:

> *"the expenditure actually incurred in respect of the cost of acquisition or creation of that asset."*

This means that the premium incurred on entering into the option contract would be the base cost of the option contract (contractual right).

The proceeds on exercise date of the option would be according to paragraph 35(1) of the Eighth Schedule to the Act:

> *"…the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal…"*

It follows therefore that where an index option contract is of a capital nature, there is an argument to be made that the Eighth Schedule of the Act provides for the CGT treatment of such an option contract.

4.4 CREDIT DEFAULT SWAP

A credit default swap is a contract under which one of the parties (the protection seller), in exchange for a premium, is obliged to make a payment to the other party (protection buyer) if a credit event of a third entity (the reference entity which is not party to the credit default swap agreement) occurs. Some of the most common credit default events are bankruptcy, insolvency, payment default on obligations, failure to meet financial obligations or covenants or a rating down-grade below an agreed threshold (van Wyk, K and Engelbrecht, H (1999:193)).

A taxpayer whose business generates a significant amount of debtors may wish to protect himself against defaults by his customers. The taxpayer may therefore enter into a Credit Default Swap ("CDS"), so that when for example a specific customer default payment would be made to the taxpayer by the writer of a CDS.

From an economic perspective, a CDS can been seen as an option, as the protection seller would be obliged to pay an amount to the protection buyer in the event of that a so-called credit event occurs (Brincker 2008, X-11).

In terms of a CDS, a taxpayer would pay a premium and the CDS writer would receive a premium. This is similar to an option contract where the writer of an option receives a premium from the buyer.

The CDS holder has the right and no obligation to exercise his right in terms of the CDS. The CDS writer only has the obligation to perform when the CDS holder exercises his right. This is no different to an option contract.

In terms of the Master International Swap and Derivative Association agreements (ISDA), a credit default swap would be entered into on the basis of the parties ostensibly entering into a fixed rate for floating rate swap. A notional amount is agreed upon by the parties, which would more often than not be equal to the exposure of the protection buyer with reference to the so-called reference entity and a reference obligation. The obligation of the protection buyer or the floating rate

payer to make payment is conditional upon the occurrence of a credit event (Brincker 2008, X-11).

Instead of the taxpayer paying a premium on entering into a CDS, the parties could for example agree that payments would be made to one party or the other depending on the credit rating of a particular company or country. The parties could agree, for example, that payment would be based on a notional amount of R100 million and one party would pay a fixed rate of 10% and the other party would pay a variable rate linked to a credit rating. If for example the variable rate is 11%, the variable rate payer would pay a fixed rate payer 1% of R100 million.

A credit default swap could thus consist of the following which would need to be analysed from an income tax perspective:

a) Taxability of the premium received by the protection seller
b) Deductibility of the premium paid by the protection buyer
c) Taxability of the payment received by the protection buyer
d) Deductibility of the payment made by the protection seller

A credit default swap could also, to the extent that it is structured in such a manner, result in the protection buyer paying a fixed rate and the protection seller paying a floating rate with reference a notional amount. This notional amount would be equal to the exposure of the protection buyer with reference to the reference entity and a reference obligation.

4.4.1 PREMIUM RECEIVED

To the extent that the credit default swap is structured such that the protection buyer pays a premium and upon a happening of a credit event receives payment from the protection seller, it should be considered whether or not such an arrangement would not meet the definition of an option contract.

As discussed above, an option contract is defined in section 24L and this is dealt with above under index option (see section 4.3 above).

If the credit default swap is structured in such a manner that the protection buyer would be paid out an amount on a future date depending on whether a value of a reference obligation is higher or lower before or on that future date than a pre-arranged value, the credit default swap would meet the definition of an option.

If that is the case, the premium received by the protection seller would be included in income on a day to day basis.

If on the other hand it does not meet the definition of the option contract, the premium would be included in gross income when the protection seller is unconditionally entitled to the premium. This would most likely be on the day that the credit default swap is entered into.

4.4.2 PREMIUM PAID

As discussed above, if the credit default swap meets the definition of an option contract, the premium paid would be dealt with in terms of section 24L of the Act, and such premium would be deemed to have been incurred on a day to day basis over the period of the contract.

If it is not an option contract, the premium would be deductible when the protection buyer has incurred an unconditional obligation to pay. This would most likely be on the day that the credit default swap is entered into.

4.4.3 PAYMENT RECEIVED BY THE PROTECTION BUYER

When a default event or a pre-agreed event occurs, the protection seller would be obliged to make payment to the protection buyer. Whether or not the credit default swap met the requirement of an option contract the protection buyer would be unconditionally entitled to the payment received.

If however, the protection buyer has incurred a loss on the asset which was actually covered by the credit default swap; such loss would not be allowed as a deduction in terms of section 23(c) of the Act. Section 23(*c*) of the Act provides as follows:

> *"No deduction shall in any case be made in respect of the following matters, namely any loss or expense, the deduction of which would otherwise be allowed, to the extent to which it is recoverable under any contract of insurance, security or indemnity".*

This would imply that any payments received under a credit default swap in excess of the loss incurred on the asset would be included in taxable income.

According to Brincker (2008:X13), in view of the fact that there is at least an indemnity which is given on the basis that the protection seller will pay to the protection buyer an amount equal to at least the loss so suffered, payments made under the credit default swap would thus most probably be covered by section 23(*c*) of the Act.

4.4.4 PAYMENT MADE BY THE PROTECTION SELLER

From a protection seller's point of view, whether or not the credit default swap is treated as an option contract, the payment made would be deductible when the default event or the pre-agreed event occurs.

This is so because, at the occurrence of such event, the protection seller would have incurred an unconditional obligation to pay an amount as per the credit default swap agreement. It is unlikely that the amount would be of a capital nature as a CDS is entered into to protect against credit risk of revenue assets (i.e. debtors). Furthermore, a CDS is entered into for speculative purposes.

4.4.5 FIXED FOR FLOATING PAYMENTS

If on the other hand, a credit default swap is structured such that the protection buyer pays a fixed rate and the protection seller pays a floating rate, it would have to be considered whether or not the credit default swap could be considered to be an interest rate agreement as defined in section 24K of the Act.

In order for section 24K to apply, one party must pay a variable rate with reference to a notional amount or when one party receives a fixed amount such party must in return pay a variable rate with reference to a notional amount.

It is therefore likely that a credit default swap could fall within the ambit of section 24K depending on how it was structured.

If a credit default swap falls within the ambit of section 24K the payments made or received would be deemed to have been incurred or accrued on a day to day basis.

If however, the credit default swap does not meet the requirements of section 24K, it would be dealt with in terms of the general unconditional entitlement or obligation requirements. The payment would most likely be included or deducted at the date when the payment is due or receivable. Section 24J of the Act would not apply as a CDS does not amount to an instrument as defined in section 24J.

4.4.6 CGT IMPLICATIONS OF A CREDIT DEFAULT SWAP

If it could be proved that the gain made on a Credit Default Swap is of a capital nature, such gain would not form part of gross income. The question which arises is how the gain would be treated for CGT purposes.

Where the Credit Default Swap is structured in a nature of an option contract, the CGT implications would be the same as discussed under index options above.

On the other hand if the Credit Default swap is structured in such a manner that it meets the definition of a swap, enquiry has to be made as to how the Eighth Schedule would apply.

As discussed in Chapter 3, a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset and a contractual right meet the definition of an asset.

It therefore follows that where a taxpayer enters into a Credit Default Swap, the act of entering into such a derivative contract would result in a creation of rights and the creation of those contractual rights would amount to a disposal event.

In terms of paragraph 13(1)(*a*)(ii) of the Eighth Schedule:

> *"the time of disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law is, in the case of any agreement which is not subject to a suspensive condition, the date on which such an agreement is concluded."*

This means that in the case of a Credit default Swap which has been structured in such a manner that it meets the definition of an interest rate agreement, the time of disposal would the date on which the agreement is entered into.

Any payments received under the Credit Default Swap would form part of the proceeds in terms of paragraph 35 of the Eighth Schedule of the Act and any payments made would form part of the base cost in terms of paragraph 20 of the Eighth Schedule of the Act.

It follows therefore that where a Credit Default Swap is of a capital nature, there is an argument to be made that the Eighth Schedule of the Act provides for the CGT treatment of such an option contract.

4.5 CONTRACT FOR DIFFERENCE

In the broadest sense, contract for differences (CFDs) are traditionally an over-the-counter derivatives whereby both parties agree on the reference price of the underlying reference instrument and further agree that, should the underlying reference instrument increase in value, then the party that is long in respect of the CFD gets compensated and similarly the party that is short in respect of the CFD would pay this compensation (Watson, N 2007:18).

There is no specific section in the Act which deals with a CFD. The income tax implications of the CFD would therefore be analysed in terms of the general principles. The general principles would be applied to the various elements or cash flows of the CFD, as outlined above.

4.5.1 INITIAL MARGIN PAYMENT

When a person enters into a CFD, a deposit of cash margin is required instead of a payment for the full value of the underlying position (Nedbank.co.za, Not dated).

The Initial Margin paid by a taxpayer on entering into a CFD would no be allowed as a deduction as such amount would not amount to an expenditure actually incurred in terms of section 11(a) of the Act. This is because the Initial margin is like a deposit and is held as security over potential future claims against the taxpayer.

4.5.2 INTEREST ON INITIAL MARGIN

The funds that are deposited into a margin account would normal earn interest at an agreed rate of interest (Nedbank.co.za, Not dated).

This means that where a taxpayer has paid an Initial Margin pursuant to the CFD, such amounts are entitled to earn interest on a pre-agreed market related interest rate. In terms of section 24J of the Act, the payment would amount to interest as defined (see discussion under Cross Currency Swap at section 4.2.2.2).

The interest earned on the Initial Margin, calculated on the yield to maturity basis, would therefore be included in taxable income in terms of section 24J of the Act.

4.5.3 MARK-TO-MARKET MOVEMENTS ON CFD RESULTING IN A GAIN OR LOSS

Mark-to-market payments are payments to be made or received by the taxpayer, in accordance with any movements in the reference instrument. Mark-to-market payments reflect the profit or loss with respect to the CFD. This profit or loss reflect the income or loss that a person would receive or pay if the CFD were to b e terminated. If the reference instrument increases in value while the CFD is open, a person who is short on a CFD must pay the amount of the corresponding increase in the CFD value to the person who is long on the CFD. Conversely, if the reference instrument decreases in value while the CFD is open, the person who is long on the CFD must pay the amount of the corresponding decrease in the CFD value to the person who is short on the CFD (Nedbank.co.za, Not dated).

A long position means that a person who is long is the owner of that instrument as opposed to a short position (Van den Berg, 2006: 266).

This means that a long taxpayer on a CFD receives the returns generated by the reference instrument or asset referred to in a CFD and makes payment to a short taxpayer when there are negative returns from the reference asset.

The taxpayer who is short on the CFD makes good the growth or return generated by the reference assets and receives payments from the long taxpayer when there is negative growth in the reference asset. If the market moves in favour of or against the investor in CFDs, the investor's account would be credited or debited with the value of the gain or loss on his open position.

The question that needs to be addressed is whether such gain or loss would be included in or deducted from taxable income.

As discussed in chapter 2, whether the gain or loss is capital or revenue would depend on the intention of the taxpayer. If the CFD was entered into in scheme of profit making, the gain would be of a revenue nature and would be included in gross income.

If for example, a CFD was entered into as a hedge of a capital asset to preserve capital in the underlying asset, the gain would be of a capital nature.

On the question of when such gain or loss would be included or deducted for income tax purposes, it would depend on whether there is unconditional entitlement or obligation at the time of determining the gain or loss.

In terms of the CFD arrangement, where there has been a mark-to-market adjustment and a taxpayer suffers a loss, such taxpayer is required to top-up is Initial Margin. If a taxpayer makes a gain, his margin account would be credited with the gain.

This means that the taxpayer would be unconditionally entitled to the gain on the CFD and that gain would be included in taxable income when credited to the taxpayer's margin account. Conversely, the taxpayer who is required to top-up his margin account would have an unconditionally obligation to pay and the loss would be allowed as deduction when the loss is debited into his margin account. The payments on the mark-to-market movement happens during the agreed period of the CFD and also at termination of the CFD.

4.5.4 VALUE OF DIVIDENDS CREDITED TO THE LONG HOLDER OF A CFD

If a person holds a long position in a CFD at the close of business on the day prior to the ex dividend date of the underlying reference instrument, that person would receive an amount equal to the cash dividend on that security (Nedbank.co.za, Not dated). In other words, a holder of long position on a CFD is treated as if he owns the shares (i.e. enjoys the economic benefit of owning a share). When a dividend is

declared by a company, an equivalent cash payment is credited to the holder of the CFD. The person who is short on the CFD is required to make this payment to the holder.

This would happen where the reference asset is a share. When a dividend is declared on such a share the long taxpayer's margin account would be credited with the value of dividends in proportion to the size of the exposure under the CFD.

A dividend is defined in section 1 of the Act as *inter alia*

> *"any amount distributed by a company to its shareholders,"*

To receive voting rights related to JSE-listed securities a person must actually own the securities in their own name, this is not the case with a CFD (Nedbank.co.za, Not dated)

It is therefore important to note that a CFD is not a share and thus taxpayers who are long on CFD are not shareholders and thus payments received under a CFD although is made with reference to a dividend is not a dividend as defined.

This means that the amount received would not be treated as exempt dividend income. The nature of the income and the timing thereof would be as discussed above.

4.5.5 VALUE OF DIVIDENDS DEBITED TO A SHORT HOLDER OF A CFD

Where a person holds a short position in a CFD at the close of business on the day prior to the ex dividend date, that person is required to pay an amount equal to the cash dividend (Nedbank.co.za, Not dated).

As discussed above the payment made by a taxpayer who is short on a CFD would not amount to a dividend. This means that the amount would not be treated as a dividend which is subject to secondary tax on companies.

The nature of the loss and the timing thereof would be as discussed above.

4.5.6 CLOSING A CFD POSITION AND RETURN OF INITIAL MARGIN

At the close-out of a CFD when all mark-to-market movements have been taken into account, a taxpayer would receive his initial margin paid at the inception of a CFD. The return of the initial margin payment to the CFD investor would not be subject to tax as such original initial margin would be treated as a return of a deposit. In other words, such an amount does not meet the requirements of gross income as defined in section 1 of the Act.

4.5.7 CGT IMPLICATIONS OF A CFD

If it could be proved that the gain made on a CFD is of a capital nature, such gain would not form part of gross income. The question which arises is how the gain would be treated for CGT purposes.

As discussed in Chapter 3, a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset and a contractual right meet the definition of an asset.

It therefore follows that where a taxpayer enters into a CFD, the act of entering into such a derivative contract would results in a creation of rights and the creation of those contractual rights would amount to a disposal event.

In terms of paragraph 13(1)(*a*)(ii) of the Eighth Schedule:

> *"the time of disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by operation of law is, in the case of any agreement which is not subject to a suspensive condition, the date on which such an agreement is concluded."*

This means that in the case of a CFD, the time of disposal would the date on which the agreement is entered into.

Any payments received (except for the interest earned on the Margin account) under the CFD would form part of the proceeds in terms of paragraph 35 of the Eighth Schedule of the Act and any payments made would form part of the base cost in terms of paragraph 20 of the Eighth Schedule of the Act.

4.6 CONCLUSION

It would seem that from an analysis of a Cross Currency Swap, Index Option, Credit Default Swap and Contract for Difference, there are some specific sections within the Act which deals with certain elements of these derivatives.

As far as the nature of gains accrued or losses incurred on these derivatives is concerned, the intention of the taxpayer is of paramount importance. Where these derivatives are entered into with the intention of scheme of profit making, the gains accrued or losses incurred would be of a revenue nature. Similarly, where the derivatives are entered into as a hedge of a revenue asset, the gain accrued or losses incurred would be of a revenue nature in line with the underling asset.

Where these derivatives are entered into as a hedge of an underlying capital asset, the gain or loss would be of a capital nature. It would be difficult though to prove a capital intention with a derivative such as an index option, as this derivative is always cash settled. Where a derivative is cash settled as opposed to physical settlement, it would be very difficult for a taxpayer to prove that the intention was capital unless such derivative was entered into as a hedge of a capital asset.

As far as the timing of gains accrued or losses incurred is concerned, unless a specific section in the Act deals with such a derivative, the general principles of unconditional entitlement or obligation would apply.

Section 24L which deals with option contracts and section 24K which deals with interest rates agreements applies the day to day method of accrual or incurral. Derivatives such index options would so far as the premium paid or received is concerned be dealt with in terms of section 24L.

However, where the option contract is treated as trading stock by the Holder, the provisions of section 24L are not applicable as such section specifically exclude option held as trading stock. In such as case the general provisions of section 11(a) which deals with deductibility of expenditure and losses together with the provisions of section 22 which deals with trading stock would be applied.

Section 22(1)(*a*) is favourable to the taxpayer as it allows the taxpayer to claim unrealized losses and to disregard unrealized gains. This is because trading unexpired options at the end of the year of assessment are allowed to be included at the lower of cost of net realizable value.

Section 22(1)(*b*) applies to option contracts where a taxpayer has elected the market value method in terms of section 24J(9). The method of bringing stock into taxable income results in both unrealized gains and losses being taxable or deductible.

As far as the treatment of trading stock is concerned, a taxpayer who does not make an election in terms of section 24J(9) is better off as he would be able claim as a deduction unrealized losses on unexpired option contracts and disregard unrealized gains.

A derivative such as a Cross Currency Swap is dealt with under more than one specific section in the Act. These are section 24J and section 24I. In addition, it is dealt with in terms of general principles of the Act. This is because it has elements of an instrument as defined in section 24J and also has an element of an exchange item as defined in section 24I.
A credit default swap could, depending on how it is structured, be dealt with as an option contract under section 24L in which case the premium paid or received would be deemed to have been incurred or accrued on a day to day basis. Alternatively, based on how it is structured, it could be treated as an interest rate agreement in

terms of section 24K in which case the fixed or floating rate amounts would be deemed to have accrued or incurred on a day to day basis.

A contract for difference on the other hand is not dealt with under any specific section of the Act, although with respect to the interest on initial margin, it will be dealt with in terms of section 24J of the Act.

A contract of difference due to its design and how it works, lends itself to the general principles of unconditional entitlement or obligation. A contract of difference is designed in such a way that whenever there is a mark-to-market movement, the parties to the contract of differences are immediately unconditional entitled to receive or obligated to pay the amount due by way of margin calls.

Except for a CCS, where the derivative discussed in this Chapter could be proven to be of a capital nature, there appears to be some argument to be made in terms of the Eighth Schedule of the Act that such derivatives are generally catered for.

A disposal event for these derivatives would generally be the date on which the derivative contract is disposed of.

The time of disposal would be the date on which the contract is disposed of or terminated and this date would be the disposal of the personal rights created on entering into the derivative contract.

To a certain extent, the disposal event and the time of disposal for an option contract is specifically dealt with in the Eighth Schedule. However, where an option contract is cash settled, the general rules as mentioned above would apply. Where the option contract is physically (or equity) settled, the cost of the option contract would form part of the base cost of the asset actually acquired.

Chapter 5

CONCLUSION AND RECOMMENDATIONS

5.1 INTRODUCTION

The research problem which was considered in this dissertation was whether the Act deals with the income taxation of derivatives with respect to the nature and timing of gains and losses.

Having considered the research material around the taxation of derivatives this chapter deals with the conclusions and recommendations.

5.2 NATURE OF GAIN OR LOSS

With respect to the nature of gains or losses arising from derivative financial instruments, there is no specific section in the Act which dictates the nature of such gain or loss. The analysis of the research material indicates that in order to determine the nature of the gain or loss from a derivative enquiry has to be made as to the intention of the taxpayer when dealing in a particular derivative financial instrument. The nature of the expenditure or loss incurred or a return derived from a derivative financial instrument can either be of a capital or revenue nature.

The analysis of the research material indicates that where a taxpayer enters into derivative financial instruments for speculative purposes, this would amount to a scheme of profit making and the nature of the gain or loss would be of a revenue nature and would thus be subject to normal tax.

If on the other hand the taxpayer has entered into derivatives as a hedge of a capital asset or capital intention, the gain or loss would be of a capital nature and would be treated in terms of the Eighth Schedule of the Act.

5.3 TIMING OF INCOME AND EXPENDITURE

As far as the timing of gains or losses arising from derivative is concerned, the research shows that some derivatives are dealt with in the Act. More specifically, section 24I of the Act deals with the treatment of foreign currency option contracts and forward exchange contract. These are derivative which derives its value from a foreign currency.

In addition, section 24K of the Act deals with the timing of payments made in terms of interest rate derivatives. Also, section 24L deals with the timing of payments made under option contracts. The Eighth Schedule of the Act also deals with the CGT implications of option contracts which are physically settled.

Other than the above, the research material indicates that the Act has no specific sections dealing with derivatives which are not covered under section 24I, 24K and 24L. In addition, the only derivative which is specifically mentioned and dealt with in the Eighth Schedule is an option contract which is physically settled, the rest of the derivative are not specifically dealt with in the Eighth Schedule.

The analysis of the research indicates that one would have to deal with the timing of gains or losses from derivatives in terms of the general provisions of the Act. The general timing rules indicates that income of the taxpayer arising from derivative transactions would form part of gross income during the year in which that taxpayer becomes unconditional entitled to such income.

Also, expenditure or losses arising from derivative transactions would be allowed as a deduction in terms of section 11(*a*) of the Act during the year of assessment in which such taxpayer incurs an unconditional liability to pay.

Where a derivative contract is of a capital nature, the timing of the income or expenditure would be dealt with in terms of the Eighth Schedule of the Act. In terms of the Eighth Schedule a time of disposal would be the date on which the derivative contract is entered into, thus any payments received on or subsequent to that date

would be proceeds and any payments made on or subsequent to that date would be base cost as defined.

5.4 SPECIFIC DERIVATIVES

The analysis of the research material indicates that, there are some specific sections within the Act which deals with certain elements of a Cross Currency Swap, Index Option, Credit Default Swap and Contract for Difference.

In as far as it relates to whether the gain or loss arising from derivatives is of a capital or revenue nature, the intention of the taxpayer is of paramount importance. Where these derivatives are entered into with the intention of scheme of profit making, the gains accrued or losses incurred would be of a revenue nature. Similarly, where the derivatives are entered into as a hedge of a revenue asset, the gain accrued or losses incurred would be of a revenue nature in line with the underlying asset.

Where these derivatives are entered into as a hedge of an underlying capital asset, the gain or loss would be of a capital nature. It would be difficult though to prove a capital intention with a derivative such as an index option, as this derivative is always cash settled. Where a derivative is cash settled as opposed to physical settlement, it would be very difficult for a taxpayer to prove that the intention was capital unless such derivative was entered into as a hedge of a capital asset.

Derivatives such as index options would so far as the premium paid or received is concerned be dealt with in terms of section 24L. However, where the option contract is treated as trading stock by the Holder, the provisions of section 24L are not applicable as such section specifically exclude option held as trading stock. In such as case the general provisions of section 11(*a*) which deals with deductibility of expenditure and losses together with the provisions of section 22 which deals with trading stock would be applied.

Section 22(1)(*a*) is favourable to the taxpayer as it allows the taxpayer to claim unrealized losses and to disregard unrealized gains. This is because trading

unexpired options at the end of the year of assessment are allowed to be included at the lower of cost of net realizable value. Section 22(1)(*b*) applies to option contracts where a taxpayer has elected the market value method in terms of section 24J(9). The method of bringing stock into taxable income results in both unrealized gains and losses being taxable or deductible.

As far as the treatment of trading stock is concerned, a taxpayer who does not make an election in terms of section 24J(9) is better off as he would be able claim as a deduction unrealized losses on unexpired option contracts and disregard unrealized gains.

A derivative such as a Cross Currency Swap is dealt with under more than one specific section in the Act. These are section 24J and section 24I. In addition, it is dealt with in terms of general principles of the Act. This is because it has elements of an instrument as defined in section 24J and also has an element of an exchange item as defined in section 24I.

A credit default swap could, depending on how it is structured, be dealt with as an option contract under section 24L in which case the premium paid or received would be deemed to have been incurred or accrued on a day to day basis. Alternatively, based on how it is structured, it could be treated as an interest rate agreement in terms of section 24K in which case the fixed or floating rate amounts would be deemed to have accrued or incurred on a day to day basis.

A contract for difference on the other hand is not dealt with under any specific section of the Act, although with respect to the initial margin, it will be dealt with in terms of section 24J.

A contract of difference due to its design and how it works, lends itself to the general principles of unconditional entitlement or obligation. A contract of difference is designed in such a way that whenever there is a mark-to-market movement, the parties to the contract of differences are immediately unconditional entitled to receive or obligated to pay the amount due by way of margin calls.

A disposal event for these derivatives would generally be when the derivative contract is exercised, terminated or at maturity date.

The time of disposal would also be the date on which the derivative contract is exercised, terminated or at maturity date.

To a certain extent, the disposal event and the time of disposal for an option contract is specifically dealt with in the Eighth Schedule. However, where an option contract is cash settled, the general rules as mentioned above would apply. Where the option contract is physically (or equity) settled, the cost of the option contract would form part of the base cost of the asset actually acquired.

5.5 RECOMMENDATIONS

In light of the conclusions above, the following are recommended:

5.5.1 HEDGING

The Legislature should include rules governing the income tax treatment of a derivative used as a hedge. The concern is that, the life span of a derivative is very short as it is expensive to keep derivatives positions open for a very long time. So, for example where a taxpayer intends to hedge a capital investments and does so by entering into a series of derivatives with a maturity profile (i.e. short-term) different to the underlying asset (i.e. long-term), it is likely that a conclusion could be reached that a taxpayer maybe speculating without giving consideration to the purpose of entering into those derivatives.

The recommendation made by the TAC in 1994 which has as yet to be implemented is supportable and it is repeated below.

> *Special hedging rules would match the tax treatment of the hedging instrument to that of the underlying transaction, position or asset. These rules would attempt to achieve a composite tax treatment whereby the hedge and*

the underlying instrument are taxed as a single unit. If the underlying transaction was taxed on a compounding accrual basis, the hedging instrument would also be taxed on a compounding accrual basis. If the underlying transaction was taxed on a due and receivable basis, the hedging instrument would be taxed on a due and receivable basis" (TAC 1994:63).

It is important to clarify here that there would have to be some requirements on the part of the taxpayer to provide supporting evidence of the hedging relationship between the transaction or position being hedged and the derivative.

5.5.2 SPECIFIC DERIVATIVES

As highlighted in Chapter 1 of this document, even a casual observer of capital markets would have noted that the past 25 years have witnessed an explosion in the development of new financial instruments. Indeed, this awareness is so widespread that the idea of explosive financial innovation, presumably in response to the increasing volatility of interest rates and exchange rates, is almost as trite at this point as the idea of globalisation (Edgar 2000:1).

It is therefore recommended that that the Commissioner of the South African Revenue Service should provide guidance (this guidance should be supported by the legislature and should be binding) on the income tax treatment of a class of derivatives or specific derivatives as and when they emerge. This would ensure consistent treatment of derivative financial instruments by all taxpayers.

5.5.3 CAPITAL GAINS TAX

The Act only specifically deals with the CGT implications in the Eighth Schedule in as far as it relates to option contracts which are equity or physically settled. It is recommended that there should also be guidance with respect to the CGT implications of derivatives which are of a capital nature. This guidance should clearly and specifically indicate the disposal event, the time of disposal, base costs and proceeds.

5.5.4 TIMING RULES

The introduction of section 24I, 24K and 24L of the Act has to some extent assisted with the timing of income or expenditure of some derivatives like foreign currency option contracts, swap transactions (i.e. interest rate agreements) and option contracts.

It is therefore recommended that the timing rules also be introduced to a wider group of derivative financial instruments in order to have clarification and consistency in treatment.

LIST OF REFERENCES

Hutton S. 1998. The taxation of derivatives in South Africa. The Taxpayer Journal, Vol 47.

Joubert, Faris and Harms. 2008. *The law of South Africa. Second* Edition, Vol 15 part 2. Durban: LexisNexis.

Van den Berg. 2006. *Understanding Financial Markets & Instruments.* Roosevelt Park Gauteng: Eagle Rock Financial Services CC.

van Wyk, K and Engelbrecht, H. 1999. South Africa: The tax treatment of Credit default swaps proceeds. Derivative & Financial Instruments Journal, Vol 1 No. 4.

Nedbank.co.za, Not dated. Contract for Difference. [Online] Available from: https://www.nedbank.co.za/website/content/CFD/faqs.asp [Accessed: 2008-03-22].

Huxham and Haupt, 2009. Notes on South African Income Tax. Roggebaai : Hedron CC.

Lategan v CIR 1926 CPD 203, 2 SATC 16.

CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A).

Mooi v SIR 1972 (1) SA 675 (A), 34 SATC 1.

Nasionale Pers Bpk v KBI 46 SATC 83.

CIR v Golden Dumps (Pty) Ltd 55 SATC 198 (A).

CIR v Felix Schuh (SA) (Proprietary) Limited 56 SATC 57.

The Tax Advisory Committee, 20 July 1994. South Africa: Consultative document on the tax treatment of financial arrangements.

Van Wyk, K and Engelbrecht, H. 1999. South Africa: The tax treatment of Credit default swaps proceeds. Derivative & Financial Instruments Journal, Vol 1 No. 4.

Brincker, T. E. 2008. Taxation principles of interest and other financing transactions. Issue 5.

CIR v Pick 'n Pay Employee Share Purchase Trust 1992 (4) SA 39 (A).

WJ Fourie Beleggings CC v CSARS (70 SATC 8).

New State Areas Ltd v CIR 1946 AD 610.

CIR v African Oxygen Ltd 1963 (1) SA 681 (A), 25 SATC 67.

Burmah Steam Ship Co Ltd v IRC (1931 SC 156).

CIR v Visser 1937 TPD 77, 8 SATC 271.

Cir v George Forest Timber Co Ltd 1924 AD 516, 1 SATC 20).

Elandsheuwel Farming (Edms) Bpk v SBI 1978 (1) SA 101.

COT v Booysens Estates Ltd 1918 AD 576.

Overseas Trust Corporation Ltd v CIR 1926 AD 444, 2 SATC 71.

CIR v Illovo Sugar Estates Limited 1951 (1) SA.

Tim Edgar, 2000. The Income Tax Treatment of Financial Instruments: Theory and Practice.

Bodie, Cane and Marcus. 1998. *Essentials of Investments.* Third Edition. Boston: Irwin McGraw-Hill.

Thuronyi V Senior Counsel (Taxation) IMF. 17 August 2001. Taxation of New Financial Instruments [Online] Available from: http://unpan1.un.org/intradoc/groups/public/documents/unpan004463.pdf [Downloaded: 2007-03-02]

Van Wyk, K and Rudnicki M, H. 2000. South Africa: The tax treatment of Index Options. Derivative & Financial Instruments Journal, Vol 1 No. 6.

Watson, N. September 2007. The ABC of CFDs. Accountancy SA: 18.