

# **The Taxation of Financial Derivative Instruments in South Africa**

by

**Rohan Kruger**

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Supervisor: Carika Keulder

## Summary

The financial derivatives market is by its very nature extremely innovative and new financial instruments are constantly being developed. Financial derivatives, in particular poses a threefold challenge to taxation, i.e. the character of derivative income; the jurisdiction to tax derivatives; and when derivative income is taxed. As such, this dissertation is a discussion on the taxation of financial derivative instruments and seeks to answer the question whether or not the South African tax dispensation can adequately cater for the taxation of financial derivatives.

Firstly, the reader is introduced to the most common types of derivative instruments as well as the transactions in which they are utilised. Practical examples are also provided so as to illustrate each derivative contract and/or transaction in question. Secondly the ordinary South African tax principles are discussed with a focus as to their applicability in the taxation of financial derivatives. Thirdly, and by having regard to the position in the United Kingdom, this dissertation answers the aforementioned question by identifying the weaknesses in the South African tax dispensation and providing proposals as to how such weaknesses, in relation to the taxation of financial instruments, can be remedied.

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## **Chapter 1: Introduction**

### **1.1 Introduction**

The dissertation deals with the taxation treatment of derivative financial instruments in terms of the Income Tax Act 58 of 1962 (“the Act”), and seeks to answer the question as to whether the Act contains adequate provisions for the taxation of such derivatives.

In essence the question posed is whether the Act and the established principles of taxation in South Africa are elastic enough to find application to each and every derivative contract and/or transaction entered into. This is of particular importance especially when the taxation principles are considered in light of the constant innovation in the derivative markets. The dissertation will also contain a discussion of the taxation treatment of derivative contracts in the United Kingdom, where after the position will be juxtaposed to that of South Africa.

### **1.2 Limitations encountered**

The major limitation encountered in the writing of this dissertation was a lack of research material available on the topic, both in South Africa and abroad. Even though numerous academic articles, case law and legislation pertaining to derivative contracts in general exists, there has been extremely little written about the taxation of derivative contracts.

### **1.3 Background**

In simple terms derivatives are defined as financial instruments that derives their value from the values of underlying securities or other variables. The variables can either be an index, for example JSE All Share Index, or any other underlying instrument, such as an equity, bond, foreign exchange or commodity.<sup>1</sup>

Derivative instruments have increased in importance and value over the last 20 years to such an extent that it is now speculated that the worldwide derivatives market has

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<sup>1</sup> Goodspeed *Introduction to Financial Markets* (2013) at 129.

overtaken the worldwide securities market.<sup>2</sup> So much so that in June 2008, the Over the Counter (“OTC”) derivatives market reached a peak of more than \$680 trillion of gross outstanding notional value.<sup>3</sup>

The taxation of derivatives has proved to be challenging as the financial engineers often tend to be a step ahead of the tax authorities by devising new derivatives, which in a majority of cases includes a tax incentive.<sup>4</sup>

South Africa does have legislation in place which extensively deals with the regulation of financial services.<sup>5</sup> However, according to Oguttu, South Africa’s income tax system has struggled to keep abreast with the complex and sophisticated developments in the derivative industry. Oguttu further opines that in some instances South Africa’s ordinary tax principles are inadequate to deal with the taxation of derivatives, and there is merely a few sections of the Act which finds application to the taxation of derivatives.<sup>6</sup>

Derivative contracts are mostly used to reduce certain risks. This practice is known as hedging. Hedging entails that a position<sup>7</sup> is taken in an instrument which produces a price movement. This price movement is hopefully opposite to an existing or anticipated position and thus serves to protect against a loss caused by fluctuations in prices, interest rates or exchange rates.<sup>8</sup>

Derivatives can also be used as a source of revenue by way of speculation or arbitrage transactions.<sup>9</sup> Speculation entails a transaction where the participants (described as speculators) hope to profit by accepting the risk that stems from taking outright positions in anticipation of price movements. Phrased in a tax paradigm, speculation entails a

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<sup>2</sup> Brinker *The taxation Principles of Interest and Other Financing Transactions* (2011) at W1.

<sup>3</sup> National Treasury “An Examination of the South African OTC Derivatives Market to Recommend Measures for Strengthening their Regulatory Oversight” (2012) at 16 available at <http://bit.ly/1C9QVsr> (Accessed on 21 March 2015).

<sup>4</sup> Oguttu “Challenges in Taxing Derivative Financial Instruments: International Views and South Africa’s Approach” (2012) 24 *SA Merc LJ* at 385.

<sup>5</sup> Which amongst others includes the Financial Markets Act 19 of 2012.

<sup>6</sup> Oguttu *op cit* n4 at 386.

<sup>7</sup> The position is taking by entering into a derivative contract as either a “long” or a “short” as more fully explained in paragraph 2.4.1 below.

<sup>8</sup> Oguttu *op cit* n4 at 389.

<sup>9</sup> Oguttu *op cit* n4 at 389.



scheme of profit making by entering into derivative contracts with the sole objective of obtaining a profit.<sup>10</sup> Arbitrage is a generic term which refers to a number of techniques which can be utilised to exploit the pricing and regulatory anomalies in the derivatives market.<sup>11</sup> This is done by the arbitrators taking advantage of the volatility in the financial markets by profiting from discrepancies in prices among similar instruments in different markets and locations.<sup>12</sup>

Derivatives poses a threefold challenge to Income Tax, namely the following:<sup>13</sup>

- the character of derivative Income;<sup>14</sup>
- the jurisdiction to tax derivatives;<sup>15</sup>
- when derivative income is taxed.<sup>16</sup>

Internationally tax laws have struggled to keep up with the innovations in the financial markets, especially as financial instruments become increasingly more complex and sophisticated. South African tax laws are no different, and apart from a few sections of the Act, the taxation of derivative contracts and/or transactions is not specifically regulated in the Act.<sup>17</sup> These sections are:

- section 24K, which deals with interest rate agreements;
- section 24L, which pertains to option contracts; and
- section 24M, which contains the provisions in respect of assets acquired or disposed of for unquantifiable amounts.<sup>18</sup>

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<sup>10</sup> Oguttu *op cit* n4 at 389.

<sup>11</sup> National Treasury *op cit* n3.

<sup>12</sup> Oguttu *op cit* n3 at 389. These transactions and the use of derivatives will be elaborated on in Chapter 2.

<sup>13</sup> See also Olivier & Honniball *International Tax A South African Perspective* (2011) at 257-261.

<sup>14</sup> Oguttu *op cit note* 3 at 391.

<sup>15</sup> Oguttu *op cit note* 3 at 392.

<sup>16</sup> Oguttu *op cit note* 3 at 393.

<sup>17</sup> Olivier & Honniball *op cit* n12 at 257.

<sup>18</sup> It must be noted that sec 24 M would also find application in other scenarios concerning assets acquired or disposed of for unquantifiable amounts and is not limited to a scenario concerning the taxation of derivative contracts.

It must be noted that the aforementioned sections of the Act only pertains to the timing aspect of derivative contracts, and neither seeks to regulate the character of the derivative income, nor the jurisdiction on which the derivative income should be taxed.

Consequently, and as the Act only seems to address the timing aspect of a few of the derivative contracts in use, the ordinary tax principles has to find application in the context of a derivative transaction.<sup>19</sup> The ordinary tax principles are those pertaining to the classification of an amount as either revenue or capital of nature, as well as the ordinary principles applicable to source and timing, of an accrual.

One of the first major studies on how derivatives should be taxed was a report by the Organisation for Economic Co-operation and Development (“OECD”)<sup>20</sup>, which dealt with the taxation of derivatives in different OECD countries.<sup>21</sup> Another major study was done by the International Fiscal Association in 1995,<sup>22</sup> and in 1998 the OECD published a report on the taxation of global trading of financial instruments.<sup>23</sup> According to Oguttu, with whom I agree, all of the above mentioned studies found that the three challenges in the taxation of derivatives are:

- how to determine the character of derivative income;
- the jurisdiction to tax the derivative income; and
- when that income should be taxed.<sup>24</sup>

With regards to the South African context, the only study that has been done as of yet, was in 1994 when the Tax Advisory Committee published a document entitled: “Consultative Document on the Tax Treatment of Financial Arrangements.”<sup>25</sup>

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<sup>19</sup> Olivier & Honniball *op cit* n12 at 257.

<sup>20</sup> OECD *Taxation of New Financial Instruments* (1994).

<sup>21</sup> Oguttu *op cit* n4 at 390.

<sup>22</sup> IFA *Tax Aspects of Global Trading of Financial Instruments* (1995).

<sup>23</sup> OECD *The Taxation of Global Trading of Financial Instruments* (1998). The findings of these studies will not be dealt with at length in this dissertation, mainly for the reason that all three of the aforementioned studies came to similar findings

<sup>24</sup> Oguttu *op cit* n4 at 391.

<sup>25</sup> Tax Advisory Committee *Consultative Document on the Tax Treatment of Financial Arrangements* (1994).

Having regard to the above this dissertation aims to contain a study on the taxation of derivative contracts and/or transactions, by especially having regard to the applicability of the general and established principles of taxation in relation to these transactions.

#### **1.4 Research Question**

The research question which this dissertation seeks to answer is the following:

Does the South Africa tax dispensation possess adequate provisions for the taxation of financial derivatives?

#### **1.5 Aim Of The Dissertation**

The aim of this dissertation will be threefold. Firstly, it will seek to explain derivative contracts. This will be done by embarking upon an analysis of the legal nature of a derivative contract as well as by defining the most common types of derivative contracts and the transactions in which they are most frequently made use of.

Secondly the current South African income taxation principles, as laid down either by the Act itself, or by virtue of the case law, will be explored. The discussion of these principles will specifically focus on their applicability in the context of derivative contracts and/or transactions. As mentioned above<sup>26</sup>, the specific provisions of the Act which finds application to derivative contracts will also be discussed in Chapter 3.

Lastly, in order to ascertain whether the South African tax dispensation can adequately cater for the taxation of derivative contracts and/or transactions, a chapter will be devoted to a discussion of the position in the United Kingdom. Where after the position in the United Kingdom will be compared to the South African position.<sup>27</sup>

It is submitted that only after having due regard to the above mentioned three factors can one reach an opinion on whether or not the current South Africa tax dispensation can adequately cater for the taxation of derivative contracts.

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<sup>26</sup> As discussed in paragraph 1.3 above.

<sup>27</sup> For purposes of the comparative study, the United Kingdom is chosen as many emerging market transactions are conducted through and from the United Kingdom.

## 1.6 Brief synopsis of each chapter to this dissertation

The second chapter will deal with the definition of derivative contracts. Firstly it will explain the legal nature of a derivative contract, after which the derivative contracts entered into most frequently will be explained. This chapter will also analyse the transactions in which these derivative contracts are employed.

The third chapter will *inter alia* be a study of the general principles of South African taxation and their applicability to derivative contracts, as well as the specific provisions of the Act which pertains to derivative contracts. This chapter will seek to answer and interpret, through a South African tax paradigm, the aforementioned three taxation challenges posed by derivative contracts.

The fourth chapter will contain a discussion of how the United Kingdom chose to deal with the taxation of derivative contracts. Here the provisions applicable in the United Kingdom will be analysed.

The last chapter will be a juxtaposition between the South African approach and that of the United Kingdom. It will seek to answer whether the South African tax dispensation can in any way benefit by adopting a similar approach to that of its counterpart in the United Kingdom.

The last chapter will also answer the research question which was posed herein, and if answered in the negative will contain recommendation as to how the South African tax dispensation can improve in order to adequately cater for the taxation of derivative contracts.

## Chapter 2: Derivative Financial Instruments

### 2.1 Introduction

The object of this chapter is to provide the reader with an understanding of what a derivative contract and/or transaction entails, as well as to discuss the definitions of the more frequently used types of derivatives, namely that of forwards, futures, options and swaps. Furthermore, the types of transactions in which derivatives are employed will be explained, with the focus being on speculation and hedging transactions.

Derivatives allow businesses to manage, or hedge risks that arise from volatile equity prices, interest rates, foreign currencies and a wide range of other variables. They are also used by investors seeking profits by betting on which way the price will move.<sup>1</sup>

### 2.2 Definition of a Derivative

A derivative is in essence a contract whose value depends on the value of an underlying asset.<sup>2</sup> Therefore the value of derivatives depends on the value of the instruments in an underlying market.<sup>3</sup> This market is described as the “cash market”, which is the market for the immediate delivery of the particular underlying instrument or commodity from which the value of the derivative contract is derived from.<sup>4</sup> Derivatives can also be alluded to as contingent claims, as the value of the claim is contingent on the value of the underlying variable.<sup>5</sup>

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<sup>1</sup> Goodspeed *Introduction to Financial Markets* (2013) at 133.

<sup>2</sup> National Treasury “An Examination of the South African OTC Derivatives Market to Recommend Measures for Strengthening their Regulatory Oversight” (2012) at 12 available at <http://bit.ly/1C9QVsr> (Accessed on 21 March 2015).

<sup>3</sup> *Ibid.*

<sup>4</sup> *Ibid.*

<sup>5</sup> Goodspeed *op cit n1* at 133.

The Financial Markets Act 19 of 2002, (“the Financial Markets Act”) defines a derivative instrument as:

“any-

- (a) financial instrument;
- (b) or contract,

that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, on a measure of economic value or on a default event”.<sup>6</sup>

Interestingly under the definition of settle in the Financial Markets Act, it is stated that settle in respect of both listed and unlisted derivative instruments means the completion of a transaction by the fulfilment of all contractual obligations associated with the resultant position in the derivative instrument.<sup>7</sup> From the foregoing it is clear that the Financial Markets Act postulates that a derivative transaction envisages a contractual relationship between the relevant parties, the terms of which would be dependent on the type of derivative contract entered into.

As such it would be necessary to look at a derivative transaction in a legal context, as a derivative is nothing other than a contract which confers certain rights and obligations on the parties to the derivative contract. According to Rudnicki, there are four main pillars of a derivative contract, which are:

- an agreement;
- rights and obligations;
- future performance;
- underlying asset.<sup>8</sup>

The first requirement namely that of an “agreement” merely relates to the fact that the requirements of any legally binding contract should be present.<sup>9</sup>

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<sup>6</sup> Sec 1 of the Financial Markets Act.

<sup>7</sup> Sec 1 of the Financial Markets Act.

<sup>8</sup> Rudnicki *A framework for the taxation of derivative transactions* (unpublished dissertation) (2003) at 28. See also Brown “How to recognise a derivative” (1995) *The International Financial Law Review* at 28.

A derivative contract embodies a series of rights and obligations, which right and obligations vest in the parties to the derivative transaction.<sup>10</sup> The rights and obligations envisaged in a derivative contract are mainly the right or obligation to purchase or sell shares (or any other underlying instrument as the case may be) at some point in the future.<sup>11</sup> These right and obligations are fixed notwithstanding any value fluctuations in the underlying asset to the derivative transactions.<sup>12</sup>

A derivative contract envisages the transfer of risk between the parties thereto. An example of the transfer of the price risk from one party to another would be the following. Under a forward purchase agreement<sup>13</sup> it may very well happen that, at the future date agreed upon, the value of the underlying asset will be less than the purchase price agreed upon. The buyer will still have the obligation to perform by way of complying with purchase price agreed upon, notwithstanding the lower value of the underlying asset.<sup>14</sup>

Rudnicki further opines that the legal challenge of a derivative contract is the incidence of ensuring performance under the derivative contract and that the performance needs to be agreed upon between the parties. Furthermore, appropriate remedies needs to be agreed upon, should either party default upon their rights and/or obligations in terms of the contract.<sup>15</sup> The International Swaps and Derivatives Association's ("the ISDA") standard derivative contract documentation, more specifically the ISDA Master Agreement, caters extensively for the protection of the future performance, especially in the events of default.<sup>16</sup>

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<sup>9</sup> Rudnicki *op cit* n8 at 28. The requirements for a contract are: consensus; contractual capacity of the parties; possibility of performance; legality of the agreement and compliance with the prescribed formalities, if any. (Van der Merwe, Van Huysteen, Reinecke, Lubbe *Contract General Principles* (2012) at 7).

<sup>10</sup> Rudnicki *op cit* n8 at 29.

<sup>11</sup> Persuad *Taxing Transactions in Financial Derivatives: Problems and Solutions* (2014) at 5.

<sup>12</sup> Rudnicki *op cit* n8 at 29.

<sup>13</sup> As discussed in paragraph 2.4.1 below.

<sup>14</sup> *Ibid.*

<sup>15</sup> Rudnicki *op cit* n8 at 30.

<sup>16</sup> Rudnicki *op cit* n8 at 30; National Treasury *op cit* n2 at 20. The ISDA Master Agreement caters for protection of either parties should an event of default occur. The events of default catered for in the ISDA Master Agreement are *inter alia*: failure to pay or deliver; breach and repudiation; credit support default; misrepresentation and

The underlying asset is the subject matter which constitutes the basis of any derivative contract.<sup>17</sup> In short, the underlying asset refers to the asset from which a derivative derives its value.<sup>18</sup>

There exists a wide range of assets which have been used as underlying assets for purposes of a derivative contract which includes equities, equity fixed indices, fixed income instruments, foreign currencies, commodities, and credit events.<sup>19</sup> In certain instances the underlying asset itself can be another derivative contract.<sup>20</sup>

Depending on the type of underlying asset, the value of the derivative contract can be obtained or derived from the corresponding equity price, interest rate, exchange rate, commodity price, or the probability of certain credit events occurring.<sup>21</sup>

Therefore it is crucial to have regard to what constitutes the underlying asset in each and every derivative contract.

### 2.3 Types of Transactions

Derivatives can either be used in a speculative transaction, where they are entered into for the sole reason of making a profit. They are also used for hedging transactions, whereby a party uses a derivative to hedge, minimize his risk and/or exposure to the price fluctuation in the underlying asset.

A hedging transaction can be described by way of the following example. In November 2008 a farmer is concerned that the maize price will fall and that his expected crop of 2 000 tons of maize will be sold in July 2009 at a lower price. He enters into a futures contract,<sup>22</sup> based on the value of maize. Maize futures contracts for delivery in July 2009 are trading at R1200 per ton, with a contract size of 100 tons each. The farmer

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bankruptcy. (Clause 5 of the International Swaps and Derivatives Association 2002 Master Agreement). The exact provisions of the ISDA Master Agreement, however, does not fall within the scope of this dissertation.

<sup>17</sup> Rudnicki *op cit* n8 at 30.

<sup>18</sup> Investopedia *Underlying Asset (2015)* available at <http://bit.ly/1CcDLuC> (Accessed on 22 March 2015).

<sup>19</sup> Chui “Derivatives markets, products and participants: an overview” (2012) *IFC Bulletin* No 35 at 3.

<sup>20</sup> Chui *op cit* n19 at 3. An example of where the underlying asset of a derivative contract is another derivative, is in the case of a swaption, which is a swap contract, with an option contract as the applicable underlying asset.

<sup>21</sup> Chui *op cit* n19 at 3.

<sup>22</sup> A futures contract will be defined in paragraph 2.4.2 below.



therefore sells 20 futures contracts. In July 2009 the price of maize is R1100 per ton and the farmer sells his crop of 2 000 tons at R1100 per ton. Also in July 2009 the futures fall to R1100 per ton and the farmer buys back his futures at R1100 per ton and realises a gain of R100 per ton in the futures market. Therefore the farmer effectively receives R1200 per ton for his maize.<sup>23</sup>

Derivatives can also be used to enter into an investment transaction, or even an arbitrage transaction. In the context of the derivatives market, arbitrage is a generic term which refers to a number of techniques to exploit the pricing and regulatory anomalies that arise in the derivatives market. This is done by *inter alia* taking advantage of exchange rate fluctuations when a share is listed on two exchanges in two different jurisdictions.<sup>24</sup>

## 2.4 Types of Derivative Instruments

As stated above, a derivative is a type of security that derives its value from the value or return of another asset or security.<sup>25</sup> A physical exchange exists for many options contracts and futures contracts, which are referred to as exchange-traded derivatives and are backed by a clearinghouse. On the other hand, forwards and swaps are custom instruments and are traded by dealers in a market with no central location; these are referred to as over-the-counter derivatives (“OTC”).<sup>26</sup> The important differentiating factor between exchange traded derivatives and OTC derivatives is that OTC derivatives are not, except to the extent that the ISDA Master Agreement is used, subject to the same regulations and standardisation as exchange traded derivatives.

The largest OTC markets are those in interest rate contracts, contract with foreign exchange as the underlying asset, as well as credit default swaps.<sup>27</sup> In 2012 it was estimated that the gross nominal value of the OTC markets are in the vicinity of \$648

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<sup>23</sup> Goodspeed *op cit* n1 at 135.

<sup>24</sup> National Treasury *op cit* n2 at 16.

<sup>25</sup> Paragraph 2.2 above. Kaplan *Fixed income, derivatives and alternative investments CFA Level 1 Book 5* (2012) at 191. See also National Treasury *op cit* n2 at 12.

<sup>26</sup> Kaplan *op cit* n25 at 191.

<sup>27</sup> Braithwaite “OTC derivatives, the courts and regulatory reform” *Capital Markets Law Journal* (2012) at 2.

trillion.<sup>28</sup> It is likely that the value of the OTC market today far exceeds the above stated value.

### 2.4.1 Forwards

Briefly, a forward contract is a type of derivative where one party agrees to buy, and the counterparty to sell a physical asset or security at a specific price on a specific date in the future. If the future price of the asset increases, the buyer has a gain and the seller a loss, and *vice versa*.<sup>29</sup> In essence it is merely a contract to exchange the underlying instrument at a future time.<sup>30</sup>

It is a bilateral contract that obligates one party to buy and the other party to sell a specific quantity of an asset, at a fixed price, on a specific future date. Typically neither party pays anything to enter into the contract.<sup>31</sup> The exchange envisaged in the contract can either be physical, in which instance the parties exchange the full principal amounts in settlement of their obligations, or it can be notional, whereby a single net-cash payment between the parties is all that is required.<sup>32</sup>

The profit or loss of a forward contract can be explained as follows:<sup>33</sup>

- If the expected future price of the asset increases over the life of the contract, the right to buy at the agreed price will have a positive value and the obligation to sell will have an equal negative value;
- If the expected future price of the asset decreases over the life of the contract, the right to sell at the agreed price will have a positive value and the obligation to buy will have an equal negative value.

The terminology used in a forward contract is that, the party to a forward contract whom agrees to buy the financial or physical asset has a long forward position, and it is

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<sup>28</sup> *Ibid.*

<sup>29</sup> Kaplan *op cit* n 25 at 192.

<sup>30</sup> National Treasury *op cit* n2 at 13.

<sup>31</sup> Kaplan *op cit* n25 at 197.

<sup>32</sup> National Treasury *op cit* n2 at 13.

<sup>33</sup> Kaplan *op cit* n25 at 197.

referred to as the long. Whereas the party that agrees to sell or deliver the asset has a short forward position and it is referred to as the short.<sup>34</sup>

The parties to a forward contract may enter into the contract as a speculation on the future price of the underlying asset. More often it is entered into in order to hedge a risk it already has, where the forward contract is used to eliminate uncertainty about the future price of an asset, which the party either intends on buying, or selling at a future date.<sup>35</sup>

An example of a forward contract would be where Party A agrees to buy one R1 000.00 face value treasury bill from Party B 30 days from today and at a price of R990. Party A would thus constitute the long and Party B the short. Therefore the parties have both removed the uncertainty in relation to the amount they would receive/pay at the determined date. However, 30 days from now, the treasury bills are trading at R992. Thus the short must deliver the treasury bill to the long in exchange for the payment of R990 and in consequence making a loss of R2. In the instance that the treasury bill would trade at R998 at the future date, the long must purchase the treasury bill from the short for the agreed contract price of R990, and thus making a profit of R8.<sup>36</sup>

### 2.4.2 Futures Contracts

Futures contracts are similar to the forward contracts in that both can be either deliverable or cash settlement contracts, both futures and forwards are also priced to have a zero value at the time the party enters into the contract.<sup>37</sup> However, they differ in certain instances, as futures are traded on organised exchanges, they are also highly standardised and regulated.<sup>38</sup>

Futures contracts have standardised terms in that they specify the quality and quantity of goods that can be delivered, and also specify the delivery time and the manner of

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<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> Kaplan *op cit* n25 at 198.

<sup>37</sup> Kaplan *op cit* n25 at 213.

<sup>38</sup> *Ibid.*

delivery. The exchange also sets a minimum price fluctuation, and the contract has a daily price limit, which sets the maximum price movement allowed in a single day.<sup>39</sup>

In futures contracts, the purchaser is said to have gone long, or taken a long position, while the seller is said to have gone short, or taken a short position. For each contract traded there is a buyer and a seller.<sup>40</sup>

The obligations of the parties, as described in the above paragraph, is that the long has contracted to buy the underlying asset at the contract price at contract expiration, and therefore has the obligation to buy the underlying asset, whereas the short has an obligation to sell at that price.<sup>41</sup>

Futures contracts are used by speculators to gain exposure to changes in the price of the underlying asset of a futures contract. Whereas a hedger will use futures contracts to reduce exposure to price changes in the underlying asset.<sup>42</sup>

The example provided above with regards to the forward contract applies *mero motu* to a futures contract.<sup>43</sup>

### 2.4.3 Option Contracts

Options are considerably more complex than futures and forwards, as the option provides the right to one of the parties to choose whether or not to buy, or sell something at a predetermined price at a predetermined date in the future.<sup>44</sup>

An option contract gives the owner the right, but not the legal obligation, to conduct a transaction involving an underlying asset at a predetermined future date and at a predetermined price. Options give the option buyer the right to decide whether or not

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<sup>39</sup> *Ibid.*

<sup>40</sup> Kaplan *op cit* n25 at 214.

<sup>41</sup> *Ibid.*

<sup>42</sup> *Ibid.*

<sup>43</sup> A futures contract is in essence nothing other than a standardised forward contract, traded on an organised exchange.

<sup>44</sup> National Treasury *op cit* n2 at 12.

the trade will eventually take place, however, the seller of the option has the obligation to perform if the buyer exercises the option.<sup>45</sup>

Option contracts can be divided into two groups, namely a call option and a put option. In a call option, the owner of such a call option has the right to purchase the underlying asset at a specific price and for a specified time period.<sup>46</sup> Whereas in the case of a put option, the owner of the put option has the right to sell the underlying asset at a specific price, for a specified time period.<sup>47</sup>

For every owner of an option, there must be a seller. The seller of the option is also referred to as the option writer.<sup>48</sup> In order to require the right under an option, the owner thereof must buy them by paying a price, referred to as the option premium, to the seller of the option.<sup>49</sup>

Consider the example of a share in ABC which sells for R55 and has a call option available on it that sells for R10 (the option premium), which call option has an exercise price of R50 with an expiration in five months' time. If the ABC call option is purchased, the buyer can at any time in the five month period choose to purchase the share in ABC from the option seller for R50. The seller of the option gets to keep the R10 option premium no matter what happens to the price of the share in ABC. If the buyer decides to exercise the option, the seller receives the R50 on top of the option premium, and is obligated to deliver the share in ABC to the buyer. It follows that the buyer will only exercise the option in the event that it would be profitable to do so.<sup>50</sup>

In the event of a put option, and by having regard to the aforementioned, the buyer of the put option will have the right to sell the share in ABC at any time during the five months for R50 and the seller would have the obligation to purchase same at R50.<sup>51</sup>

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<sup>45</sup> Kaplan *op cit* n25 at 226.

<sup>46</sup> *Ibid.*

<sup>47</sup> Kaplan *op cit* n25 at 226.

<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.*

<sup>50</sup> Kaplan *op cit* n25 at 227.

<sup>51</sup> *Ibid.*

### 2.4.4 Swap Contracts

Swaps are agreements, or contractual arrangements, to exchange a series of cash flows on specific intervals over a certain time period. A simple type of swap is where one party makes fixed-rate interest payments on the notional principal specified in the swap, in return for floating-rate payments from the other party. At each settlement date the two payments are “netted” so that only one net payment is made, i.e. the party with the greater liability makes a payment to the other party.<sup>52</sup> At least one of the series of cash flows is uncertain when the swap agreement is initiated.<sup>53</sup>

Swaps are largely unregulated and do not trade in an organised secondary market. Swaps do not require payment by either party at initiation. The majority of participants in the swap market are mostly institutions, such as large banks, institutional investors as well as corporations.<sup>54</sup>

In the case of *Hazell v Hammersmith and Fullham London Borough Council and Others*<sup>55</sup> the court described the nature of a swap contract and/or transaction as follows:

“The swap market assists traders to solve financial problems arising out of variations in interest rates and currency exchange rates, different taxation regimes and rates of inflation and different creditworthiness. In the simplest case a bank which found it easy to raise fixed finance would swap its interest obligations with a company which could only borrow at variable rates but for good commercial reasons needed the certainty and security of fixed rates... The swap market enables a borrower to raise funds in the market to which the borrower has best access but to make interest and principal payments in its preferred form of currency.”

Brinker, with reference to the *Hazell* case, provides the following example of a swap transaction. Where the swap transaction is described as an agreement, by which each party agrees to pay to the other on a specified date, or dates an amount. The amount calculated with reference to the interest which would have accrued over a given period

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<sup>52</sup> Kaplan *op cit* n25 at 255. See also Goodspeed *op cit* n1 at 141.

<sup>53</sup> Goodspeed *op cit* n1 at 141.

<sup>54</sup> Kaplan *op cit* n25 at 255. See also National Treasury *op cit* n2 at 12.

<sup>55</sup> 1991 1 All ER 545 (HL) at 549.

on the same notional principal amount, assuming that different rates of interest are payable in each case.<sup>56</sup> An example hereof is if one rate is fixed at 10% and the other rate fixed at the LIBOR rate.<sup>57</sup> The party agreeing to receive the LIBOR rate will receive more than the party whom agreed to the 10% rate, assuming that the LIBOR rate exceeds 10%.<sup>58</sup> In this scenario, each party will settle the payment on a net basis, where the party under the obligation to pay the greater amount will merely pay the difference between the two amounts in question.<sup>59</sup>

## 2.5 Conclusion

Now that the types of derivatives have been explained, the following chapter will deal with the taxation principles applicable to derivative transactions.

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<sup>56</sup> Brinker *Taxation Principles of Interest and Other Financing Transactions* (2011) at X2.

<sup>57</sup> The LIBOR rate is the London Interbank Offered Rate, which is the interest rate at which major banks offer to lend amounts to other banks in the London interbank market. In this regard see Brinker *op cit* n56 at X2.

<sup>58</sup> Brinker *op cit* n56 at X2.

<sup>59</sup> *Ibid.*

## Chapter 3: The Taxation of Derivatives in South Africa

### 3.1 Introduction

This chapter deals with the South African principles of taxation and their applicability to derivative contracts and/or transactions. Firstly, this chapter will contain a discussion of the general principles in relation to the character of income and the allowable deductions, after which a discussion of the specific provisions pertaining to derivative contracts and/or transactions as envisaged in the Income Tax Act (“the Act”)<sup>1</sup> will follow.

### 3.2 Character of Derivative Income

#### 3.2.1 Taxable Income

The Act imposes a liability for tax based on a taxpayer’s taxable income.<sup>2</sup> The term “taxable income” is defined in section 1 of the Act as:

“the aggregate amount of-

- a) the amount remaining after deducting from the income of any persons all the amounts allowed under Part 1 of Chapter II to be deducted against such income; and
- b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act.”

In terms of section 5(1) of the Act, income tax is levied on the taxable income received by, or accrued to a taxpayer in a relevant year of assessment. The terms “received by” or “accrued to” are both artificial concepts, which are included in the taxpayers gross income.<sup>3</sup> Therefore the starting point is determining a taxpayer’s gross income.<sup>4</sup>

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<sup>1</sup> Act 58 of 1962.

<sup>2</sup> De Koker *SILKE on South African income tax* (2014) at 1-7.

<sup>3</sup> De Koker *op cit* n2 at 1-7.

<sup>4</sup> Hutton “The taxation of derivatives in South Africa” (1998) 47 *The Taxpayer* at 164.



### 3.2.2 Gross Income

Gross income is defined in section 1 of the Act to be the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, excluding amounts of a capital nature.<sup>5</sup> The onus of proof as to whether the receipt is of a capital nature, and therefore not to be included in the gross income, rests with the taxpayer.<sup>6</sup>

The phrase “receipts or accruals of a capital nature” is not defined in the Act and although it has been held that the ordinary economic meaning should be attached to the word “capital” it has not been possible to devise a definite test to determine whether a receipt or accrual is of a capital nature.<sup>7</sup> Therefore it seems that common sense would be the most useful tool in resolving this issue.<sup>8</sup>

The most important test employed by the courts in deciding whether the proceeds arising upon the disposal of an asset are in the nature of income, or capital is the test of intention, namely with what intention did the taxpayer acquire and hold the asset?<sup>9</sup>

In emphasising the importance of the taxpayer’s intention, the following *dicta* from the case of *Secretary for Inland Revenue v The Trust Bank of Africa Ltd*<sup>10</sup> is worth mention:

“The question whether the profits realized on the sale of the shares in the National Fund Holdings constituted a revenue or capital accrual depended ... upon whether the purchase, holding and sale of these shares were steps in a scheme of profit making ... or whether the sale constituted the realization of a capital asset acquired and held for purposes other than such a profit-making scheme. This is fundamentally a question of intention...”

The test of intention is a subjective test and thus its application involves a consideration of all the surrounding circumstances.<sup>11</sup>

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<sup>5</sup> In the case of a non-resident, “gross income” is defined as the total amount received by or accrued to, or in favor of the non-resident from a source within South Africa. The scope of this dissertation is limited to a discussion on the applicability of the South African taxation principles in relation to residents. In the case of a non-resident one would also have to look at the various Double Taxation Agreements and whether or not the non-resident will be deemed to be exclusively resident in another country for purposes of taxation.

<sup>6</sup> Sec 102 of the Tax Administration Act 28 of 2011.

<sup>7</sup> *WJ Fourie Beleggings v CSARS* 71 SATC 125 at p129 par 7.

<sup>8</sup> *Ibid.*

<sup>9</sup> *De Koker op cit* n2 at 3-7.

<sup>10</sup> 31 SATC 87 at 101-102.

- The proceeds will be income in nature and taxable if the asset was acquired and held for the purpose of resale at a profit in a scheme for profit-making.<sup>12</sup>
- The proceeds will be capital in nature, and thus not constitute gross income, if the asset was acquired and held not for the purpose of resale at a profit in order to produce income.<sup>13</sup>

The determination of the taxpayer's intention is in all cases a factual enquiry, and in concept it is only the intention at the time that the asset is disposed of that is relevant in determining whether the resultant receipt or accrual is of capital or revenue in nature.<sup>14</sup>

It must be mentioned that the test of a taxpayer's intention is in no way conclusive and the courts will also give regard to many other objective factors.<sup>15</sup> As the court said in *CIR v Pick 'n Pay Employee Share Purchase Trust*:<sup>16</sup>

“There are a variety of tests for determining whether or not a particular receipt is one of a revenue or capital nature. They are laid down as guidelines only – there being no single infallible test of invariable application. In this respect I agree with the following remarks of Friedman J in ITC 1450 [(1988)] 51 SATC at 76 –

‘But when all is said and done, whatever guidelines one chooses to follow, one should not be led to a result in one's classification of a receipt as income or capital which is, as I have occasion previously to remark, contrary to sound commercial and good sense’.

In terms of the established practice of SARS, fortified by numerous Tax Court decisions, it is not essential for the taxpayer to be carrying on a trade or business in a particular type of asset in order for the proceeds derived from the sale of such asset to be

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<sup>11</sup> De Koker *op cit* n2 at 3-7.

<sup>12</sup> De Koker *op cit* n2 at 3-8.

<sup>13</sup> *Ibid.* This paragraph is cited with approval in the case of *ITC 1510* (1989) 54 SATC 30 at 36. See also *Natal Estates v SIR* 38 SATC 193 at 215 where it was said that: “it is undoubtedly correct that if, on the facts of a given case, the most that can be said is that the taxpayer was merely realizing a capital asset to the best advantage, the proceeds do not become part of his income”.

<sup>14</sup> Clegg & Stretch *Income Tax in South Africa* (2015) at 5.2.2.

<sup>15</sup> De Koker *op cit* n2 at 3-32.

<sup>16</sup> 54 SATC 271 at 279. See also De Koker *op cit* n2 at 3-35.

regarded as income.<sup>17</sup> An isolated transaction not in the ordinary course of a taxpayer's business is not necessarily free from tax, the real test depends on the intention or motive behind the transaction and whether there is a scheme of profit-making involved.<sup>18</sup>

In the case of *CIR v Stott*<sup>19</sup> the court stated that it is sufficient to say that the intention was an important factor and unless some other factor intervened to show that when the article was sold it had been sold in pursuance of a scheme of profit-making, it is conclusive in determining whether the proceeds constituted capital or gross income.<sup>20</sup> The court also mentioned that every person who invested his surplus funds into land, stock or any other asset is entitled to realise such an asset to the best advantage and to accommodate the asset to the exigencies of the market in which he was selling.<sup>21</sup> Ultimately the court held that the facts of the case did not support the inference that the assets had been sold in pursuance of a scheme of profit.

In *John Bell & Co (Pty) Ltd v SIR*<sup>22</sup> the court remarked that the mere change of intention to dispose of an asset hitherto held as capital does not mean that the resultant profit can *per se* be classified as income in nature, something more is required in order to metamorphose the character of the asset and so render its proceeds income. In *Natal Estates Ltd v SIR*<sup>23</sup> it was said that in deciding whether a case is one of realizing a capital asset one must think one's way through all of the particular facts of each case. From the totality of the facts considered, one enquires whether it can be said that the taxpayer had crossed the Rubicon, so to speak, and gone over or embarked on a scheme of profit-making.<sup>24</sup>

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<sup>17</sup> De Koker *op cit* n2 at 3-38.

<sup>18</sup> *Ibid.*

<sup>19</sup> 3 SATC 253.

<sup>20</sup> *CIR v Stott* 3 SATC 253 at 262.

<sup>21</sup> *CIR v Stott* 3 SATC 253 at 261.

<sup>22</sup> 38 SATC 87 at 103.

<sup>23</sup> 37 SATC 193 at 220.

<sup>24</sup> The expression crossing the Rubicon refers to 49BC when Julius Caesar defied the Roman Senate by crossing the Rubicon River with his army in order to enter Italy. This act has become to symbolise passing a point of no return. In South African tax jurisprudence the expression has been widely used to distinguish between capital gains and taxable income in the disposal of property. *C: SARS v Founders Hill (Pty) Ltd* 2011 ZASCA 66 at par 1.

In *CIR v Pick 'n Pay Employee Share Purchase Trust*<sup>25</sup> the court placed a great emphasis on whether the taxpayer had been engaged in a scheme for profit-making.<sup>26</sup> The court ultimately found that the taxpayer did not intend to carry on a scheme of profit-making, and that the receipts of the trust were neither intended, nor worked for, but merely fortuitous.<sup>27</sup>

In *Elandsheuwel Farming (Edms) Bpk v SBI*<sup>28</sup> the court described a profit-making scheme as the acquisition of an asset for the purpose of reselling it at a profit, the profit is then the result of the productive turn-over of the capital represented by the asset and thus falls into the category of income.<sup>29</sup>

### 3.2.3 The classification of derivative income

Generally receipts and accruals associated with speculation would be of an income or revenue nature, and receipts and accruals associated with synthetic investments,<sup>30</sup> or hedging would be of a capital nature.<sup>31</sup>

Derivatives are mostly used for speculative purposes, in which instances the profits will be seen to be part of a business carrying out a scheme of profit making, in other words the profit is designedly sought and worked for.<sup>32</sup> As such derivative transactions entered into in pursuance of a scheme of profit making will be of an income nature.<sup>33</sup>

*ITC 43*<sup>34</sup> dealt with a taxpayer, who conducted a business of a storekeeper and often entered into transactions in grain and other produce in the ordinary course of his business. However, the subject matter of this decision comprised a cash settled forward

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<sup>25</sup> 54 SATC 271.

<sup>26</sup> *CIR v Pick 'n Pay Employee Share Purchase Trust* 54 SATC 271 at 297-298. See also Clegg & Stretch *op cit* n14 at 5.2.1.

<sup>27</sup> *Ibid.*

<sup>28</sup> 39 SATC 163.

<sup>29</sup> *Elandsheuwel Farming (Edms) Bpk v SBI* 39 SATC 163 at 180-181. See also De Koker *op cit* n2 at 3-6.

<sup>30</sup> Synthetic Investments in this context means an investment in which the taxpayer will obtain exposure to the underlying asset, without actually physically acquiring the underlying asset. In this regard see Brinker *Taxation Principles of Interest and Other Financing Transactions* (2011) at W2.1.

<sup>31</sup> Brinker *op cit* n30 at W4.1.

<sup>32</sup> *CIR v Pick 'n Pay Employee Share Purchase Trust* 54 SATC 271 at 297-298. See also Brinker *op cit* n30 at W2.1.

<sup>33</sup> Brinker *op cit* n30 at W4.2.1.

<sup>34</sup> 2 SATC 115 at 115 – 116.

contract, in terms of which he purchased mealies at a fixed price in the future. The price of mealies increased and the seller of the forward contract therefore tendered the payment of the settlement sum to the taxpayer in order to cancel the contract. The taxpayer contended that his business did not include forward transactions and as such the proceeds should not be categorised as income. The Court found that the transaction nevertheless fell within the scope of the taxpayer's business, as he was a dealer in produce, and the forward contract was a deal in produce, the success of which very much depended on the knowledge the taxpayer had acquired through his occupation as a dealer in produce.

The period of holding a derivative contract is not necessarily a decisive factor in order to determine the nature of the proceeds upon their disposal.<sup>35</sup> As it is extremely expensive to enter into derivative contracts for a longer period, derivative contracts are by their very nature only held for short periods of time.<sup>36</sup> If derivatives are entered into for a long period, they are normally rolled over, or in essence renewed, every couple of months in order to provide the same result.<sup>37</sup> The crux hereof is that just because a taxpayer cannot afford an expensive long term hedge, it does not imply that the proceeds thereof should be of an income nature, as it is the intention of the taxpayer to run the derivative on a continuous basis.<sup>38</sup>

With regard to the use of derivative contracts in hedging transactions, two alternative arguments have been formulated, namely:<sup>39</sup>

- If derivatives are categorised as a protection mechanism, or insurance, the argument is that losses or risk are mitigated by entering into derivative transactions, and that payments pursuant to the realisation of the derivatives will compensate taxpayers in those circumstances. Thus the question is whether the proceeds fills a hole in the taxpayers income earning structure, or income earning operations;

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<sup>35</sup> Brinker *op cit* n30 at W4.1.3.

<sup>36</sup> Brinker *op cit* n30 at W4.1.3.

<sup>37</sup> Brinker *op cit* n30 at W4.1.3.

<sup>38</sup> Brinker *op cit* n30 at W4.1.3.

<sup>39</sup> Brinker *op cit* n30 at W4.1.4.

- One should determine whether the underlying or reference asset of the derivative is held as a capital asset, and proceeds arising from the hedging transaction should then follow the nature of the underlying asset. Therefore if the underlying asset is held as a capital asset, the proceeds arising from the hedging transaction will then also be capital in nature.

Brinker opines that the latter of the aforementioned arguments constitutes the preferred approach to determine the amount received by, or accrued to the taxpayer by way of a derivative contract.<sup>40</sup> I agree with the aforementioned option of Brinker, as an underlying asset is a *sine qua non* for a derivative contract, the logical approach is to have regard to the nature and reason the taxpayer is holding the underlying asset.

In *ITC 340*<sup>41</sup> a taxpayer imported goods from the United Kingdom and settled the price in pounds sterling. He entered into forward exchange contracts in terms of which he fixed his exposure to the fluctuating foreign currencies. The result of the forwards exchange contracts was that his bank would pay him pounds at a predetermined forward exchange rate, which the taxpayer used in order to settle the purchase price of his imports. The taxpayer realised profits on these forward exchange contracts and the question arose whether or not these profits were of a capital nature. The taxpayer argued that he did not have the intention to make a profit, but that he had entered into these transactions as a way to hedge his exposure to pounds sterling. The taxpayer also contended that the profits were merely fortuitous, as his business was the buying and selling of goods, and not that of speculating with forward exchange contracts. The court accepted that the taxpayer was not speculating with these derivatives, but still found the profits to be of a revenue nature, as the profits were incidental to the normal business operations of the taxpayer. In other words the profits were so closely linked to the business of the taxpayer that the accrual arose as part of the business that was conducted. On a factual basis, it was also found that the taxpayer had the intention to

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<sup>40</sup> Brinker *op cit* n30 at W4.1.4.

<sup>41</sup> 8 SATC 362.

make a profit from the forward exchange contracts, and not only in order to protect himself against fluctuating currency prices.<sup>42</sup>

*ITC 1498*<sup>43</sup> was the first case which clearly indicated that a derivative should be categorised on the same basis as its underlying asset. This case concerned a taxpayer who purchased a printing press and had entered into a number of forward exchange contracts in order to fund the purchase price associated with the acquisition of the printing press. The transaction was structured in a manner that the balance of the purchase price of the printing press was payable over a period of up to seven years, whereas the duration of the forward exchange contracts were limited. The taxpayer made profits each time the forward exchange contracts were extended, but corresponding losses were made when the instalments on the purchase price became payable. The taxpayer led evidence that the printing press was a capital asset in the hands of the taxpayer, and there was also evidence that although the taxpayer was aware that profits might be made as a result of the fluctuation in currency prices, it was not the intention of the taxpayer to make a profit from the derivative transactions. The Court held that as the forward exchange contracts were entered into in order to hedge a capital liability, the profits were also of a capital nature, as the foreign exchange contracts should assume the character of their originating cause.<sup>44</sup>

The test to determine the nature of the proceeds arising from a derivative seems to be whether the derivative contract is so closely associated with the business operation of the taxpayer, that it can be said that the two are inextricably linked together, in which case the proceeds will be of an income nature.<sup>45</sup> Although ultimately the test should be, what was the intention of the taxpayer in hedging the underlying asset and whether that intention is in itself of a capital nature and consistent with the holding of the underlying capital asset.<sup>46</sup> In other words did the taxpayer have the requisite intention to hedge an

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<sup>42</sup> *ITC 340* 8 SATC 362 at 365. See also *Brinker op cit* n30 at W4.1.4; *Hutton op cit* n4 at 167.

<sup>43</sup> 53 SATC 260.

<sup>44</sup> *ITC 1498* 53 SATC 260 at 265.

<sup>45</sup> *Brinker op cit* n30 at W4.1.4.

<sup>46</sup> *Ibid.*

underlying capital asset and does all of the surrounding circumstances support such an intention.<sup>47</sup>

It is not sufficient to merely indicate that a derivative instrument has been entered into in respect of an underlying asset, there should be a satisfactorily close link between the derivative and the underlying asset. This would be determined by having regard to the correlation, the extent of the mitigation of risk as well as the duration of transactions.<sup>48</sup>

### 3.2.3 General Deductions

As stated above,<sup>49</sup> the Act only imposes a tax obligation in respect of a taxpayer's taxable income. In order to determine the taxable income, one has to deduct from the taxpayer's "income" all of the allowable deductions in terms of the Act.<sup>50</sup>

The term "income" is defined in section 1 of the Act, as the amount remaining, in any year of assessment, from the taxpayer's gross income after deducting therefrom all amounts exempt from normal tax under Part I of Chapter II to the Act. In this regard the *dicta* of *Sub-Nigel v CIR*<sup>51</sup> is sensible, where the court said:

"The court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act".

Sections 11 to 19, as well as section 23 of the Act contains the main provisions pertaining to deductions, however there are quite a few other provisions of the Income Tax Act also dealing with deductions.<sup>52</sup>

Section 11 contains the provisions relating to the general deductions, as such section 11(a) read together with section 23(g) is referred to as the general deduction formula.<sup>53</sup>

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<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

<sup>49</sup> In paragraph 3.2.1 above.

<sup>50</sup> Sec 1 of the Act. See also De Koker *op cit* n2 at 7-2.

<sup>51</sup> 15 SATC 381 at 389.

<sup>52</sup> De Koker *op cit* n2 at 7-3 – 7-4. The other provisions of the Act pertaining to deductions are *inter alia* sec 20 which deals with the set off of an assessed loss, sec 22 which provides for the deductions of trading stock, sec 24C which applies to future expenditure on contracts and sec 24I pertaining to the gains or losses on foreign exchange transactions.



The general deduction formula is as follows:<sup>54</sup>

“The expenditure and losses, must be actually incurred, during the year of assessment, in the production of income, they must not constitute expenditure and losses of a capital nature, and if they are claimed as a deduction against income derived from trade, they must either in part, or in full constitute moneys that are laid out or expended for purposes of trade.”

As such, it is necessary to briefly analyse each aspect of the aforementioned general deduction formula by having regard to the case law pertaining thereto.

It has to be mentioned that in order for a deduction to be allowable in terms of the aforesaid general deduction formula, the taxpayer must be carrying on a trade.<sup>55</sup> The opening words of section 11 of the Act makes this abundantly clear as it provides that:

“For the purpose of determining taxable income derived by any person from carrying on any trade, there shall be allowed as deduction from the income of such person so derived...”.

Although the term “trade” is defined in section 1 of the Act, the court in *Burgess v CIR*<sup>56</sup> held that the definition should be given a wide interpretation, one which is not necessarily exhaustive. It is trite that the carrying on of a trade involves an active step, something more than the intention to carry out a business activity or particular transaction.<sup>57</sup> However, the question of whether or not a taxpayer is carrying on a trade constitutes a question of law which is to be decided by having regard to the facts of each case.<sup>58</sup>

### 3.2.3.1 Expenditure and losses

The phrase “expenditure and losses” is not specifically defined in terms of the Income Tax Act, however the court in *Joffe & Co (Pty) Ltd v CIR*<sup>59</sup> said that in relation to trading operations, the word “loss” is used to usually signify an involuntary deprivation, as

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<sup>53</sup> *Port Elizabeth Electric Tramway Co Ltd v CIR* 8 SATC 13 at 16. See also De Koker *op cit* n2 at 7-8-2.

<sup>54</sup> Sec 11(a) of the Act, read together with section 23(g). See also De Koker *op cit* n2 at 7-9.

<sup>55</sup> De Koker *op cit* n2 at 7-4.

<sup>56</sup> 55 SATC 185 at 196 – 197. See also De Koker *op cit* n2 at 7-4.

<sup>57</sup> *ITC 1476* 52 SATC 141 at 148. See also De Koker *op cit* n2 at 7-7.

<sup>58</sup> *ITC 1476* 52 SATC 141 at 146. See also De Koker *op cit* n2 at 7-5.

<sup>59</sup> 13 SATC 354 at 360. See also De Koker *op cit* n2 at 7-11.

suffered by the loser, whereas “expenditure” would in the normal course of events signify a voluntary payment of money.

In *Port Elizabeth Electric Tramway Co Ltd v CIR*<sup>60</sup> the court considered the word “loss” appeared to mean the loss of floating capital employed in the trade which produces the income, and in *COT v BSA Investments Ltd*<sup>61</sup> the court held that “loss” is confined to the actual expenditure or outgoing amount which the taxpayer seeks to deduct from his gross income.

The word “expenditure” was dealt with by the Supreme Court of Appeal in the matter of *C:SARS v Labat Africa Ltd*,<sup>62</sup> wherein it was said that as the term is not defined in the Income Tax Act, it must be given its ordinary meaning as the action of spending funds, disbursements or consumption. The Courts stated that expenditure means at the very least the movement of assets of the person who expends.

### 3.2.3.2 Actually incurred

In the case of *Caltex Oil (SA) Ltd v SIR*<sup>63</sup> it was held that “expenditure” actually incurred does not mean expenditure actually paid during the year of assessment, but means all expenditure for which a liability has been incurred during the year of assessment, whether or not the liability has been discharged during the year of assessment.<sup>64</sup>

It was held in *Edgars Stores Ltd v CIR*<sup>65</sup> that only expenditure for which the taxpayer has incurred an unconditional legal obligation during the year of assessment may be deducted by virtue of the provisions of section 11(a) of the Income Tax Act. It is therefore evident that for as long as the liability remains contingent, it does not constitute expenditure which was actually incurred.<sup>66</sup>

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<sup>60</sup> 8 SATC 13 at 15. See also De Koker op cit n2 at 7-11.

<sup>61</sup> 28 SATC 1 at 6-7. See also De Koker op cit n2 at 7-11.

<sup>62</sup> 74 SATC 1 at p 6 par 12. See also De Koker op cit n2 at 7-13.

<sup>63</sup> 37 SATC 1 at 12.

<sup>64</sup> See also De Koker op cit n2 at 7-14-1.

<sup>65</sup> 48 SATC 55 at 69.

<sup>66</sup> See also De Koker op cit n2 at 7-15 as well as the numerous judgements cited at n64 thereof.

### 3.2.3.3 Incurred during the year of assessment

This is a requirement that has been read into the provisions of section 11(a) by our courts, as it was held in quite a number of decisions that deductible expenditure is restricted to that which has been incurred during the year of assessment.<sup>67</sup>

Section 24M of the Income Tax Act provides the exception hereto in that where an asset is required for consideration which consists of an amount which cannot be quantified during the year of assessment in respect of which the asset is acquired, the expense is deemed to have only been incurred in the year which the amount can be quantified.<sup>68</sup>

### 3.2.3.4 In the production of income

The court in *Port Elizabeth Electric Tramway v CIR*<sup>69</sup> seems to have established the principle in relation to this requirement, in that it was said that if expenditure is to be performed for the purposes of earning income, then that expenditure would be deductible.<sup>70</sup> The court went on to state that:

“all expenses attached to the performance of a business operation bona fide performed for the purposes of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it”.

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<sup>67</sup> De Koker op cit n2 at 7-18-2. The cases referred to are *inter alia Concentra (Pty) L v CIR* 12 SATC 95 at 98; *Sub Nigel Ltd v CIR* 15 SATC 381; *Caltex Oil (SA) Ltd v SIR* 37 SATC 1 at 11; as well as *CIR v Edgars Stores Ltd* 48 SATC 89 at 93.

<sup>68</sup> De Koker op cit n2 at 7-18-3.

<sup>69</sup> 8 SATC 13 at 16 -18.

<sup>70</sup> “Income” in this context, entails “income” as defined in section 1 of the Income Tax Act. In *C:SARS v Mobile Telephone Networks Holdings (Pty) Ltd* 76 SATC 205 at 211, it was held that in order to determine whether an amount paid by the taxpayer constituted “expenditure incurred in the production of income” an important, and sometimes conclusive factor is the purpose of the expenditure and what the expenditure actually effects. Here the court needs to assess the closeness of the connection between the expenditure and the income earning operations of the taxpayer.

In *Sub-Nigel Ltd v CIR*<sup>71</sup> it was held that it does not matter whether any particular item of expenditure produced any part of the income, but in order for the item of expenditure to qualify as a deduction, it should have been incurred for the purposes of earning income.

### 3.2.3.5 Not of a capital nature

Often it is difficult to distinguish between capital and revenue expenditure, and although there exists numerous court decisions on the subject it is virtually impossible to distil the principles into one test applicable to all circumstances, so as to be able to accurately distinguish between the two classes of expenditure.<sup>72</sup>

*New State Areas Ltd v CIR*,<sup>73</sup> however provides a guide to determine the foregoing. The court stated that if expenditure is incurred for the purpose of acquiring a capital asset for the business it is clearly a capital expenditure, even if it is paid in instalments, however if the expenditure is no more than part of the cost incidental to the performance of the income producing operations, then the expenditure is a revenue expenditure, even if it is paid in a lump sum.

*CIR v George Forest Timber Co Ltd*<sup>74</sup> is also of value. It was held that money spent in acquiring an income-producing concern must be a capital expenditure as it is spent in order to enable the concern to yield profits in the future, whereas money spent in working the capital asset is a revenue expenditure as it is spent in working the concern for the present production of profit.

### 3.2.4 The nature of losses and expenditure associated with derivatives

Whether or not the expenditure and/or losses associated with derivative transactions will be deductible, will depend on whether the amounts were actually incurred in the production of income for trade purposes and are not of a capital nature.<sup>75</sup>

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<sup>71</sup> 15 SATC 381 at 394.

<sup>72</sup> De Koker *op cit* n2 at 7-21.

<sup>73</sup> 14 SATC 155 at 170.

<sup>74</sup> 1 SATC 20 at 25 – 26.

<sup>75</sup> Brinker *op cit* n30 at W4.2.

The test relating to the nature is whether the purpose of the taxpayer is to enhance his income producing structure, as opposed to being seen as part of the cost incidental to the performance of the income earning operations.<sup>76</sup>

If the above test is to be applied in order to ascertain the capital or income nature of expenditure incurred by a taxpayer with regards to a derivative transaction, one should have regard to the purpose for which the expenditure was incurred, which will depend on the taxpayer's purpose in entering into the transaction.<sup>77</sup>

Therefore, it follows that where a derivative transaction is entered into in pursuance of a scheme of profit making, the losses and/or expenditure associated therewith will constitute part of the taxpayer's income earning operation and will thus be income in nature.<sup>78</sup> Conversely, expenditure incurred and losses associated in acquiring a derivative instrument as a long term investment, will be regarded to be incurred for the purpose of adding to the taxpayer's income earning structure, and will be classified as capital in nature.<sup>79</sup>

If a derivative transaction is entered into for hedging purposes, the deductibility of the expenditure and/or losses associated therewith will be dependent on whether the hedging transaction was entered into in the course of the taxpayer's income earning operation. In which case the expenditure and/or losses will be of an income nature. If the hedging transaction was entered into for purposes of protecting the taxpayer's income earning structure, the associated expenditure and/or losses will be of a capital nature.<sup>80</sup>

### 3.3 Source of derivative income

The source of derivative income has lost some of its importance as South Africa changed to a residence based system of taxation, as opposed to a source based

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<sup>76</sup> *New State Areas Ltd v CIR* 14 SATC 155 at 154; *CIR v George Forest Timber Company Ltd* 1 SATC 20 at 25. See also *Brinker op cit* n30 at W4.2

<sup>77</sup> *Hutton op cit* n4 at 170.

<sup>78</sup> *Ibid.*

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid.*

system.<sup>81</sup> This means that residents are taxed on their worldwide income, irrespective of the source thereof, and that it is only non-residents who are taxed on income received from a source within South Africa. It is however still relevant to determine the source of income associated with derivatives as financial institutions enter into derivative transactions on a cross-border basis.<sup>82</sup>

As South African residents enter into derivative contracts and/or transactions with non-residents, it is important to determine the source of the income so as to tax the non-resident, in the event that the source of the income should be found to have originated in South Africa.<sup>83</sup>

*CIR v Lever Brother*<sup>84</sup> laid down a judicial formula of the word “source”, i.e. that it means the originating cause, and that this involves two questions, namely: what is the originating cause of the income, and is the originating cause in the Republic?<sup>85</sup> In essence one should first determine the cause of the receipt and thereafter the location thereof.<sup>86</sup>

However the Courts have since the decision of *Essential Sterolin Products (Pty) Ltd v CIR*<sup>87</sup> adopted a different type of approach to the determination of source, in which it was decided that more emphasis should be placed on the overall activities of the taxpayer as opposed to the place of conclusion of the actual agreement as well as the place of payment. This has been confirmed by the Supreme Court of Appeal in *First National Bank of Southern Africa Ltd v CSARS*,<sup>88</sup> in which it was held that one should have regard to the underlying factual matrix.<sup>89</sup>

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<sup>81</sup> Brinker *op cit* n30 at W8.

<sup>82</sup> *Ibid.*

<sup>83</sup> Oguttu “Challenges in Taxing Derivative Financial Instruments: International Views and South Africa’s Approach” (2012) 24 SA Merc LJ at 405.

<sup>84</sup> 1946 AD 441 at 449 – 450. See also Hutton *op cit* n4 at 187.

<sup>85</sup> De Koker *op cit* n2 at 5-13.

<sup>86</sup> Brinker *op cit* n29 at W8.

<sup>87</sup> 55 SATC 357 at 366.

<sup>88</sup> 64 SATC 245.

<sup>89</sup> *First National Bank of Southern Africa Ltd v CSARS* 64 SATC 245 at 252. See also Brinker *op cit* n30 at W8.

In *CIR v Black*<sup>90</sup> it was held that if it could be shown that the only true and reasonable conclusion on the facts found the dominant, or main, or substantial, or real and basic cause of the accrual of income was to be found in South Africa, then the source of income would be South Africa.<sup>91</sup>

It is submitted that the approach of the Court in *Overseas Trust Corporation Ltd v CIR*<sup>92</sup> is the preferred approach. Here the taxpayer conducted business in South Africa as a financial and investment company by buying and selling securities with a view to profit, they also sold shares through brokers situated in Germany. The Court found that the source of the sale of shares through German brokers was still South Africa as the capital which earned the profit was not employed in Germany.<sup>93</sup>

A similar approach was adopted in *ITC 313*,<sup>94</sup> here the taxpayer made a profit by selling gold for pounds sterling and the reconverting it into gold. The Court held that these profits were so closely linked to the business operations of the taxpayer in South Africa that the originating cause thereof had to be South Africa.<sup>95</sup>

Therefore, income derived by a foreign counterparty from derivative transactions entered into with a South African counterparty will not necessarily be sourced in South Africa, unless the foreign counterparty conducts a derivative business through an operation situated in South Africa. It then follows that income derived by a South African taxpayer from a derivative transaction with a foreign counterparty will be sourced in South Africa, unless the taxpayer conducts its derivatives business through an operation situated outside of South Africa.<sup>96</sup>

It is argued that where a derivative was used in a hedging transaction, the source or the gain realised on the derivative should coincide with the source of the hedged asset.<sup>97</sup>

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<sup>90</sup> 21 SATC 226.

<sup>91</sup> *CIR v Black* 21 SATC 226 at 234. See also De Koker *op cit* at 5-14.

<sup>92</sup> 2 SATC 71.

<sup>93</sup> *Overseas Trust Corporation Ltd v CIR* 2 SATC 71 at 77. See also Brinker *op cit* n30 at W8; De Koker *op cit* n2 at 5-28.

<sup>94</sup> 8 SATC 157.

<sup>95</sup> *ITC 313* 8 SATC 157 at 161. See also Brinker *op cit* n30 at W8.

<sup>96</sup> Brinker *op cit* n30 at W8. See also Hutton *op cit* n4 at 188.

<sup>97</sup> Olivier and Honniball *International Tax A South African Perspective* (2011) at 261.

An example would be that of a futures contract entered into in order to hedge income derived in South Africa, the gain or loss realised on the derivative should also be sourced in South Africa.<sup>98</sup>

Section 9(2) of the Act does provide for the deemed source of a wide range of receipts or accruals to be in South Africa, and to the extent that these provisions apply, the true source of the receipt or accrual is irrelevant.<sup>99</sup> However none of the provisions of section 9(2) is directly applicable to the taxation of derivative transactions. As such one should still apply the rules as laid out in the aforementioned case law so as to determine the source of the receipt or accrual associated with the particular derivative transaction.

Thus, in determining the source of derivative associated expenses and amounts included in the taxpayer's gross income, one should have regard to the overall business operations of a taxpayer and to which extent the derivatives can be seen to be inextricably linked thereto.<sup>100</sup> Ultimately one should establish whether the derivative is part of the general business operations conducted by the taxpayer in South Africa.<sup>101</sup>

### 3.4 Timing of the taxation of derivative income

One of the most significant opportunities for taxpayers relating to the use of derivatives lies in the timing differences that can arise pursuant to a mismatch of accruals or receipts on the one hand and expenses and losses on the other hand.<sup>102</sup>

This arises from the fact that financial exchanges uses a mark-to-market approach to settle financial instruments, under which the daily gains and/or losses of each trader is taken into account. Such daily gains or losses are credited or debited to a trader's account at the clearing house on a daily basis. In essence this means that the financial instrument is settled at the end of each day and a new contract is entered into the next day.<sup>103</sup>

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<sup>98</sup> *Ibid.*

<sup>99</sup> De Koker *op cit* n2 at 5-34.

<sup>100</sup> Brinker *op cit* n30 at W8.

<sup>101</sup> *Ibid.*

<sup>102</sup> Brinker *op cit* n30 at W5.

<sup>103</sup> Olivier and Honniball *op cit* n97 at 257.



From a tax perspective it is possible to treat these mark-to-market gains and losses as realised or incurred. However this would lead to an extremely complex system of taxation and would not be reconcilable with the acquisition of a derivative to be used as a hedge against the risk in price fluctuations.<sup>104</sup> In other words, a derivative might have been obtained to eliminate the periodic movements in the price of a specific asset as only the price agreed upon will be paid. The financial gain or loss realised for tax purposes may thus not bear any relation to the financial gain or loss realised on the day the obligations are settled.<sup>105</sup>

The alternative system would be to tax the gains and losses on the day the holder of the derivative either receives or has to pay an amount.<sup>106</sup> However this system would be open to abuse, in that it may lead to a situation where the income and/or losses from the derivative transaction being taxed at a different time as that of the underlying instrument.<sup>107</sup> This mismatch in tax timing can cause the taxpayer's transactions to be matched in an economic sense, but unmatched for tax purposes, which mismatch may be manipulated as taxpayers could claim tax deductions upfront, although the deductions, in an economic sense, may only be attributed at a later stage.<sup>108</sup>

The general taxation principles dictate that an amount accrues to a taxpayer when the taxpayer becomes unconditionally entitled thereto, and that expenditure may be deducted in the year in which an unconditional obligation to pay exists.<sup>109</sup> In *SIR v Silverglen Investments (Pty) Ltd*<sup>110</sup> the Court held that the revenue service is not entitled to choose whether to tax income in the year of receipt or the year of accrual, when a taxpayer discloses the amount accrued in a year of assessment which precedes the

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<sup>104</sup> *Ibid.*

<sup>105</sup> *Ibid.*

<sup>106</sup> *Ibid.*

<sup>107</sup> Oguttu *op cit* n83 at 406.

<sup>108</sup> Oguttu *op cit* n83 at 406. See also Hutton *op cit* n4 at 185.

<sup>109</sup> *Lategan v CIR* 1926 CPD 203; *CIR v People's Stores (Walvis Bay) Ltd* 1990 (2) SA 353 (A); *Port Elizabeth Electric Tramway Co Ltd v CIR* 8 SATC 13; *Caltex Oil (SA) Ltd v SIR* 37 SATC 1. See also Olivier and Honniball *op cit* n97 at 257.

<sup>110</sup> 1969 (1) All SA 382 (A).

receipt thereof, then the revenue services is obliged to levy the tax in the year which it is disclosed.<sup>111</sup>

In *Mooi v SIR*<sup>112</sup> a taxpayer was granted certain options in 1963, which he was only able to exercise in 1966, as a condition of the options was that he was still to be employed by the granter of the option during 1966. The Court held that an accrual associated with the exercise of the option only arose in 1966 as that was the earliest date when he became unconditionally entitled to exercise the options.<sup>113</sup> This decision is in line with the fact that an amount only accrues to a taxpayer once he becomes unconditionally entitled thereto.

With regard to the deduction of expenses and/or a loss in a derivative context *ITC 1444*<sup>114</sup> finds application. The case concerned a taxpayer who endeavoured to deduct expenses associated with the acquisition of raw materials acquired from its Swedish parent company; however the payment and delivery in respect of the materials were postponed until a future date. Here the Court held that the taxpayer has not incurred an unconditional obligation to pay the purchase price until such time as the seller has delivered or tendered delivery of the raw materials concerned.<sup>115</sup> Therefore when an obligation is incurred it will only be deemed, for tax purposes, to be unconditional to the extent that a reciprocal obligation is performed or tendered.<sup>116</sup>

### 3.5 Specific Provisions of the Income Tax Act

In terms of the Act there are certain provisions that are specifically applicable to derivative transactions. These are encapsulated in section 24K, which regulates the incurral and accrual of interest rate agreements, and section 24L which in turn regulates the incurral and accrual of option contracts.

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<sup>111</sup> *SIR v Silverglen Investments (Pty) Ltd* 1969 (1) All SA 382 (A) at 390. See also Hutton *op cit* n4 at 185.

<sup>112</sup> 34 SATC 1.

<sup>113</sup> *Mooi v SIR* 34 SATC 1 at 11. See also Brinker *op cit* n30 at W5.

<sup>114</sup> 51 SATC 35.

<sup>115</sup> *ITC 1444* 51 SATC 34 at 40. See also Brinker *op cit* n30 at at W5.

<sup>116</sup> See also Brinker *op cit* n30 at at W5.

Section 24M, which may also be applicable to derivative transactions, aims to regulate the incurral and accrual of assets acquired or disposed of for unquantified amounts during a specific year of assessment.

### 3.5.1 Section 24K and Interest Rate Swaps

Brinker is of the view that, in an attempt to address the most common form of a swap agreement, namely an interest rate swap, the legislature inserted section 24K into the Act, which section deals with interest rate agreements.<sup>117</sup>

Section 24K(1) defines an “interest rate agreement” as an agreement where one person becomes liable to pay and the other acquires the right to receive:<sup>118</sup>

- an amount calculated by applying a rate of interest to a notional principal amount as specified or referred to in the agreement; or
- an amount calculated as the difference between any combination of rates of interest applied to such a principal amount; or
- a fixed amount calculated by applying a rate of interest to a notional principal amount or paying an amount equal to the difference between the fixed amount and the other amount.

The definition of an “interest rate agreement” accordingly embraces amounts receivable, or payable in terms of interest rate swap agreements or any similar agreements where the cash flows are calculated with reference to a notional capital amount and an interest rate or combination of interest rates.<sup>119</sup>

According to Hutton, an interest rate swap clearly falls within the ambit of the above definition.<sup>120</sup> However the definition is wide, so as to include a whole host of other transactions, which transactions grants the right to receive, or impose the obligation to

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<sup>117</sup> Brinker *op cit* n30 at X3.1.

<sup>118</sup> Sec 24K(1) of the Act. See also Oguttu *op cit* n83 at 407.

<sup>119</sup> De Koker *op cit* n2 at 17-134.

<sup>120</sup> Hutton *op cit* n4 at 224.

make payments calculated with reference to a notional principal amount and an interest rate, or combination of interest rates.<sup>121</sup>

To the extent that a swap agreement is entered into, each separate leg of the swap agreement can potentially be deemed to be a separate interest rate agreement.<sup>122</sup> However a swap agreement is not necessarily an interest rate agreement and it can very well be that only one leg of the swap agreement qualifies as an interest rate agreement. To this extent, Brinker provides the following example: if X agrees to pay Y amounts which are calculated with reference to the prime rate and a notional principal amount in terms of the swap agreement, that undertaking will be seen to be an interest rate agreement. However if Y undertakes to pay to X a total return element, for instance whatever amounts Y may receive in respect of a loan which it made to Z, that leg will in itself not be seen to constitute an interest rate agreement.<sup>123</sup>

I agree with Hutton’s opinion that the definition of an “interest rate agreement” as envisaged in section 24K, is adequately phrased to cover a further two types of interest based derivatives, namely interest rate option agreements, as well as interest rate forward agreements. This is because in both an interest rate option and interest rate forward agreement, one party either acquires the right to receive, and the other party becomes entitled to pay an amount. The amount is calculated with reference to the difference between any combinations of interest rates, as applied to the specified notional principal amount, or as referred to in such an agreement.<sup>124</sup>

Section 24K(2) states that the timing of the accrual and incurral of amounts in terms of an interest rate agreement must be calculated on a day to day basis.<sup>125</sup> Hutton argues that the language used in section 24K(2) envisages the use of the compounding or straight line accrual methods.<sup>126</sup> She goes on to further state that although those

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<sup>121</sup> *Ibid.*

<sup>122</sup> *Ibid.*

<sup>123</sup> *Ibid.*

<sup>124</sup> Hutton *op cit* n4 at 224 – 225.

<sup>125</sup> See also Oguttu *op cit* n83 at 407.

<sup>126</sup> Hutton *op cit* n4 at 225. The straight line accrual method is the accounting method where payments are allocated to the period in which they relate to, irrespective of when they are paid, or received. (See par 5.2 below)

methods are easily applied to a series of cash flows arising as result of an interest rate swap, they can neither practically be applied to interest rate forward agreements, nor to interest rate options, as the only cash flow is the gain or loss made on the maturity of the future, or on the exercise date of the option.<sup>127</sup> Therefore, it is said that the market value accounting method is the generally accepted method used to measure the gains or losses on these transactions, and it was the method proposed by the TAC for accounting for gains and losses on these transactions for tax purposes.<sup>128</sup>

Section 24K(3) is applicable when the amount is to be calculated before the date of payment and a variable rate of interest applies. Accordingly section 24K(3) provides that where the amount is to be calculated with reference to a variable interest rate, it must be calculated with reference to the variable rate applicable on the date it is to be calculated to determine all amount payable or receivable after that date.<sup>129</sup>

Section 24K does not deem payments to be made under an interest rate agreement to be interest, it only deems the amounts to have accrued to, or incurred by the taxpayer on a day to day basis.<sup>130</sup> In order for interest to be applicable one should have a capital amount that is advanced and becomes repayable, but in the context of an interest rate swap agreement no capital amount is paid and the notional principal amount is used only for calculation purposes.<sup>131</sup>

Although the principal amounts are actually exchanged in some swaps on the commencement date and the maturity date, it still does not imply that those amounts constitute the capital advanced in terms of a loan agreement.<sup>132</sup>

According to Brinker, although the payments made in terms of interest rate agreements cannot be deemed to be interest, it is unlikely that those amounts can be said to be of a

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<sup>127</sup> *Ibid.*

<sup>128</sup> *Ibid.* The mark-to-market or market value accounting method is the method in which payments are allocated to the period in which they become payable. (See par 5.2 below).

<sup>129</sup> De Koker *op cit* n2 at 17-134 and 17-135.

<sup>130</sup> Brinker *op cit* n30 at X3.3.

<sup>131</sup> *Ibid.*

<sup>132</sup> *Ibid.*

capital nature.<sup>133</sup> Even to the extent that an interest rate agreement is entered into as a hedge, the underlying asset that is sought to be hedged will in all likelihood be linked to the income earning operations of the taxpayer as opposed to its income earning structure.<sup>134</sup> He goes on to state that for the same reason that it is difficult for interest to be of a capital nature, payments made under interest rate agreements are also unlikely to preserve, enhance or add to the capital earning structure of a taxpayer.<sup>135</sup>

Section 24K does not deem the amounts concerned to be of a capital or revenue nature and therefore the normal principles should apply in order to determine the nature of the incurral or accrual arising out of these interest rate agreements.<sup>136</sup>

It thus follows that section 24K is no more than a mere timing provision, where as opposed to the amounts only having to be accounted for once it has been unconditionally accrued or have been incurred, section 24K effectively removes the “conditionality” element thereof.<sup>137</sup>

### 3.5.2 Section 24L and Option Contracts

If the ordinary timing rules apply with regards to option contracts, the option premium would have been taxed and allowed at the time when the option writer would have become unconditionally entitled to receive it and the option holder becomes unconditionally liable to pay.<sup>138</sup>

However section 24L of the Act, specifically deals with the timing of the accrual and incurral of amounts in respect of option contracts.

Section 24L(1) 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 as defined in section 24I(1))-

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<sup>133</sup> *Ibid.*

<sup>134</sup> *Ibid.*

<sup>135</sup> *Ibid.*

<sup>136</sup> *Ibid.*

<sup>137</sup> *Ibid.*

<sup>138</sup> Hutton *op cit* n4 at 207.

- (a) to buy from or to sell to another person a certain quantity of corporeal or incorporeal things before or on a future date at a pre-arranged price; or
- (b) that an amount of money will be paid 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 a pre-arranged value or price.”

Section 24L states that any premium or like consideration paid or payable by a person in terms of an option contract, or any consideration paid or payable by a person in respect of the acquisition of an option contract by that person is deemed to have been incurred by the payer on a day to day basis during the term of the option contract.<sup>139</sup>

There are however the following exceptions to the above rules:

- Firstly, section 24L(2) provides that the section does not apply to an option contract held by a person as trading stock. The normal tax principles will thus govern such situations.<sup>140</sup>
- Secondly, section 24L(3) states that when the option contract is exercised, terminated or disposed of before the end of its original term, the portion of the premium or consideration attributable to the period from the date of exercise, termination or disposal until the end of the original term of the option contract is deemed to be incurred on that date.<sup>141</sup>

Oguttu gives the following example in relation to the second exception: Where an option contract was exercised at a price lower than the market value of the underlying asset at the date of acquisition, then the day to day rule would not be applicable. In fact the part of the premium that represents the intrinsic value<sup>142</sup> is deemed to be incurred on the

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<sup>139</sup> Oguttu *op cit* n83 at 408; De Koker *op cit* n2 at 17-138-20; Brinker *op cit* n30 at Y5.1.

<sup>140</sup> Section 24L(2) of the Act. See also Oguttu *op cit* n83 at 408.

<sup>141</sup> Section 24L(3) of the Act. See also Oguttu *op cit* n83 at 408.

<sup>142</sup> The term “intrinsic value” is defined in section 24L as “an amount equal to the difference between the market price or value of an asset, index, currency, rate of interest or any other factor, as provided for in the option

date the premium is exercised, determined or disposed of.<sup>143</sup> The rationale behind this is to prevent tax avoidance as the majority of options are acquired when the market price of the underlying asset is close to the strike price<sup>144</sup> of the option.<sup>145</sup>

Section 24L however only deals with the premium paid by the option holder and does not deal with the manner in which the ultimate exercise or strike price is to be treated.<sup>146</sup>

Brinker opines that it is not necessary for the contract to be worded in the form of an option agreement and the fact that the opening words of the definition refers to an option contract does not imply that only an option contract is covered, but that in the context an option merely means a right that can be exercised.<sup>147</sup> He further states that the only limitation in respect of section 24L seems to be that the exposure of an option holder cannot exceed the premium payable.<sup>148</sup>

Furthermore, the underlying asset of the option contract does not need to be a physical asset, and that the incurral or accrual does not only cater for the premium paid in terms of the option contract, but also caters for a premium which is payable, but has not yet been paid.<sup>149</sup>

### 3.5.3 Section 24M and unquantified amounts

Section 24M of the Income Tax Act deals with the incurral and accrual in respect of assets disposed of, or acquired for an amount which cannot be quantified in a specific year of assessment.

Effectively section 24M postpones the recognition of the accrual of the proceeds to the seller and the incurral of the expenditure by the purchaser until the amount becomes

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contract, on the date of acquisition of the option contract and the pre-arranged price or value provided for in the option contract.”

<sup>143</sup> Oguttu *op cit* n83 at 408.

<sup>144</sup> The strike price is the price at which the underlying asset to the option contract may be bought in the case of a call option, or be sold in the case of a put option. Goodspeed *Introduction to Financial Markets* (2013) at 137.

<sup>145</sup> Oguttu *op cit* n83 at 408.

<sup>146</sup> Brinker *op cit* n30 at Y5.

<sup>147</sup> Brinker *op cit* n30 at Y5.2.

<sup>148</sup> Brinker *op cit* n30 at Y5.2.

<sup>149</sup> *Ibid.*



quantifiable, thereby synchronising the taxable income of the parties.<sup>150</sup> Section 24M does not deal with the nature of the unquantified amount in order to establish whether it is of capital or revenue of nature, but is only a timing rule to determine when the amounts accrue or are incurred by, or to the taxpayer.<sup>151</sup>

It is submitted that section 24M would be applicable with regards to derivative transactions, such as futures – and forward agreements, where the amounts incurred or accrued can only be quantified on the future date, as is determined in the agreement.

### 3.6 Conclusion

It is evident that through the years a number of principles have emerged which governs the taxation of proceeds and losses as result of derivative transactions. This is especially true in the instance relating to the income or capital nature of the proceeds and/or losses where a derivative instrument is used in a hedging transaction.

The Act also contains a number of relevant sections pertaining to the timing of the incurral and accrual of certain derivative contracts, but to no extent does the Act adequately cater for the taxation of the numerous derivative instruments available.<sup>152</sup>

The following chapter will deal with the taxation of derivatives in the United Kingdom and the various principles applicable in that jurisdiction, which may be of guidance in order to formulate an adequate system of taxation in respect of derivative transactions.

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<sup>150</sup> De Koker *op cit* n2 at 17-142.

<sup>151</sup> *Ibid.*

<sup>152</sup> This will be elaborated on further in Chapter 5.

## Chapter 4: The Taxation of Derivatives in the United Kingdom

### 4.1 Introduction

This chapter seeks to deal with the position in the United Kingdom (“the UK”) regarding the taxation of financial derivatives, especially focussing on the provisions of the Finance Act, 2002 (“the Finance Act”) relating to the taxation of financial derivative transactions.

### 4.2 The Position in the United Kingdom

Initially the UK did not have a comprehensive tax regime to deal with the taxation of derivatives, instead the revenue authorities relied heavily on practice notes, in particular Statement of Practice 14/1991, (“the Statement of Practice”).<sup>1</sup>

It must be noted that according to Statement of Practice 1 of 2001 which was published by the UK Revenue Authorities during February of 2001, the Statement of Practice is obsolete, and seems to have been obsolete since 2001. However, and in order to provide a historical background, the contents of the Statement of Practice will still be briefly discussed herein.

According to Oguttu the UK distinguishes between income derived from derivative transactions and income derived from hedging transactions so as to determine the character of the income.<sup>2</sup> The Statement of Practice states that a transaction in financial futures and options entered into by a taxpayer, provided that the taxpayer is not a financial trader, is regarded as a hedging transaction if the intention of the taxpayer is to eliminate or reduce risk, or reduce transaction costs in respect of the underlying transaction.<sup>3</sup>

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<sup>1</sup> Oguttu “Challenges in Taxing Derivative Financial Instruments: International Views and South Africa’s Approach” (2012) 24 *SA Merc LJ* at 399.

<sup>2</sup> *Ibid.*

<sup>3</sup> Statement of Practice 14/1991 at 1421. See also Oguttu *op cit* n1 at 399.

## 4.2.1 The Finance Act 2002

### 4.2.1.1 The Relevant Definitions

In 2002 the UK enacted the Finance Act 2002, which increased the taxation of derivatives regime to cover options, futures and contracts for difference.<sup>4</sup> Schedules 26 and 27 of the Finance Act deals with the taxation of derivative contracts.<sup>5</sup>

The Schedule provides that for the purposes of a corporation tax, any profits attributed to a company from its derivative contracts shall be taxable as income.<sup>6</sup> However, the Schedule does not apply to derivative contracts of which the disposal of the underlying subject matter would result in receipts or accruals of a capital nature.<sup>7</sup>

Furthermore the Finance Act provides a definition for derivatives contracts, in that it states that a company's derivative contracts are those of its relevant contracts. Relevant contracts are in turn defined as an option, a future, or a contract for difference.<sup>8</sup> Each of the aforementioned are specifically defined in the Finance Act.<sup>9</sup> A contract for difference is specifically as inclusive of any other contract, the purpose of which is to secure a profit or avoid a loss by reference to fluctuation in the value or price of property, or an index or other factor designated in the contract.<sup>10</sup>

Rudnicki opines that the inclusion of the definition of a contract for difference is an attempt by the legislature to invoke a catch-all clause by specifically catering for a contract for difference.<sup>11</sup> He, however, believes that an all-encompassing definition

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<sup>4</sup> Oguttu *op cit* n1 at 399.

<sup>5</sup> Finance Act 2002.

<sup>6</sup> Paragraph 1 of Schedule 26 to the Finance Act 2002. See also Oguttu *op cit* n1 at 399.

<sup>7</sup> Paragraph 4(1) and 4(2) of Schedule 26 to the Finance Act 2002. See also Oguttu *op cit* n1 at 399.

<sup>8</sup> Paragraph 2(1) and 2(2) of Schedule 26 to the Finance Act 2002.

<sup>9</sup> Paragraph 12(3), (6), (8) and (9) to the Finance Act 2002.

<sup>10</sup> Paragraph 12(3) of Schedule 26 to the Finance Act 2002 and Rudnicki *A framework for the taxation of derivative transactions* (unpublished dissertation) (2003) at 21.

<sup>11</sup> Rudnicki *A framework for the taxation of derivative transactions* (unpublished dissertation) (2003) at 21.

which defines the characteristics of a derivative would be more suitable, as opposed to defining the specific types of derivatives.<sup>12</sup>

Of particular importance is the fact that the UK legislature specifically defined the term “underlying subject matter”, which is an essential characteristic of a derivative contract.<sup>13</sup> The definition of this term is split into separate parts, each part describing the underlying subject matter of an option, future and contract for difference respectively.

The underlying subject matter of an option is defined as the property which would fall to be delivered if the option were to be exercised, or in the case that the property which would fall to be delivered is a derivative contract in itself, then it would be the underlying subject matter of that derivative contract.<sup>14</sup>

The underlying subject matter of a future is in turn defined as the property, which if the future were to run to delivery, would fall to be delivered at the date and price agreed to when the contract is entered into.<sup>15</sup> The second portion hereof is similar to the second portion of the definition of underlying subject with regards to an option.

The definition of the underlying subject matter in respect of contracts for difference, differs quite substantially from the above, and reads as follows:<sup>16</sup>

“The underlying subject matter of a contract for differences is –

- (a) Where the contract for differences relates to fluctuations in the value or price of property described in the contract, the property so described, or
- (b) Where an index or factor is designated in the contract for differences, the matter by reference to which the index or factor is determined.”

The definition goes even further and states that in the case of a contract for differences the underlying subject matter may include interest rates, weather conditions and creditworthiness.<sup>17</sup>

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<sup>12</sup> *Ibid.*

<sup>13</sup> The underlying subject matter of a derivative was discussed in Chapter 2, paragraph 2.2 above.

<sup>14</sup> Paragraph 11(2) of Schedule 26 to the Finance Act.

<sup>15</sup> Paragraph 11(3) of Schedule 26 to the Finance Act.

<sup>16</sup> Paragraph 11(4) of Schedule 26 to the Finance Act.

Rudnicki states that the reason for defining the term “underlying subject matter” is because the starting point for determining the value of a derivative is by having regard to the underlying subject matter.<sup>18</sup>

#### 4.2.1.2 Taxation of derivative income

In terms of the Finance Act, the time when the income arising from a derivative transaction is taxed, is determined by applying accounting principles.<sup>19</sup> The authorised accounting methods for the purposes of the Schedule are either a mark-to-market approach, under which any derivative contract to which it would apply is brought into account in each accounting period at fair value, or an accrual basis of accounting.<sup>20</sup>

The third part of Schedule 26 to the Finance Act is entitled “Method of Taxation” and provides that for purposes of corporation tax, the profits and losses arising from derivative contracts of a company shall be computed by using the credits and debits given for the accounting period in question.<sup>21</sup>

Insofar as a derivative contract is entered into by a company for the purposes of a trade carried on by it, the credits and debits given in respect of that contract, and for that accounting period shall be treated either as:

- receipts of that trade falling to be brought into account in computing the profits of trade for that period;
- or as expenses of that trade which are deductible in computing those profits.<sup>22</sup>

These credits and debits brought into account are the sums, which together fairly represent, for the period in question, all profits and losses of the company which arise to the company from its derivative contracts and related transactions.<sup>23</sup> It also includes all

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<sup>17</sup> Paragraph 11(5) of Schedule 26 to the Finance Act.

<sup>18</sup> Rudnicki *op cit* n11 at 22.

<sup>19</sup> Oguttu *op cit* n1 at 399.

<sup>20</sup> Paragraph 17(1) of Schedule 26 to the Finance Act.

<sup>21</sup> Paragraph 14(1) of Schedule 26 to the Finance Act.

<sup>22</sup> Paragraph 14(2) of Schedule 26 to the Finance Act.

<sup>23</sup> Paragraph 15(1) of Schedule 26 to the Finance Act.

charges and expenses incurred by the company for the purpose of its derivative contracts and related transactions.<sup>24</sup>

The above mentioned profits and losses are inclusive of any forward premiums or discounts which arise from a derivative contract whose underlying subject matter consists wholly or partly of currency.<sup>25</sup>

The charges and expenses incurred by a company for purposes of its derivative contracts and related transactions does not include any charges or expenses other than those incurred directly in bringing the contract into existence, entering into or giving effect to those transactions, making payments under or in pursuance of any of the transactions, or in taking steps for ensuring the receipt of payments under any of those contracts or transactions.<sup>26</sup>

The Finance Act does make provision for the taking into account of future charges and expenses by a company in relation to derivative contracts it may enter into, in that paragraph 15(5) of Schedule 26 states that:

“Where –

- (a) any charge or expense are incurred by a company for purposes connected –
  - (i) with entering into a derivative contract or related transaction, or
  - (ii) with giving effect to any obligation that might arise under a derivative contract or related transaction,
- (b) at the time when the charges or expenses incurred, the contract or transaction is one into which the company may enter but has not yet entered, and
- (c) if that contract or transaction had been entered into by that company, the charges or expenses would be charges or expenses incurred as mentioned in sub-paragraph 4,

those charges or expenses shall be treated for the purpose of this Schedule as charges or expenses in relation to which the debits may be brought into account in accordance with sub-paragraph (1)(b) to the same extent as if the contract or transaction had been entered into.”

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<sup>24</sup> *Ibid.*

<sup>25</sup> Paragraph 15(3)(b) of Schedule 26 to the Finance Act.

<sup>26</sup> Paragraph 15(4) of Schedule 26 to the Finance Act.

The UK does not have any special provision with regards to the jurisdictional aspect of the taxation of derivatives when dealing with cross-border transactions.<sup>27</sup> However, in terms of section 8 of the Income and Corporations Taxes Act 1998, a UK company is taxable on its worldwide income and gains.<sup>28</sup> Oguttu goes on to state that although the UK has a well-developed network of double taxation treaties, none of these have been specifically negotiated in order to cater for derivative transactions.<sup>29</sup>

#### 4.2.2 Case Law Pertaining to Financial Derivative Transactions

*British South Africa Co v Varty (Inspector of Taxes)*<sup>30</sup> dealt specifically with the tax consequences of an option and when it can be said that a taxpayer has become unconditionally entitled to the amount. The facts are briefly as follows: the taxpayer was an investment company who carried on the trade of a development and general finance and trading company. The taxpayer entered into a financial arrangement whereby it provided loans to companies, in return for options to acquire shares in those companies at a fixed price. In 1953 the taxpayer loaned an amount of £200 000 to another company in consideration of an option to acquire one hundred thousand shares in the company at a fixed value of 20s per share. The taxpayer exercised the aforementioned option in 1954, however, the shares appreciated in value and the Revenue Authority contended that the exercise of the option gave rise to a profit which profit should be taken into account in the taxpayer's profits for the particular year.

The court made a distinction between the realisation of an option and the exercise of the right in terms of an option contract. Ultimately, the court came to the conclusion that the exercise of a right in terms of an option contract does not amount to a realisation of the option contract. Therefore, it cannot be said that a profit accrued to the taxpayer

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<sup>27</sup> Oguttu *op cit* n1 at 400.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid.*

<sup>30</sup> [1965] 2 All ER 395 at 398 – 400.

upon the exercise of the right.<sup>31</sup> The following *dictum* of the court illustrates its reasoning in the aforementioned conclusion:<sup>32</sup>

“The company, however, in fact never realised its option in the sense of passing it on, for a consideration, to someone else. There was no sale of the option. There was no exchange of it for something else. An exercise of an option involves an entirely different conception. When the taxpayer company exercised its option, or in other words, used or availed itself of its rights that did not mark the end of the trading transaction: that was merely the end of the beginning of a trading transaction. There was a subscription of shares by a company that dealt in shares and which might later on make a trading profit by selling the shares.”

In *Prudential PLC v Revenue and Customs Commissioners*<sup>33</sup> the main issue which the court had to decide on, in the context of a swap transaction, was whether payments made at the inception of the transaction were to be considered as “qualifying payments” in terms of section 151(2) of the Finance Act, 1994.

In brief, Prudential entered into two different swap-transactions with international banks. The first of which was one where Prudential agreed to pay the bank in Sterling in exchange for the equivalent in Euro. The terms of the transaction was that Prudential would pay the bank £65 million “in consideration of the bank entering into the transaction”. On 12 March 2002, Prudential paid the £65 million and on 19 June 2002 Prudential received the Euros from the bank, and paid to the bank a Sterling sum, less the £65 million already paid, reflecting the value of the Euros.<sup>34</sup>

The second swap-transaction concerned a transaction where Prudential obtained Dollars in exchange for Sterling in order to finance a loan by a wholly-owned subsidiary to another company. Prudential sought to hedge the foreign exchange exposure on the loan and consequently entered into a “revised confirmation” which included a term that Prudential was to pay £40 million to the bank also “in consideration of the bank’s

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<sup>31</sup> *British South Africa Co v Varty (Inspector of Taxes)* [1965] 2 All ER 395 at 400 - 403.

<sup>32</sup> *British South Africa Co v Varty (Inspector of Taxes)* [1965] 2 All ER 395 at 400 – 401.

<sup>33</sup> [2008] STC 239 (SCD). Albeit that the case deals with the provisions of the Finance Act of 1994, it still merits being discussed herein as it is one of the few actual relevant cases pertaining to the taxation of financial derivatives.

<sup>34</sup> *Prudential PLC v Revenue and Customs Commissioners* [2008] STC 239 (SCD) at 245A – F.



entering into the transaction”. Prudential made the payment of the £40 million to the bank on 23 August 2002 and on 25 November 2002 Prudential received back in Sterling the value of what it paid to the bank in Dollars, together with the Dollar value of the £40 million.<sup>35</sup>

In its tax return for the period in question, Prudential claimed a non-trading loan relationship debit to the amount of £105 million comprising of the two abovementioned front end payments. This was on the basis that the front end payments fell within the ambit of section 151(1) of the Finance Act, 1994. The section provided that a debt contract entered into by a qualifying company could include a provision that the company became subject to a duty to make payment in consideration of another person’s entering into the contract. The Revenue Authority issued a notice that the aforesaid front end payments were not allowable as a deduction and contended that the £65 million was a part-payment of the Euros and was not an inducement to get the bank to sell the Euros cheaply. The Revenue Authority further contended that the £40 million was also not a payment made to induce the bank to buy Dollars, but was more in the nature of a deposit returnable on the termination date.<sup>36</sup>

In order to understand the case it is first necessary to embark upon an analysis of the Finance Act, 1994, especially the sections pertaining thereto, as discussed in the Prudential Case.<sup>37</sup>

Section 155 was the main provision of the second chapter of the fourth part of the 1994 Act, which comprised of the code for the taxation of qualifying contracts.<sup>38</sup> Section 155 dealt with the circumstances where profits and losses accrued to qualifying companies, the relevant sections of which read as follows:

- (1) “Where, as regards a qualifying contract held by a qualifying company and an accounting period, amount A exceeds amount B, a profit on the contract of an amount equal to the excess accrues to the company for the period,

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<sup>35</sup> *Prudential PLC v Revenue and Customs Commissioners* [2008] STC 239 (SCD) at 248A – D.

<sup>36</sup> *Prudential PLC v Revenue and Customs Commissioners* [2008] STC 239 (SCD) at 241D – F.

<sup>37</sup> *Prudential PLC v Revenue and Customs Commissioners* [2008] STC 239 (SCD) at 249F–250F.

<sup>38</sup> *Prudential PLC v Revenue and Customs Commissioners* [2008] STC 239 (SCD) at 249F.

- (2) Where, as regards a qualifying contract held by a qualifying company and an accounting period, amount B exceeds amount A, a loss on the contract of an amount equal to the excess accrues to the company for the period.
- (3) ...
- (4) ...
- (5) Where, as regards a qualifying contract held by a qualifying company's profit or loss for an accounting period falls to be computed on a particular accruals basis –
- (6) amount A is so much of the qualifying payment or payments received, or falling to be received by the company as is allocated to the period on that basis, and
- (7) amount B is so much of the qualifying payment or payments made or falling to be made by the company as is so allocated.”

Section 147(1) of the 1994 Act stated that a currency contract is a qualifying contract if the qualifying company becomes entitled to rights or subject to duties under the contract, on, or after its commencement day.

Therefore the enquiry turned to the definition of a “qualifying payment”. Section 153 states that a “qualifying payment” in relation to any qualifying contract means a payment falling within the ambit of section 151. Section 151(1) stated that:

- (1) “An interest rate contract or option, a currency contract or option or a debt contract or option may include a provision under which the qualifying company –
  - (a) becomes entitled to a right to receive a payment in consideration of its entering into the contract or option, or
  - (b) becomes subject to a duty to make a payment in consideration of another person's entering into the contract or option.”

Section 151(2) provided that a “qualifying payment” is inclusive of:

- (a) “a payment of a reasonable fee for arranging the contract or option;
- (b) a payment of reasonable costs incurred in respect of the contract or option.”

Having regard to the above, the Court held that the wording of section 151(1)(b) is directed at payments which have the function of securing and making the contract, and are to be distinguished from payments made in the fulfilment of the contract itself.<sup>39</sup> The Court further held that the payments made by Prudential were payments relating to Prudential’s principal liabilities under the contract and were not payments made in consideration of another person’s entering into the contract. The Court stated that this finding was wholly dispositive of the appeal.

### 4.3 Conclusion

From the above it is evident that the UK attempted to cater quite extensively for the taxation of financial derivative transactions. I agree with the opinion of Rudnicki that the UK legislation adopts a favourable process for the accounting of unrealised gains and losses with regards to derivative transactions, which it does by having regard to an authorised accounting method.<sup>40</sup> Rudnicki opines that effectively the method applied for tax purposes, in relation to derivative transactions, is a function of the accounting methodology.

A flaw in the UK legislation is, in my opinion, that it attempts to provide very specific definitions to the various derivative transactions concerned. However the legislature addresses this deficiency by virtue of the provisions of paragraph 13 of Schedule 26 to the Finance Act, 2002, which provides that Treasury may amend by way of adding to, removing or varying the descriptions of the derivative contracts.<sup>41</sup> As well as providing

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<sup>39</sup> *Prudential PLC v Revenue and Customs Commissioners* [2008] STC 239 (SCD) at 252E.

<sup>40</sup> Rudnicki *op cit* n 11 at 50.

<sup>41</sup> Paragraph 13(2)(a) of Schedule 26 to the Finance Act.

for the adding to, removing, or varying any of the descriptions of contracts excluded by virtue of their underlying subject matter.<sup>42</sup>

The following chapter will deal with a comparison between the taxation regime of South Africa and that of the United Kingdom in relation to the taxation of derivative transactions, as well as recommendations of where the South African regime could seek to improve.

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<sup>42</sup> Paragraph 13(2)(b) of Schedule 26 to the Finance Act.

## Chapter 5: Comparison and Conclusion

### 5.1 Introduction

This chapter contains a comparison of the taxation regimes of South Africa and the United Kingdom in so far as the tax treatment of derivative transactions and/or contracts are concerned. The aim of this chapter is to provide recommendations as to how the South African tax dispensation can be reformed in order to adequately cater for the taxation of derivatives.

### 5.2 Comparison between the South African and the United Kingdom approach

Notwithstanding the provisions relating to the timing of the incurral or accrual of certain derivative transactions, the South African tax dispensation does not contain any other specific principles directly applicable to the taxation of derivative transactions and/or contracts. The case law on the topic is also very slim.

As such, one needs to have regard to the ordinary principles of taxation and adapt them to each and every derivative transaction and/or contract in order to determine the applicable position. This is similar the position in the United Kingdom, where regard is also given to the general taxation principles, especially in so far as the character of the income derived from the derivative contract and/or transaction is concerned.<sup>1</sup>

However the United Kingdom Finance Act, 2002 (“ the Finance Act” ) pertaining to the taxation of derivatives does attempt to define a derivative contract as a company’s relevant contracts, namely, options, futures and contracts for difference.<sup>2</sup> The Finance Act does not specifically cater for swap contracts, but the definition of a contract for difference seems to be a “catch-all” provision.<sup>3</sup> It is submitted that although a swap and a contract for difference are two very different types of derivative contracts, a swap may very well fall within the ambit of this definition, as at the very essence of both is a

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<sup>1</sup> Oguttu “Challenges in Taxing Derivative Financial Instruments: International Views and South Africa’s Approach” (2012) 24 *SA Merc LJ* at 401.

<sup>2</sup> Schedule 26 of the Finance Act 2002.

<sup>3</sup> Rudnicki *A framework for the taxation of derivative transactions* (unpublished dissertation) (2003) at 21.

contract with the purpose to obtain a profit, or avoid a loss by having regard to fluctuations in an underlying asset.<sup>4</sup>

The Finance Act attempts to define the underlying subject matter insofar as it pertains to the company's relevant contracts.<sup>5</sup> Furthermore, and in my opinion the most important aspect, the Finance Act provides for the Treasury to add, amend or vary the descriptions of derivative contracts contained in the Finance Act.<sup>6</sup> A provision like this is absolutely paramount in order to allow the taxation regime the necessary flexibility to keep up with the innovation of the derivatives market.

The South African Income Tax Act 58 of 1962 (“ the Income Tax Act”) does not attempt to define the underlying asset, nor the characteristics of derivative contracts in general, but does contain definitions for interest rate agreement as well as for options.<sup>7</sup> As mentioned previously, interest rate agreements envisage interest rate swap contracts as well.<sup>8</sup> It is submitted that this position is woefully inadequate as there are more types of derivative contracts than merely options and swaps.

The South African and United Kingdom approach to the taxation of derivatives is substantially similar insofar as both the Income Tax Act as well as the Finance Act seem to cater for the timing aspect of the derivative income on a mark-to-market basis.<sup>9</sup> In other words, the income derived from a derivative transaction is deemed to have been incurred or accrued to the taxpayer on a day-to-day basis.

In the United Kingdom, the timing of the taxation of derivative contracts and/or transactions is determined by the application of accounting principles.<sup>10</sup> However, it does seem that one has a choice as to which accounting method to apply, in that the

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<sup>4</sup> As swaps most commonly pertains to interest rates calculated on a notional principal amount, this is further substantiated by the fact that the definition of the underlying subject matter with regards to a contract for difference specifically includes interest rates as contained in Paragraph 11(5) of Schedule 26 to the Finance Act 2002.

<sup>5</sup> Paragraph 11 of the Finance Act 2002.

<sup>6</sup> Paragraph 13 of Schedule 26 to the Finance Act 2002.

<sup>7</sup> These definitions are contained in section 24K and 24L of the Income Tax Act 58 of 1962.

<sup>8</sup> Brinker *Taxation Principles of Interest and Other Financing Transactions* (2011) at X3.1.

<sup>9</sup> Section 24K and Section 24L of the Income Tax Act 58 of 1962 as well as Paragraph 17 of Schedule 26 to the Finance Act 2002.

<sup>10</sup> Paragraph 17 of Schedule 26 to the Finance Act 2002, see also Oguttu *op cit* n1 at 399.

accounting methods of an accrual basis and a mark-to-market basis are referred to in the alternative.<sup>11</sup>

- The accrual basis of accounting envisages that payments are allocated to the period to which they relate, irrespective of the period in which they are made or received, or in which they become due and payable.<sup>12</sup>
- The mark-to-market basis of accounting is one in which the payments are allocated to the periods in which they become due and payable.<sup>13</sup>

The aforementioned election is particularly useful as the accrual basis of accounting is more relevant to hedging transactions, and the mark-to-market basis of accounting is more applicable to speculative and arbitrage transactions.<sup>14</sup>

It is submitted that the South African tax regime could benefit from incorporating such an election instead of merely providing outright for the day-to-day incurral or accrual of the income derived from derivative transactions and/or contracts. The Income Tax Act does however, to a certain extent, provide for a similar provision as the accrual basis of accounting, by virtue of section 23M of the Income Tax Act. Section 23M in essence states that where a taxpayer disposes of an asset for an unquantified amount, only the portion of that amount that can be quantified in the year of assessment be accounted for in that particular year of assessment.

Insofar as the tax jurisdiction of derivative contracts and/or transactions are concerned, both South Africa and the United Kingdom imposes tax on their residents on worldwide income and gains, irrespective of the source thereof.<sup>15</sup>

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<sup>11</sup> Paragraph 17(1) of Schedule 26 to the Finance Act 2002.

<sup>12</sup> Paragraph 17(3)(a) of Schedule 26 to the Finance Act 2002.

<sup>13</sup> Paragraph 17(4) of Schedule 26 to the Finance Act 2002.

<sup>14</sup> *Uys A critical discussion of the tax aspects of derivative instruments* (unpublished dissertation) (2002) at 44.

<sup>15</sup> *Oguttu op cit* n1 at 400.

### 5.3 Recommendations

It is almost trite that in order for any taxation dispensation to function effectively, it needs to have regard to the canons of taxation, namely equity, certainty, convenience, efficiency and neutrality.<sup>16</sup>

The canons of taxation was formulated in 1776 by Adam Smith and published in a book entitled *The Wealth of Nations* and encapsulates the characteristics of a good taxation system.<sup>17</sup> In this context, equity entails that similar individuals be taxed on a similar basis, as well as that the higher an individual's level of economic wellbeing, the higher a tax burden ought to be imposed on the individual.<sup>18</sup> The canon of certainty relates to the fact that a taxpayer should be reasonably certain as to the extent of their tax liabilities.<sup>19</sup> Tax ought also to be levied and imposed at a time, or manner, which would be most convenient for the taxpayer to pay same.<sup>20</sup> Efficiency relates to the requirement that a system of taxation should be administered in the most efficient manner possible, which in turn results in reduced costs for both the fiscus as well as the taxpayer.<sup>21</sup> Lastly, the principal of neutrality is that a taxpayer's decisions should not be influenced solely because the tax effect of one course of action is greatly beneficial to the tax effect of the other course of action.<sup>22</sup>

The Tax Advisory Committee indicated that the taxation of derivatives transactions and/or contracts should comply with the aforementioned canons of taxation.<sup>23</sup> They, in particular indicated that the taxation of derivative transactions and/or contracts should be in conformity with the principles of certainty and neutrality in that the taxpayer needs to know on which basis the derivatives are to be taxed, as well as that similar derivative

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<sup>16</sup> Croome *Taxpayers' rights in South Africa: An analysis and evaluation of the extent to which the powers of the South African Revenue Service comply with the Constitutional rights to property, privacy, administrative justice, access to information and access to courts* (unpublished dissertation) (2008) at 6

<sup>17</sup> Wilcocks and Middelman "Evaluation of the Need to Introduce a System of Group Taxation in South Africa" (2004) 8(3) *South African Business Review* at 49.

<sup>18</sup> Wilcocks and Middelman *op cit* n17 at 49.

<sup>19</sup> Wilcocks and Middelman *op cit* n17 at 50.

<sup>20</sup> Wilcocks and Middelman *op cit* n17 at 49.

<sup>21</sup> Wilcocks and Middelman *op cit* n17 at 50.

<sup>22</sup> Wilcocks and Middelman *op cit* n17 at 49.

<sup>23</sup> The Tax Advisory Committee *Consultative document in the tax treatment of financial arrangements* (1994) see also Brinker *op cit* n8 at W3.



transactions and/or contracts should be taxed on a similar basis.<sup>24</sup> It was also indicated that the advantage of having certainty should far outweigh the disadvantages of complexity pursuant to the legislation having to be adaptable in order to adequately cater for the innovation in the financial markets.<sup>25</sup>

Currently, there is no certainty as to the taxation of derivative transactions and/or contracts. This is something which the Legislature should remedy as soon as reasonably possible.

It is submitted that the following factors may assist in the development of an adequate taxation dispensation with regards to the taxation of derivative transactions and/or contracts:

Firstly, the rules pertaining to the classification of receipts pursuant to derivative transactions and/or contracts as either revenue or capital in nature, should be provided for in legislation.<sup>26</sup>

Secondly, and in accordance with the suggestion made by Rudnicki, the legislation should contain an all-encompassing, but highly adaptable definition of a derivative by having regard to the true characteristics of a derivative.<sup>27</sup> The legislation should preferably contain a similar adaptable provision as that of the United Kingdom.<sup>28</sup>

Thirdly, both speculative and hedging transactions should be defined and the provisions relating to the timing of the incurral or accrual should follow these definitions. Thus the timing of the incurral or accrual with regards to speculative transactions should be on a day-to-day basis, with the incurral or accrual in the context of a hedging transactions on the day in which the hedging transaction is exited from.

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<sup>24</sup> The Tax Advisory Committee *op cit* n17. See also Brinker *op cit* n17 at W3.

<sup>25</sup> Brinker *op cit* n18 at W3.

<sup>26</sup> Currently, one has to apply the general principles contained in case law in order to ascertain the position.

<sup>27</sup> Rudnicki *op cit* n3 at 21.

<sup>28</sup> Paragraph 13(2) of Schedule 26 to the Finance Act 2002.

## 5.4 Conclusion

In conclusion, although the South African tax dispensation does possess some provisions for the taxation of financial derivatives, those provisions are by no means enough to adequately cater for the taxation of derivative contracts and/or transactions.

The current day-to-day incurral or accrual of amounts in respect of interest rate swaps and options is an untenable position as this creates an administrative burden, both on the taxpayer as well as the revenue authorities, in order to account for the taxation of derivatives.

Furthermore, the day-to-day incurral or accrual also effectively makes the use of a hedge redundant, in that it may very well happen that if the gains or losses are taken into account on a day-to-day basis, the effectiveness of the hedge might be mitigated by virtue of the tax burden imposed on the transaction.

The aforementioned would be a manner in which to ensure that the risk management goal of a hedge is not made redundant by imposing too high a tax burden, but also that the tax principles are not abused by speculation and arbitrage transactions.

The recommendations made herein should have the effect of reforming the South African tax dispensation in so far as derivative transactions and/or contracts are concerned, so as to be in line with the canons of taxation.

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