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A COMPARATIVE STUDY BETWEEN SOUTH AFRICA AND THE UNITED KINGDOM ON THE TAXATION OF FUTURES AND INDEX OPTIONS

by

Reinier Stoltz

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Study leader: Professor M Cronje

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ABSTRACT

A COMPARATIVE STUDY BETWEEN SOUTH AFRICA AND THE UNITED KINGDOM ON THE TAXATION OF FUTURES AND INDEX OPTIONS

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Reinier Stoltz

SUPERVISOR: PROF M CRONJE
DEPARTMENT: TAXATION
DEGREE: MAGISTER COMMERCII

This study focuses specifically on single stock futures and single stock future options transactions and the related tax consequences in South Africa and the United Kingdom.

People expect their wealth to increase when they invest their time, money and other scarce resources. In other words, they expect a return on their investment, which ultimately increases their wealth. Governments usually levy tax on returns. This means a taxpayer's wealth is decreased by the tax levied on his return on investment. The tax treatment of returns is therefore an important factor to consider when investing.

The nature and market mechanics of single stock futures and single stock future options are considered in this study in order to determine the related tax consequences in terms of each country's tax legislation. Further, the concept of a "hedge" is explored in order to determine whether it affects the tax treatment of these derivatives.

A comparison of the tax treatment of single stock futures and single stock future options between South Africa and the United Kingdom revealed that the intention of the taxpayer is an important factor to consider in order to determine whether the transaction is taxed in terms of the provisions relating to normal tax or capital gains tax.

OPSOMMING

'N VERGELYKING VAN DIE BELASTINGHANTERING VAN GELYSTE AFGELEIDE INSTRUMENTE EN VERBANDHOUDENDE OPSIES TUSSEN SUID-AFRIKA EN ENGELAND

deur

Reinier Stoltz

STUDIELEIER: PROF M CRONJE
DEPARTEMENT: BELASTING
GRAAD: MAGISTER COMMERCII

Die studie fokus op die belastinggevolge van gelyste afgeleide instrumenttransaksies in Suid-Afrika en Engeland. Die belastinggevolge van opsies wat verband hou met die gelyste afgeleide instrumente word ook in die studie aangespreek.

Mense verwag dat hul rykdom sal vermeerder wanneer hulle hul tyd, geld en ander skaarse hulpbronne aanwend. Met ander woorde, hulle verwag 'n opbrengs op hul belegging. Die Regering hef gewoontlik belasing op opbrengste. Dit beteken dat die belastingpligtige se rykdom verminder as gevolg van die belastinguitgawe. Dus die belastinggevolge wat verband hou met die beleggings is 'n belangrike faktor wat in ag geneem moet word ten tye van die beleggingsbesluit.

Die aard en mark dinamika van die gelyste afgeleide instrumente en die verbandhoudende opsies word in ag geneem vir doeleindes van die studie om die belastinggevolge van die transaksies in elke land te bepaal. Die konsep van "verskansing" word ondersoek om te bepaal of dit 'n effek het op die belastinggevolge van die transaksies.

'n Vergelyking van die belastinghantering van die gelyste afgeleide instrumente en verbandhoudende opsies tussen Suid-Afrika en Engeland dui aan dat die bedoeling van die belastingpligtige 'n belangrike faktor is om in ag te neem om te bepaal of die transaksie belas moet word ingevolge die normalebelasting of kapitaalwinsbelasting reëls.

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CHAPTER 1
INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

People expect their wealth to increase when they invest their time, money and other scarce resources. In other words, they expect a return on their investment, which ultimately increases their wealth (Jaff & Walras, 2003:65). The question is: how should the return on investment be valued? One method is to calculate the current value of the related future cash flows of the investment (Corria, Flynn, Uliana & Wormald, 2000:200-203). Analysis shows amongst other things that it is the amount and timing of the future cash flows that influence the value of a return (Corria *et al*., 2000:285).

It is important to realise that governments usually levy tax on returns. The payment of tax results in a cash outflow related to the investment and should therefore form part of the valuation. The tax expense is also influenced by the nature and timing of the income or gain as well as a country's sovereignty to levy tax. For example, income in the form of dividend from a South African company is exempt from income tax in South Africa in terms of section 10(1)(k)(i) of the Income Tax Act No.58 of 1962 (hereafter referred to as "the Act"). The tax charge or benefit plays a role in the valuation and may influence the investment decision. (Corria *et al*., 2000:281.)

These principles suggest that it is important to consider the tax consequences when investing. This study focuses specifically on single stock futures and single stock future options transactions and the related tax consequences.

1.2 CORE RESEARCH QUESTIONS

There are two core research questions:

- how are single stock futures and single stock future options taxed in South Africa and the United Kingdom; and
- does taxation affect the value of these financial instruments?

1.3 RESEARCH OBJECTIVES

The main research objective is to compare the tax effect of single stock futures and single stock future options in South Africa and the United Kingdom. The result of the main research objective will be guided by the following specific research objectives:

- explaining in brief the market mechanics of futures and index options;
- explaining why single stock futures and single stock future options fall within the ambit of the accounting definition of a derivative;
- explaining the purpose of a hedge and identifying its key characteristics;
- illustrating how to calculate the tax effect of single stock futures and single stock future options in terms of each country's tax legislation;
- critically comparing the tax legislation dealing with single stock futures and single stock future options of each country;
- briefly listing the most important factors and assumptions that influence the value of single stock futures and single stock future options, other than the tax effect;
- briefly listing the relevant valuation techniques appropriate to value single stock futures and single stock future options;
- briefly listing the limitations of each valuation technique; and
- comparing the valuation result of single stock futures and single stock future options in relation to each country's tax legislation.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

It appears that previous research studies on financial instruments and taxation did not list the commonly-used financial instruments, neither did they compare and illustrate the effect of tax legislation from different countries on the value of these financial instruments (Gentry & Schizer, 2003:167-195; Morris, Crosland, Collins, Clemens, Frazer & Snowden, 2008:13-14; Novack, 2003; Chen, 2003).

This study includes the most commonly-used financial instruments, namely:

- single stock futures; and
- single stock future options.

The study also seeks to illustrate the different approaches by each of the two countries to taxing these financial instruments. The concept "financial instrument" frightens most students because they regard the concept as abstract and complex. The study seeks to demystify financial instruments and taxation, and to show instead that they are not difficult concepts to understand.

1.5 DELIMITATIONS

Financial instruments in terms of their character, timing and international (location) effect are used for financial engineering or hedging purposes. An example of financial engineering is to transfer the interest income character of an investment to a dividend income character using a swap. The different permutations used to change the character, timing and location are not publicly announced. They are known as over-the-counter-transactions (hereafter referred to as "OCT"). The lack of data could make it difficult to research some of these aspects. The study will therefore not investigate the OCTs used for financial engineering purposes.

The study is limited to

- single stock futures; and
- single stock future options.

Single stock futures and single stock future options are futures and index options that specifically relate to listed equity shares.

These derivatives trade on recognised security exchanges (for example the South African Futures Exchange, hereafter referred to as "the SAFEX"), and will provide external data for the study (Corria *et al.*, 2000:687; van der Berg, 2007:124-125). The study will focus exclusively on the taxation effect on a resident company in South Africa and the United Kingdom respectively.

1.6 DEFINITION OF KEY TERMS

A financial instrument and a derivative are defined for accounting purposes in terms of the internationally recognised definitions as set out in the International Financial Reporting Standards ("IFRSs") and International Accounting Standards ("IASs") published by the International Accounting Standards Board ("IASB"). South Africa and the United Kingdom are members of the IASB; this means that both countries use the same definitions for accounting purposes.

A "derivative" is a contract between two parties. The contract's value changes in response to an underlying variable i.e. interest rates or share prices. It requires no initial investment or initial investment less than the amount required to invest in the actual share or bond. In addition, the contract is settled in the future. (IFRS, 2009:1998.)

An "equity instrument" gives the holder the right to the net asset value of an entity (IFRS, 2009:1563).

A "financial asset" can be cash or equity instruments. It also includes any right to receive a financial asset, as well as the right to exchange financial assets or liabilities that will result in a probable benefit (IFRS, 2009:1562).

A "financial instrument" is a contract between two parties. The result of the contract creates a financial asset for one party and a corresponding financial liability or equity instrument for the other party (IFRS, 2009:1562).

A "financial liability" is a contractual obligation to deliver a financial asset to another entity (IFRS, 2009:1562-1563).

A "single stock future" is a future contract in which the underlying asset is a listed equity share (van der Berg, 2007:123).

A "single stock future option" is a specific type of option, where the underlying instrument is a single stock future and is traded on the SAFEX (JSE Equity Options Brochure, n.d.:2).

A “warrant” is a specific type of option traded on a recognised exchange, where the underlying instruments are listed instruments (van der Berg, 2007:151).

1.7 ABBREVIATIONS USED IN THIS DOCUMENT

Abbreviation	Meaning
CGT	Capital gains tax
Eighth Schedule	The Eighth Schedule of the Income Tax Act No. 58 of 1962
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRSs	International Financial Reporting Standards
OCT	Over-the-counter-transactions
SARS	South African Revenue Services
SSF	Single stock future
SSFO	Single stock future contract
the Act	Income Tax Act No. 58 of 1962 as promulgated in the Republic of South Africa
DCL	The Derivative Contracts Legislation in terms of Part 7 of the Corporate Tax Act 2009 as promulgated in the United Kingdom
FA 2002	Finance Act 2002 as promulgated in the United Kingdom
SAFEX	South African Futures Exchange

1.8 RESEARCH DESIGN AND METHODS

The study seeks to describe and explain the taxation of futures and index options in South Africa and the United Kingdom. It also explores and allows interpretation of how the tax effect influences the value of these derivatives. The nature of the

research study is contextually bound to the South African and United Kingdom's tax legislation. The study will employ a holistic approach to illustrate the taxation of single stock futures and single stock future options by specifically narrowing the group or population of transactions to publicly traded instruments.

Data collection is not limited to the numeric, because in dealing with tax legislation, data in the form of case law forms an integral aspect of the study. The cases in the South African context are available in the LexisNexis tax library. The case law illustrates the application and interpretation of the provisions of the Act. This data is thus textual and informative. Case law will form a major part of the research and will be considered as primary data.

Inductive reasoning is the use of specific instances or occurrences to draw conclusions about entire classes of events (Leedy & Ormrod, 2005:32). In applying the provisions of the Act, supported by case law precedents, to the transaction data of futures and index options, these specific events will shed light on the taxation of single stock futures and single stock future options. In essence, the approach falls within the ambit of inductive reasoning as a method of research. Single stock futures and single stock options are henceforth referred to as "SSFs" and "SSFOs" respectively.

1.9 CHRONOLOGICAL STAGES OF THE STUDY

Chapter 2 sets out the market mechanics of futures and index options. The discussion of market mechanics clarifies what futures and index options are, particularly SSFs and SSFOs. The chapter also explains how profits and losses are made on SSFs and SSFOs when holding a long or a short position. Finally it considers whether SSFs and SSFOs are derivatives for accounting purposes.

Chapter 3 explores the key characteristics of hedges by explaining their purpose, referring to dictionary definitions, account definitions and comparative taxation support.

Chapter 4 determines how SSFs and SSFOs are taxed in South Africa, first in a scenario in which a company trades in these derivatives and secondly in a scenario in which a company uses the derivatives as hedges for its share portfolio.

Chapter 5 determines how SSFs and SSFOs are taxed in the United Kingdom using the same scenarios cited above.

Chapter 6 compares the results of Chapters 4 and 5 in respect of the tax treatment of SSFs and SSFOs in South Africa and the United Kingdom.

Chapter 7 determines in brief whether taxation of SSFs and SSFOs influences the value of these derivatives.

Chapter 8 draws a conclusion based on the results in order to answer the core research questions posed in Chapter 1.2.

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CHAPTER 2
MARKET MECHANICS OF FUTURES AND INDEX OPTIONS

2.1 INTRODUCTION

Chapter 1 indicated that South Africa and the United Kingdom use the same definitions for accounting purposes but not for tax purposes. In this chapter, the market mechanics of futures and index options are briefly explained. The chapter also explains why SSFs and SSFOs fall within the ambit of the accounting definition of a derivative.

2.2 MARKET MECHANICS OF FUTURES AND INDEX OPTIONS

The market mechanics of futures and index options are set out below.

2.2.1 Futures

Futures, as opposed to forward agreements, are standardised contracts traded on a recognised exchange (Lindsay, 2000:203). In other words, futures are standardised in terms of the type, quantity and quality of the underlying asset (e.g. rice or listed share). The terms in respect of the price, delivery or future settlement date and method of settlement are also standardised. (CIMA, 2002:216; van der Berg, 2007:124.) Futures are normally classified with reference to the underlying asset. For example, an agreement between two parties to buy and sell a specific amount and quality of corn at a specific price at a future date is called a commodity futures contract (van der Berg, 2007:123). This study focuses specifically on SSFs exchanged on the SAFEX.

The SAFEX regulates the futures market in South Africa. It also facilitates matching the different positions held by the market participants. Market participants (or traders) hold either long or short positions. A trader holding a long position is obliged to buy the underlying asset at a future date for the contracted price. A trader holding a short position is obliged to sell the underlying asset at a future date for the contracted price. Future contracts are normally settled in cash rather than in the

physical delivery of the underlying asset. Cash settlement effectively eliminates the lengthy and onerous process of delivering the physical asset along with any additional costs (e.g. administration costs). (CIMA, 2002:219; van der Berg, 2007:127-129.)

A trader holding a long position on an SSF makes a gain when the market value of an equity share is greater than the contracted price. The opposite applies when the market value of the equity share is less than the contracted price. A trader holding a short position on an SSF makes a gain when the market value of an equity share is less than the contracted price. The maximum gain or loss the holder can make is unlimited. (van der Berg, 2007:125-127.)

When entering into a futures contract, the parties are required to advance an initial security deposit (hereafter referred to as "the initial margin") with the SAFEX. The initial margin is a security measure that counters the risk in the eventuality of one of the parties being in a loss position and unable to pay (van der Berg, 2007:133). There is also the risk that the initial margin will not be enough in cases of adverse market movements in the market prices (van der Berg, 2007:133). To cover the risk of default, the parties are required to settle their accounts daily. This process is called mark-to-market. (Corria *et al.*, 2000:687; van der Berg, 2007:134.)

2.2.2 Index options

Options trade on recognised exchanges or OCT. An option contract gives the holder the right, but not the obligation, to buy or sell an underlying instrument at a pre-determined price during a specific period or at a specific time (CIMA, 2002:222; Corria *et al.*, 2000:681; van der Berg, 2007:148;). In exchange for this right, the holder pays a premium to the option writer. The SAFEX requires that the option holder and writer deposit an initial margin, which differs from the option premium in that the latter indicates the value of the option. The SAFEX mark-to-market the option and recalculate the initial margin on a daily basis and as a result there might be daily cash flows for the option holder as well as the option writer. (JSE Equity Options Brochure, n.d.:11-12.)

This study focuses on a specific type of warrant called an SSFO. A warrant is a type of option traded on a recognised exchange, where the underlying instruments are

listed intruments (van der Berg, 2007:151). The underlying instrument of an SSFO is an SSF. It is important to note that an option that may be exercised only on a specific date is referred to as a European-style option (Corria *et al*., 2000:682; van der Berg, 2007:149). In contrast, an American-style option can be exercised at any time before the expiry date of the option (van der Berg, 2007:149). An SSFO issued in South Africa can be exercised at any time before or on the expiry date and is therefore regarded as an American-style option (JSE Equity Options Brochure, n.d.:1). Warrants issued in the United Kingdom may be exercised only on a specific future date and are therefore regarded as European-style options.

There are two types of option, namely:

- call options; and
- put options (Corria *et al*., 2000:682; van der Berg, 2007:148).

A call option means that the holder has the right, but is not obliged, to purchase a certain quantity of the underlying financial instrument at a pre-determined price (CIMA, 2002:222; Corria *et al*., 2000:681; van der Berg, 2007:148). In a put option, the holder has the right, but is not obliged to sell the underlying financial instrument at a pre-determined price (van der Berg, 2007:149). The holder of a call or put option is referred to as holding a long position (van der Berg, 2007:152).

The holder of a call option normally exercises his right to buy an equity share when the market value is higher than the strike price (the price stipulated in the contract). In other words, the profit made is the saving of buying at a lower rate rather than at the market rate. The holder of a put option normally exercises his right to sell an equity share when the market value is lower than the strike price. In other words, the profit made is the fact that the underlying instrument would be sold at a rate higher than the market rate (Corria *et al*., 2000:681; van der Berg, 2007:152-155.) The maximum loss incurred by the holder of an option is limited to the premium paid, as opposed to the holder of a future.

2.3 THE NATURE OF AN SSF AND SSFO

Chapter 1 defines a financial instrument and derivative for accounting purposes. Financial instruments may be categorised in three groups: equity instruments, financial assets and financial liabilities. Further, the definition of a derivative indicates

that it is a financial instrument and may therefore be either a financial asset or a financial liability, depending on the circumstances. In other words, the change in value of a derivative may be favourable or unfavourable depending on the movement of the underlying variable, resulting in a financial asset in the case of a gain and a financial liability in the case of a loss.

The question is whether SSFs and SSFOs fall within the definition of a derivative for accounting purposes. The table below compares the characteristics of an SSF and an SSFO (as discussed in Chapter 2.2.1 and 2.2.2) with the accounting definition of a derivative.

Table 1 Comparison of the accounting definition of a derivative with the characteristics of a SSF and SSFO

Accounting definition of a derivative	SSF	SSFO
It is a contract between two parties;	A single stock future is a contract between two parties;	A SSFO is a contract between two parties;
Its value changes in response to the underlying variable (market factors). The underlying variable is, for example, a specific interest rate or share price;	The value of a single stock future changes when the price of the underlying equity share changes;	The value of an SSFO changes when the price of the SSF changes;
It requires no initial net investment or initial net investment that is less than required to invest in the actual share or bond; and	The SAFEX requires a small security deposit as an initial margin; and	The SAFEX requires a small security deposit as an initial margin; and
Settlement is set at a future date.	The settlement date for the future is set in the future.	The exercise date of the SSFO is set in the future.

It is clear from the comparison in the above table that SSFs and SSFOs meet the requirements of the accounting definition of a derivative.

2.4 SUMMARY

From the above, it is understood that the main difference between futures and index options is that the latter gives the holder the option of abandoning the agreement. This means that losses on futures are unlimited in comparison with index options. SSFs and SSFOs are futures and index options that relate specifically to listed equity shares and are the focal point of this study. A SSF is settled at a future date and mark-to-market on a daily basis by the SAFEX. SSFOs are also mark-to-market on a daily basis. Both fall within the accounting definition of a derivative and are therefore considered financial instruments for accounting purposes.

In Chapter 3, the key characteristics of a hedge are explored, which, together with the principles set out in Chapter 2, must be kept in mind when determining how these two derivatives are to be taxed.

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CHAPTER 3
KEY CHARACTERISTICS OF A HEDGE

3.1 INTRODUCTION

The objective of this chapter is to explain the purpose of a hedge and to identify its key characteristics. The Act does not define a hedge. The Act also does not include specific legislation applying to hedging transactions. Why, then, are hedging transactions important for tax purposes? Although the Act is silent on this point, it does not mean that a hedging transaction has the same tax consequences as a normal commercial transaction. It is therefore important to understand what a hedging transaction entails and to explore the related tax implications. In order to understand a hedging transaction it is crucial to keep in mind the principles concerning the market mechanics of SSF and SSFO transactions, as explained in Chapter 2.

3.2 THE PURPOSE OF A HEDGE

The purpose of hedge can be effectively illustrated with an example:

On 1 December 20X1, Company B is expecting a decline in the mining share price and holds several such mining shares in its share portfolio. The value of the mining shares on 1 December 20X1 is R90 000. How would Company B try to mitigate or eliminate the probable decline in the value of the share portfolio? The options available to Company B are set out below.

Company B may opt to sell the mining shares at the current market price, which means in effect that they will not be affected by any future decline in the mining share price. However, the down-side is that Company B would not have the benefit of any future increase if the market took a favourable turn. Furthermore, the mining shares may not be available for repurchase in the future.

Company B could opt to enter the futures market and take up a short position by acquiring five mining futures that would mature in three months' time. In Chapter

2.2.1, it was explained that a trader holding a short position on an SSF makes a gain when the market value of an equity share is less than the contracted price. Company B pays an initial margin of R30 000 for the SSFs to SAFEX. On 31 December 20X1, the index points amount to 5 500 points per future contract. Each point represents a value of R10. On 31 January 20X2, Company B decides to sell all the SSFs. On that date, the index points amount to 6 000 points per future contract. The profit made on the sale amounts to R25 000 (R10/point X 5 contracts X (6 000-5 500) points).

On 31 December 20X1, the value of the mining shares was R70 000. This means that if Company B had sold the shares on 1 December 20X1 it would have made R20 000 more than if it had sold the shares on 31 December 20X1. However, because Company B entered into the future contract and sold it on 31January 20X2, it made a profit of R25 000, which absorbed the unrealised loss of R20 000. Company B therefore entered into the mining future contracts in order to hedge itself against the risk of a decline in the mining share price. (Pretorius, Venter, Von Well & Wingard, 2009:466.)

3.3 IDENTIFYING THE KEY CHARACTERISTICS OF HEDGES

When constructing a definition of a hedge, a balance between specific and general requirements must be struck. Specific requirements may lead to a definition that is not entirely or sufficiently embracing of the characteristics pertaining to a hedge. However, if the definition is too general, it could be ambiguous (Rudnicki, 2003:52). A useful definition to identify whether a transaction is a hedge for tax purposes could be arrived at by comparing different sources that define or highlight the key characteristics of a hedge.

The question arises whether the definition of a hedge is to be subjective or objective. The analogies made when determining whether an amount is revenue or capital in nature in a gross income context illustrates the subjective and objective elements under consideration when defining a concept. The objective factors support the intention of the taxpayer, who is the subjective factor. (Rudnicki, 2003:53.) The possibility therefore exists that the definition of a hedge includes both subjective and objective elements from the taxation perspective.

3.3.1 Dictionary definition of a hedge

The key characteristic of a hedge is a position designated to offset or mitigate the risk of financial exposures or the effect of undesirable movements (Oxford Reference Online, 1997, 1999, 2008, 2009a). Another key characteristic relates to the effectiveness of a hedge to mitigate the financial risk exposure. Hedges that eliminate the risk exposures are referred to as perfect hedges. Hedges that only partially eliminate risk exposures are referred to as imperfect hedges. (Oxford Reference Online, 1997.)

The term “designated” cited above indicates that a decision or an intention was expressed to enter into the hedge to mitigate the risk of financial exposures. This would indicate that a subjective element was contained in the hedging definition. (Rudnicki, 2003:57.)

The effectiveness of a hedge is measured by determining the strength of the inverse correlation of the change in value of the derivative and the underlying asset or liability. The inverse correlation is best illustrated with an example. A taxpayer’s foreign debt, payable in US Dollars, becomes payable in the next two months and it is expected that the Rand will weaken against the US Dollar in the future. The taxpayer enters into a foreign currency future to purchase US Dollars to hedge itself against the weakening Rand. The movement in the Rand/US Dollar spot rate and the value of the future have a high inverse correlation.

However, if, for example, the taxpayer were to enter into a weather future, the value of the weather future and the Rand/US Dollar exchange would have a low inverse correlation because the underlying risk covered by the weather future would have nothing to do with the exchange rates. The analysis shows that the effectiveness of a hedge is measurable, indicating that an objective element is contained in the hedging definition. (Rudnicki, 2003:56.)

3.3.2 Definition of a hedge form an accounting perspective

IFRS explains the concept of a hedge but, as already stated, the Act in the South African context does not. However, other countries often draft their tax legislation with reference to accounting practices. (Rudnicki, 2003:58.) The fact that the

derivative contracts legislation in the United Kingdom bases the taxation of certain qualifying financial transactions on the accounting treatment supports this statement (Lindsay, 2000:207). An analysis of the concept of a hedge for accounting purposes facilitates a comparison between the key characteristics contained in the concept and the characteristics of the dictionary definition. Based on the international trend of maintaining a parallel between tax and accounting, it is important to focus on the accounting concept of a hedge and the requirements for a transaction to qualify for hedge accounting (Rudnicki, 2003:58).

The example used in Chapter 3.2 is useful in explaining the concept of a hedge for accounting purposes. The mining shares are the hedged items because they are assets in Company B's hands, and are exposed to the risk of changes in the market price, i.e. the expected future decline in the mining share price. The mining shares are designated as the items being hedged.

It is important to note that hedged items could also be liabilities, firm commitments or highly probable forecast transactions. The difference between a firm commitment and a forecast transaction is that the latter is uncommitted but anticipated. A firm commitment is an agreement that is binding for the exchange of a specific quantity of resources and price at a specified future date. (IFRS, 2009:2001.)

The risk of changes in market prices or interest rates is categorised as a risk of changes in fair value or future cash flows, depending on the circumstances. A risk of changes to future cash flows means there is a risk that an entity will pay more cash or receive less cash in the future owing to changes in interest rates. This means in effect that the risk in changes in fair value relates to the changes in the value of an item that does not lead to cash in or out flows. (IFRS, 2009:2021.)

The five mining futures entered into by Company B are the hedging instruments, because they are derivatives and are designated as a hedge. It is expected that the change in fair value or cash flow, meaning that the value of R25 000 will offset the changes in the fair value or cash flows of the designated hedging items, i.e. the R20 000 decline in the value of the mining shares. (IFRS, 2009:2001.)

The profit of R25 000 related to the five mining futures exceeds the decline in value of the R20 000 related to the mining shares. The hedge effectiveness is measured

by the degree to which the change in value of the hedging instruments offsets the change in value of the hedged item (IFRS, 2009:2001). This indicates that the effectiveness of the hedge was high, because the correlation coefficient was close to -1.

The correlation coefficient indicates the strength of the linear relationship between two variables x and y, x being the value of the mining shares and y the value of the mining futures. A correlation coefficient is a value between -1 and 1. If the correlation coefficient is close to -1, this indicates a strong inverse relationship between x and y. (du Toit, Smit, Steyn & Strasheim, 1998:177.)

Based on the above, a hedge for accounting purposes contains the following elements:

- a designated hedged item and hedging instrument; and
- a high degree of hedge effectiveness.

According to the above analysis of a hedge for accounting purposes, reference to the term “designated” indicates that there is a degree of subjectivity contained in the hedging definition. This degree of subjectivity is also present in the analysis of the dictionary definition in Chapter 3.3.1. The above analysis of the measurement of the effectiveness of a hedge indicates a degree of objectivity, which is also present in the analysis of the dictionary definition in Chapter 3.3.1.

The analogy suggests that, although a person may have the intention of designating a derivative as a hedge, it does not mean that it is a hedge, unless a high degree of hedging effectiveness exists. The analogy does not indicate that the hedge should be a perfect hedge, only that a high degree of hedge effectiveness should be present.

3.3.3 Hedge accounting

IAS 39 paragraph 88 (IFRS, 2009:2022) states that hedge accounting applies only if all of the following requirements are met:

- at commencement of the hedge there is a formal designation and documentation of the hedging relationship, the entity’s risk management objectives, and the strategy relating to the hedge;

- it is expected that the hedge will be highly effective, which should be consistent with the documented risk management strategy;
- the hedge effectiveness can be reliably measured;
- the hedge is assessed on a continuous basis in order to determine whether it will remain highly effective throughout the financial reporting period; and
- in respect of cash flow hedges, the forecast transaction must be highly probable and exposed to variations in cash flows that ultimately affect profit or loss.

Documentation of the hedging relationship includes describing the hedging instrument, the hedge item, the nature of the risk hedged and how the hedge effectiveness will be measured. A hedge is regarded as highly effective if it has a high inverted correlation and the actual results are within a range of 80% to 125% (IFRS, 2009:2071).

The example used in Chapter 3.2 is useful for illustrating the calculation of the 80% to 125% requirement. The division of the profit of R25 000 from the disposal of the mining futures with the unrealised loss of R20 000 from the mining shares equals 125%, and the inverse of the calculation equals 80%, which means that the hedge is highly effective.

The courts have determined that a taxpayer's *ipse dixit* as far as his intentions are concerned should be supported by the objective factors surrounding the case (*ITC 1185,* (1972) (35 SATC 122 at 123–4)). In the case of a company, reference to the formal acts passed in resolutions constitutes evidence as to the company's intention (*CIR v Richmond Estates (Pty) Ltd,* 1956 (1) SA 602 (A) (20 SATC 361)). The five requirements for hedge accounting indicate the company's intention with respect to the hedging transaction. Further, the measurement of the hedge effectiveness at commencement and throughout the life-cycle determines whether the intended hedge of the risk will be, is and was obtained. The achievement of the intended objective is measurable. If the hedge is highly ineffective, it means that the transaction is speculative in nature rather than being an intention to hedge.

Comparing the above analysis with the analogy of the accounting and dictionary definition of a hedge, it is clear that, for accounting purposes, the hedge effectiveness has to fall within a specified range in order for a hedge to qualify for

hedge accounting. The strict requirements may lead to incompleteness as well as ambiguity in a legal interpretational environment for tax purposes. (Rudnicki, 2003:62.)

However, the restrictiveness may shed light on the actual intention of a taxpayer when entering into a hedging transaction. The 80% to 125% requirement means that the measurement of the hedge effectiveness is the same for all taxpayers. This means that all profits and losses made on the hedging instrument that fall within the required range relate to the hedging relationship, while the excess does not. From the perspective of tax, the intent of a hedging provision is to bring about a tax-neutral effect as far as commercial transactions and related hedging transactions are concerned (HMRC, 2009).

3.3.4 Comparative taxation support

Rudnicki (2003:66) indicated that (at the time of writing) the United Kingdom did not seek to define a hedge for tax purposes. He also maintained (2003:66) that the United States required a hedging transaction to have a risk reduction motive and to be designated as a hedge. However, the concept of correlation was not required. Although this study focuses exclusively on South Africa and the United Kingdom taxation, Rudnicki's statement supports the analysis of the dictionary meaning and accounting definition of a derivative in respect of the risk reduction motive and designation requirement.

The United Kingdom has since promulgated the derivative contracts legislation that defines the term "hedging relationship". The Finance Act 2002 (hereafter referred to as "the FA 2002") introduced the derivative contracts legislation, which set out the provisions for taxing derivatives. Part 7 of the Corporate Tax Act 2009 is the latest version of the derivative contracts legislation (hereafter referred to as "the DCL").

In terms of section 707 of the DCL, a hedging instrument and hedged item must be designated by the company as a hedge, if a hedging relationship is to be brought into operation. The hedging instrument is intended to act as a hedge for the exposure to changes in the fair value of the hedged item, which is attributable to a particular risk and could affect the profit or loss of the company. Moreover, the hedged item must be an asset or liability recognised for accounting purposes or must

be an identifiable part of it. The requirement of measuring the hedge effectiveness is absent from the definition of a hedging relationship in terms of section 707 of the DCL.

The above analysis does not differ from the analogies above except for the strict requirements for the measurement of the hedge effectiveness.

3.3.5 Salient characteristics

The above analogies highlight the key characteristics of a hedge. These characteristics include the subjective and objective attributes required to develop a definition for tax purposes. The key characteristics that emerge from the above discussion are summarised here:

- the presence of risk reduction motive;
- a designation of an hedging instrument and hedged item at inception, indicating the intent to enter into a hedge;
- a high degree of inverted correlation between the hedging instrument and hedged item that supports the intention as an objective factor.

Rudnicki (2003:69) proposed the following hedge definition for tax purposes:

“A financial asset or liability, that is designated as a hedging instrument, whose value desirously changes inversely in relation to the hedged item (being an asset, liability, firm commitment or forecast future transaction), or part thereof in order to limit the taxpayer’s economic exposure, which hedged item is identified by the taxpayer as being the subject of the hedging instrument.”

The phrase “...desirously changes inversely...” in the above definition is subject to different interpretations because what may be a desirous correlation for one taxpayer may be entirely different for another. It is therefore prudent to investigate what would constitute a “desirous correlation” in order for the definition to be impartial for all taxpayers. In other words to what extent should the correlation coefficient be near -1 in order for a transaction to be a hedge from an objective point of view. The proposed definition currently places the onus of proof on the taxpayer in proving that the intent and result is a hedging transaction.

3.4 SUMMARY

The purpose of a hedge is to reduce a certain economic risk related to an underlying item, the hedged item. To achieve a probable reduction of a certain economic risk, derivatives such as SSFs and SSFOs are used. The Act does not define a hedge in the South African tax context, but the DCL does define a hedging relationship in the United Kingdom tax context. The above analogies make it possible to identify a hedge based on the characteristics highlighted, namely risk reduction, designation and correlation. It is important to keep these principles in mind when determining how the two derivates are taxed, which will be considered in the next chapter.

In Chapter 4 the treatment of amounts received or that have accrued to a taxpayer relating to transactions in SSFs and SSFOs in the South African context is determined for tax purposes.

A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

CHAPTER 4
TAXATION OF SSF AND SSFO TRANSACTIONS IN SOUTH AFRICA: RECEIPTS/ACCRUALS

4.1 INTRODUCTION

This chapter focuses on the treatment of receipts or accruals in respect of SSFs and SSFOs in terms of the Act, keeping in mind the principles set out in Chapters 2 and 3. Taxation of derivatives may differ depending on the taxpayer's intention. The chapter therefore focuses on two possible intentions, namely the intention to

- trade in SSFs and SSFOs; and
- use SSFs or SSFOs for hedging purposes.

4.2 EXAMPLE OF AN SSF AND AN SSFO TRANSACTION

The analysis in the chapter is based on actual SSF and SSFO transaction data. The data relates to an SSF in respect of 100 equity shares of the MTN Group Ltd and an SSFO in respect of the MTN SSF.

The transactions of Company XYZ and Company ABC will illustrate the treatment of receipts or accruals for tax purposes related to the two intentions (refer to Chapter 4.1). For the purposes of this chapter, Company XYZ and Company ABC are residents as defined in terms of section 1. Both companies may borrow funds at an annual rate of 11%. Moreover, no dividend payment is expected for the 3-month period ending 30 June 2009.

Company XYZ purchases or enters into index future and warrant contacts to sell or hold until maturity in order to make a profit.

Company ABC, on the other hand, is not a dealer in index futures and warrants. It holds 100 equity shares in MTN Group Ltd for long-term investment purposes. The company acquired the shares five years earlier. Company ABC expects a major future decline in the market price of the MTN equity share and wishes to hedge itself against the risk by entering into a short SSF or put SSFO. The decision to enter into

the hedge is consistent with the company's risk management policy. However, the directors of the company have to approve the hedge.

The analysis in this chapter is based on the tax effect in the case where each company

- sells the derivatives on 29 May 2009 for a consideration equal to their market value; and
- holds the derivatives until maturity or settlement date.

The last point must be interpreted to mean that the companies exercise the SSFO if it is in-the-money. The term "in-the-money" means that the strike price is

- lower than the market value of an SSF in the case of a call option; and
- higher than the market value of an SSF in the case of a put option.

The market price of an MTN equity share on

- 1 April 2009 equals R109,20/share;
- 29 May 2009 equals R115,35/share; and
- 18 June 2009 equals R117,51/share (refer to column B of Table 2).

In Chapter 2.2.1 it was stated that SAFEX mark-to-market on a daily basis. The data reflected in Table 2 and Table 3 (refer to Annexure A) does not contain all the business days because it is considered superfluous for the purposes of this study. However, there is no implication that the SAFEX does not mark-to-market on a daily basis.

Any reference to a section in the paragraphs that follow means a section of the Act.

4.2.1 MTN SSF contract information

The information is extracted from Table 2.

Inception date	01 April 2009
Maturity date/Settlement date	18 June 2009
Contract size	100 MTN equity shares
Contract price	R109.20
Nominal value (Contract size X Contract price)	R10 920

Initial margin	R1 920
Settlement method	Cash settled
Position taken up	Short

It is important to note that the initial margin is the amount paid in respect of the MTN SSF on the inception date and is considered a deposit (refer to column E of Table 2 and Chapter 2.2.1). Further, Column F of Table 2 reflects the daily profits and losses (JSE, 2009a & 2009b.)

4.2.2 Fair value of an SSF

The fair value of the MTN SSF is calculated using the following formula:

$$FVF = C + (C \times (r/100 \times t/365)) - (D/(1+r/100) \times (v-p)/365)$$

Where,

- FVF is the fair value of the SSF;
- C is the current market price of the share;
- r is the annual borrowing rate;
- D is the dividend likely to be received during the life of the SSF;
- v is dividend payment date; and
- p is the future settlement date. (JSE, 2009d.)

The calculation of the fair value of a SSF may differ among individuals or organisations because of a difference in their annual borrowing rate based on their risk portfolio. However, for purposes of this study, the companies' borrowing rates are the same.

The fair value of the MTN SSF on 29 May 2009 calculated in terms of the above formula equals R116,05 (R115.35/share + (R115.35/share x 11% x 20days/365days)). The fair value of the MTN SSF on 18 June 2009 equals the market price of the MTN equity share (refer to Chapter 4.2), because there is no finance cost.

4.2.3 SSFO contract information

The information is extracted from Table 3.

Inception date	01 April 2009
Maturity date	18 June 2009
Option style	American style
Option type	Put option
Premium	R241
Contract size	1 SSF contract
Strike price	R89.10
Initial margin	R110
Settlement method	Cash or physical delivery

The buyer of the SSFO does not pay the premium in full and the seller does not receive the full premium at the inception of the contact. The premium is paid to the seller over the period of the option by means of the daily mark-to-market process (JSE, 2009e.)

4.3 THE LAW AND APPLICATION

4.3.1 When is an amount subject to tax?

In terms of section 5(1), income tax is levied on, *inter alia,* the "taxable income" of any person. In terms of section 1, the term "taxable income" is defined as the amount of "income" remaining after certain deductions. "Income" as defined in terms of section 1 means the amount of "gross income" remaining after accounting for exemptions allowed in terms of the Act. The meaning of "gross income" as defined in terms of section 1 is central to the Act, and any amounts that fall outside of this definition would usually not be subject to normal tax (Jordaan, Koekemoer, Stiglingh, van Schalkwyk, Wasserman & Wilcocks, 2008:11).

However, the amounts that fall outside of the gross income definition may be subject to the provisions set out in terms of section 26A. In terms of section 26A, the taxable capital gain as determined in terms of the Eighth Schedule of the Act (hereafter

referred to as "the Eighth Schedule") must be included in the taxpayer's taxable income.

4.3.2 When do the provisions of the Eighth Schedule apply?

In terms of paragraph 2 of the Eighth Schedule, the provisions of the Eighth Schedule apply to, *inter alia,* any asset disposed of, on or after 1 October 2001 by a resident. The requirements of the gross income definition and the relevant provisions of the Eighth Schedule are set out in the paragraphs below.

4.4 THE "GROSS INCOME" DEFINITION

"Gross income" as defined in terms of section 1 is the total amount, in cash or otherwise, received by, or accrued to, or in favour of any resident in relation to any year of assessment, excluding receipts or accruals of a capital nature.

The Act does not define all the terms used in the above definition (Jordaan et al*.,* 2008:12). The plain meaning of the words used in the Act should be adopted when interpreting the Act. In other words, the words should be interpreted in the ordinary, natural sense in which they are used in the grammatical context that indicates the intention of the legislature. However, this rule does not apply if the strictly literal meaning of the text is ambiguous, unclear or absurd, and, in consideration of the enactment as a whole, a court of law is satisfied that it is not what the Legislature intended. (*R Koster & Son (Pty) Ltd & another v CIR,* 1985 (2) SA 831 (A) (47 SATC 23).)

If the literal meaning is absurd, but the object and the intention of the statute are clear, then the statute must not be reduced to a nullity merely because the language used is somewhat obscure (*Glen Anil Development Corporation Ltd v SIR,* 1975 (4) SA 715 (A) (37 SATC 319)). If the meaning of the undefined terms is to be understood, references to the relevant case law are required.

The meanings of the terms used in the gross income definition are set out below. The meaning of the term "capital nature" will be discussed separately under a main heading on account of its complexity.

4.4.1 Total amount in cash or otherwise

The amount is the quantifiable or ascertainable value of the consideration. The emphasis is on the words quantifiable or ascertainable. If this is not possible then no amount exists. (*CIR v Butcher Bros (Pty) Ltd,* 1945 AD 301 (13 SATC 21).) The Act levies tax on a monetary amount so if no amount exists then no tax can be levied (*CIR v Delfos,* 1933 AD 242 (6 SATC 92)).

When Company XYZ and Company ABC sell the MTN SSF on 29 May 2009, the amount in respect of the sale equals R3 004, 05. The amount is calculated by adding the sum of the profits for the period ending 29 May 2009, which equals R2 888 (refer to column F of Table 2) and the consideration received of R116, 05 (refer to Chapter 4.2.2). The analysis indicates that the amount of the consideration is quantifiable. It is important to note that the allowance for a deduction of the losses for normal income tax purposes must be considered in terms of section 11(a).

When Company XYZ and Company ABC sell the SSFO in respect of the MTN SSF on 29 May 2009, the amount equals R277. The amount is calculated by adding the sum of the profits received for the period ending 29 May 2009, which equals R272 and the consideration received of R5 (refer to column E and K of Table 3). The analysis indicates that the amount of the consideration is quantifiable. It is important to note that the allowance for a deduction of the losses for normal income tax purposes must be considered in terms of section 11(a).

In the case of Company XYZ and Company ABC holding the MTN SSF until it matures, the amount equals R3 454. The amount is calculated by adding the profits received for the period ending 18 June 2009 (refer to column F of Table 2). The analysis indicates that the amount of the consideration is quantifiable.

Company XYZ and Company ABC will not exercise the SSFO on 18 June 2009 because it is not in-the-money. The SSF price on this date is R117, 51, which is higher than the strike price of R89, 10.

The term “in cash or otherwise” refers to circumstances in which it is not cash that is received but an asset, that is, any form of property, corporeal or incorporeal, which has a monetary value. The value of consideration other than in cash is generally the

open market value on the date of acquisition of the asset. (*Lace Proprietary Mines Ltd v CIR,* 1938 AD 267 (9 SATC 349).) The requirement of a monetary value does not mean that an asset or right has no value if it cannot be turn into cash *(SARS v Brummeria Renaissance (Pty) Ltd, Palms Renaissance (Pty) Ltd & Randpoort Renaissance (Pty) Ltd,* 2007 *SCA 99 (RSA*) (69 SATC 205)). In other words, a restriction in respect of the sale of a right or asset does not mean that the right or asset has no monetary value. If the settlement of a derivative is physical delivery then the market value of the underlying item is considered to be the amount.

4.4.2 Received by or accrued to

The use of the word "or" in the phrase "received by or accrued to" means that the definition of gross income applies to both receipts and accruals (de Swardt, Jordaan, Koekemoer, Stiglingh, van Schalkwyk & Wilcocks, 2009:16). However, this implies that, if no amount is received or accrued, then the gross income definition does not apply (*SARS v Cape Consumers (Pty) Ltd,* 1999 (4) SA 1213 (C) (61 SATC 91)). Amounts are therefore taxed on the earlier of accruals or receipts in any year of assessment. However, if an amount is accrued in the previous year of assessment, then the subsequent receipt in relation to that accrual in the following year of assessment will not be subject to tax. (*SIR v Silverglen Investments (Pty) Ltd,* 1969 (1) SA 365 (A) (30 SATC 199).)

The phrase "received by" does not on its own reflect the true meaning if it is compared with the phrase "received by or in favour of", in which the latter refers to proceeds received by the taxpayer on his own behalf and for his own benefit (*Geldenhuys v CIR,* 1947 (3) SA 256 (C) (14 SATC 419)). In other words, if an estate manager receives property rent on behalf of his client, then the proceeds were not received by or in favour of that estate manager because he did not receive the rent for his own benefit.

Each company receives cash in their margin account owing to the mark-to-market mechanism at the end of the previous day that resulted in profits. The cash received is for the company's own behalf and benefit, which may be drawn from or kept in the margin account. However, the SAFEX requires that the cash in the margin account may not be less than the initial margin at any given time and that the company must

immediately settle any deficit. (JSE, 2009b & 2009e.) Column E (refer to Table 2) illustrates the movements in the margin account due to cash receipts and payments.

The phrase "accrued to" means "entitled to" (*Lategan v CIR,* 1926 CPD 203 (2 SATC 16)). Proceeds from a transaction accrue on the date the taxpayer becomes entitled to claim payment in the future and not the date the payment or instalments become due and payable (*CIR v People's Stores (Walvis Bay) (Pty) Ltd,* 1990 (2) SA 353 (A) (52 SATC 9)). However, if the future payment in respect of a transaction is dependent on a condition, then the taxpayer becomes entitled to claim the future payment on the date of fulfilment of that condition. In other words, the phrase "accrued to" means "unconditionally entitled to". (*Mooi v SIR,* 1972 (1) SA 675 (A) (34 SATC 1); *Ochberg v CIR,* 1933 CPD 256 (6 SATC 1).) If an agreement provides that the buyer is entitled to a discount if it pays its account before the 25th of the month that follows after the date of invoice, then the amount that accrues is equal to the gross sale amount less the discount. The discount accrues only if the buyer does not make use of the early settlement incentive. (*Gud Holdings (Pty) Ltd v SARS,* [2008] 2 All SA 442 (N) (2007) (69 SATC 115).)

The mark-to-market mechanism determines the profit or loss at the end of each day. In the case of a profit, the companies are entitled to receive cash without any conditions attached. This means that, if the company makes a profit on the SSF on a day i.e. 3 April 2009 (refer to column D of Table 2) of R470, the company is unconditionally entitled to claim payment in the future and therefore the amount of R470 has accrued to the company on that day. The same applies to the put SSFO.

The question is whether the accrual of a profit occurs before receipt of the cash. Based on the analysis above, the accrual happens before receipt of the cash.

4.4.3 Resident

It is important to note that a person who is a "resident", as defined in terms of section 1 of the Act, is taxed on his worldwide receipts or accruals and a non-resident is taxed only on receipts or accruals from or deemed to be from a source within South Africa (Jordaan *et al*., 2008:11). This study is limited to the taxation of a resident company of South Africa as stated in Chapter 1.5. Both companies are residents as defined in terms of section 1.

4.5 EXCLUDING RECEIPTS OR ACCRUALS OF A CAPITAL NATURE

Rudnicki (2003:73) asked "[if] … it [could] be said that the existence of a hedge changes the implied revenue characterisation of a derivative to capital?"

In terms of section 82 of the Act, the burden of proof rests with the taxpayer to prove on a balance of probabilities that an accrual or receipt is of a capital nature (*Bloch v SIR,* 1980 (2) SA 401 (C) (42 SATC 7 at 14); *CIR v Middelman, 1991 (1) SA 200 (C)* (52 SATC 323 at 325)). There is no single test set out by the court of law to distinguish between "capital" and "revenue" (de Swardt *et al.,* 2009:26). The question of whether an accrual or a receipt is of a capital nature is one of law, and is decided bearing in mind the facts and circumstances of each case (*SIR v The Trust Bank of Africa Ltd,* 1975 (3) SA 652 (A) (37 SATC 87 at 108)). The court will also consider the guidelines laid down in earlier decisions (*Elandsheuwel Farming (Edms) Bpk v SBI,* 1978 (1) SA 101 (A) (39 SATC 163 at 174)).

Where a derivative is used as a hedge to mitigate a financial risk in respect of an underlying transaction, the profits resulting from the hedging instrument assume the same character as those of the underlying transaction (*ITC 1498,* (1989) (E) (53 SATC 260)). An important consideration in respect of this is the intention of the taxpayer regarding the purpose of the transaction.

The fact that the hedge must relate to a transaction where the underlying results in an amount received or accrued, or expenditure actually incurred, indicates that there should exist a realisation of a profit or loss (expenditure). In other words, an actual transaction in respect of the underlying must occur before the application of the above principle.

If there is no transaction in respect of the underlying, does it mean that the realised profit or loss relating to the hedging instrument may not assume the tax characterisation of the underlying? In the case of Company ABC, there is no transaction in respect of the MTN shares held. If, for example, a decline in the value of the MTN shares occurred it would be unrealised, which means there is no actual transaction in the underlying. Although the value of the MTN shares increased in the example, the increase remains unrealised.

An answer to this uncertainty may be found in what is considered practice in this regard. The practice in South Africa when determining the nature of a hedge is to focus on the nature of the hedged item and tax the hedging instrument in the same way that the hedged item would be taxed (Rudnicki, 2003:74).

However, the South African Revenue Services (hereafter referred to as "SARS") is of the opinion that the sale of future contracts is likely to be on revenue account, even if it is used as a hedge against losses on underlying shares held as capital assets (*SARS Comprehensive Guide to Capital Gains,* Issue 2, 2009:19). SARS' opinion is derived from the fact that where the taxpayer cannot prove beyond a balance of probabilities as envisaged in terms of section 82 that an amount is capital in nature, then it is held to be on revenue account (*ITC 1756,* (1997) (C) (65 SATC 375)).

The court did not decide on the matter of whether the transaction is capital in nature or not; it stated only that, on the merits of the case, the taxpayer did not discharge its onus of proving that the future was capital in nature beyond a balance of probabilities. Also to be borne in mind is the *obiter dicta*, an instance where the court makes an observation or expresses an opinion upon some issue that is not necessary to and does not affect the reason for the decision. An *obiter dicta,* even if it originated in the Supreme Court of Appeal, will not be binding on any court, although it may have much persuasive authority in the future on another court. (de Swardt et al., 2009:9.)

These principles in respect of the example of Company ABC are applied together with the guidelines laid down in earlier decisions in the paragraphs below.

4.5.1 Intention and objective factors

The employment of capital produces revenue, which is analogous to a tree that produces fruit. However, the tree in one man's hands may be the fruit in another's. For example, a person renting out machinery receives rental income. The rental income is the fruit and the machinery is the tree. This is in contrast with a person who sells machinery, in which case the proceeds of the sale constitute the fruit, indicating taxpayers' different intentions. (*CIR v Visser,* 1937 TPD 77 (8 SATC 271 at 276).)

A distinction between intention and contemplation is important because intention signifies direction of the mind to an object or result (*ITC 1638,* (1995) (60 SATC 423 at 428)). The court will consider the taxpayer's *ipse dixit* as to his intention and purpose, but will also consider the facts and circumstances surrounding the case in order to determine whether it supports the taxpayer's *ipse dixit* as to its true intention. These objective factors are, for example, the course of conduct of the taxpayer in respect of the transaction, the taxpayer's business and the frequency of similar transactions. This is not an exhaustive list of objective factors. (*ITC 1185, (1972)* (35 SATC 122 at 123–4).)

Company XYZ's intention as per its *ipse dixit* is to enter into the MTN SSF or MTN SSFO in order to resell or hold it until maturity in order to make a profit. The objective factors indicate that the company is a dealer in derivatives and frequently enters into such contracts in order to make a profit (refer to Chapter 4.2). The tests show positively that the derivatives are revenue in nature.

Company ABC's intention as per its *ipse dixit* is to enter into the MTN SSF or MTN SSFO in order to mitigate the risk of an expected future decline in the value of the 100 MTN equity shares that they hold. The objective factors indicate that the company is not a dealer in derivatives and does not enter into such contracts frequently. It is the company's decision to enter into the hedge, which is consistent with its risk management policy (refer to Chapter 4.2).

Moreover, the intention at the date of acquisition of the MTN shares by Company ABC was to hold them as a long-term investment. The MTN shares are held for a period of five years. This indicates that the MTN shares are capital in nature in the hands of Company ABC. Based on the practice in South Africa (refer to Chapter 4.5) the hedging instruments are treated the same way for tax purposes as the hedged item. (Rudnicki, 2003:74.)

In respect of the hedging instruments held by Company ABC, the test results are in favour of the hedging instruments being capital in nature. However, because the SSF and SSFO are held for a short period, this indicates a revenue nature. The objective factors indicating capital nature outweigh the factors indicating revenue nature.

A taxpayer may have changed his intention since the date on which he acquired the asset, which may affect the distinction between the revenue and capital nature of the receipt or accrual. The taxpayer's intention must therefore be investigated at the time he acquired the asset, during the period that he held the asset and at the time of disposal, in order to determine whether there was any change of intention (*Lace Proprietary Mines Ltd v CIR*, 1938 AD 267 (9 SATC 349)). However, the fact that a taxpayer decides to sell capital assets at a profit cannot *per se* make the resulting receipt or accrual subject to normal tax in terms of the gross income definition (*CIR v Richmond Estates (Pty) Ltd,* 1956 (1) SA 602 (A) (20 SATC 355))**.** Something more than the disposal of a capital asset is therefore required to indicate a change of intention.

The "something more" includes considering the taxpayer's planning, extent, duration, nature, degree, organisation and marketing operations in relation to his enterprise. It also includes how these activities correspond with the operations related to the normal commercial concept of carrying on a trade or embarking on a scheme of profit-making. That "something more" is considered as "crossing the Rubicon" (*Natal Estates Ltd v SIR,* 1975 (4) SA 177 (A) (37 SATC 193)). The term "crossing the Rubicon" is an idiom describing a course of action with a consequence that is impossible to retract or revoke (de Swardt *et al*., 2009:30).

The discussion that follows relates to the scenario in which Company ABC sells the SSF or SSFO (refer to Chapter 4.2). The sale of the MTN SSF or SSFO does not *per se* mean that Company ABC has changed its intention in respect of the hedging transaction. Company ABC may argue that it expected a major decline in the value of the 100 MTN equity shares held, but the price movements from 1 April 2009 to 29 May 2009 reflected an increase. The conclusion drawn on 29 May 2009 is that it was highly unlikely that there would be a major decline in the share price in such a short period i.e. 29 May 2009 to 18 June 2009, making the position held in respect of the hedging instrument unnecessary. Company ABC therefore decided to sell the MTN SSF or SSFO.

The analysis of Company ABC's *ipse dixit* and objective factors such as the fact that the MTN share price did not decrease but increased over time, making the hedge unnecessary, indicates that Company ABC had not changed its intention since

entering into the hedging transaction nor did it change at the time of sale. Company ABC did not cross the Rubicon by entering into a profit-making scheme. This test is positive for the hedge to be considered capital in nature.

A company is not a natural person with a body to kick, nor does it have a soul to damn. It is an artificial person, and the only way to determine its intention is to investigate the actions of its managing directors. Considering their formal acts passed in resolutions thus constitutes evidence as to the company's intention. (*CIR v Richmond Estates (Pty) Ltd,* 1956 (1) SA 602 (A) (20 SATC 361).)

Company ABC's intention as to its *ipse dixit* is supported by its risk management policy and the resolution approved by the directors to enter into the hedge in order to mitigate the risk of a major future decline in the value of the MTN equity shares held.

4.5.2 Fixed versus floating capital

The courts have acknowledged the distinction between fixed and floating capital in the past. Fixed capital is considered capital in nature while floating capital is considered revenue in nature. However, the application of this test is seldom appears. (de Swardt et al., 2009:32.)

Floating capital disappears, or is consumed in the very process of production i.e. raw materials such as steel used in a motor vehicle production plant. On the other hand, the plant is considered fixed capital in the motor vehicle manufacturers' hands. The raw steel is considered floating capital in the steel merchant's hands, because it is their stock-in-trade. (*CIR v George Forest Timber Co Ltd,* 1924 AD 516 (1 SATC 23).) This analysis indicates that fixed capital means the income-earning structure of a taxpayer.

Based on the above distinction between floating versus fixed capital the MTN SSF or SSFO contract in the hands of Company XYZ may be considered to be floating capital and is therefore income in nature.

On the other hand, the MTN equity shares held by Company ABC are the tree and the dividends are the fruit of the tree. The above indicates that the MTN equity shares may be considered part of the income-earning structure of Company ABC,

meaning that the MTN equity shares are fixed capital in the hands of Company ABC and are therefore capital in nature. The hedging instruments relate to the MTN equity shares and mitigate the risk of a future decrease in the value of the investment (the tree). The direct relationship to the tree suggests that the hedging instruments form part of the income-earning structure of Company ABC and may be considered fixed capital in their hands. This indicates that the hedging instruments may be considered capital in nature.

4.5.3 Isolated transactions

An isolated transaction may indicate that a receipt or accrual is capital rather than revenue in nature. However, it is not a decisive factor when determining whether a receipt or accrual is capital or revenue in nature. (de Swardt et al., 2009:32.) The example below illustrates this statement.

A taxpayer who carried on a business as a country storekeeper entered into a contract for the future delivery of supplies of grain. The taxpayer normally entered into transactions in grain and other produce. However, this was the first time he had entered into a forward agreement. The suppliers faced a loss on their forward agreements owing to the rise in grain prices. The taxpayer and suppliers agreed on a cancellation fee in respect of the forward agreements.

The court stated that it is true that the transaction was an isolated transaction. The success of the transaction depended largely on the storekeeper's knowledge, acquired through his occupation as a dealer in produce. The court therefore considered the transaction, although isolated, as falling within the scope of the normal course of business of a dealer in produce. The court held that, although an isolated transaction, it was subject to normal tax. (*ITC 43,* (1925) (2 SATC 115 (NA)).)

The following discussion highlights the principles drawn from the above court case, but also considers the tests in respect of intention, objective factors and fixed versus floating capital described in Chapters 4.5.1 and 4.5.2.

If the farmers had not cancelled the forward agreements, the grain would have been delivered to the storekeeper at the price agreed upon in the forward. The

storekeeper would have sold the grain and the proceeds would have formed part of the storekeeper's gross income as defined in terms of section 1. This indicates that the storekeeper's intention in entering into the forward agreement was to acquire grain in order to sell it for a profit, because that was the storekeeper's business conduct as a supplier of produce. There was a probability that the storekeeper could have resold the grain at increased profit to his customers in the future should the asking price of grain suppliers be higher than the fixed price in the forward agreement. The increased profits would have formed part of the storekeeper's gross income.

Moreover, the grain is considered floating capital in the hands of the storekeeper. The forward agreement gives the storekeeper the right to acquire grain and this direct relationship connotes the characteristic of floating capital to the forward agreement. This indicates the forward agreement is revenue in nature and any amounts received in relation to this will be included in the storekeeper's gross income as defined in terms of section 1.

The hedge is an isolated transaction, which indicates that it is capital in nature. However, owing to the above analysis, the fact that the hedge is an isolated transaction is not considered a decisive factor when determining whether an amount is revenue or capital in nature. The result of this test should be considered together with the results of the other tests.

4.6 SHARE TRANSACTIONS

Acquiring shares with the intention to sell them at a profit means that the receipts or accruals are revenue in nature. Paragraph (a) of the definition of trading stock in section 1 states that "it includes anything...purchased or in any other manner acquired by the taxpayer for the purposes of...sale or exchange...". Therefore, acquiring shares for the purposes of resale means that the shares held for this purpose are trading stock as defined and held on revenue account.

The derivatives entered into or purchased by Company XYZ for purposes of resale fall within the definition of trading stock in terms of section 1. Company ABC did not enter into the SSF and SSFO for purposes of resale, so the derivatives held by Company ABC are not considered trading stock as defined in terms of section 1.

This analysis supports the other facts indicating that the hedge is capital in nature in the hands of Company ABC.

However, there is an exception to the principle that shares acquired for purposes of resale are held on revenue account. The exception is described in terms of section 9C(2), which states that any amount received by or accrued to a taxpayer in respect of a qualifying share shall be deemed to be of a capital nature unless that amount constitutes a dividend.

In terms of section 9C(1), a "qualifying share" is an equity share contemplated in terms of section 44, which a taxpayer disposes of or deems disposed of in terms of paragraph 12 of the Eighth Schedule, if the taxpayer immediately prior to such disposal has been the owner of that share for a continuous period of at least three years.

The MTN shares are listed shares contemplated in the term qualifying share in terms of section 9C(1). Company ABC held the shares for more than 3 years, which makes the shares capital in nature. This, together with the practice in South Africa that the hedging instrument follows the tax treatment of the hedged instrument, indicates that the SSF and SSFO are capital in nature in the hands of Company ABC.

4.7 INSURANCE POLICY ANALOGY

A hedge may be compared to an insurance policy, where the question that must be asked to determine the tax characterisation of the payout relates to the hole which the policy is expected to fill. The phrase "filling the hole of profits" emanates from the English case *Burmah Steam Ship Co Ltd v IRC*, 1930 16 TC 67 Court of Session (1931 SC 156). In other words, does the amount refer to a consideration or compensation in respect of a loss relating to the income-earning structure or income-earning operations of a taxpayer? The amount that relates to the income-earning structure is considered capital in nature and the amount that relates to income-earning operations is considered income in nature. (*SIR v Cadac Engineering Works (Pty) Ltd,* 1965 (2) SA 511 (A) (27 SATC 61); *CIR v Illovo Sugar Estates Ltd,* 1951 (1) SA 306 (N) *(*17 SATC 387).)

The principles above refer to the term “loss”. The meaning of the term “loss” from the tax point of view is important, because it is necessary to understand whether it also includes unrealised amounts. The court indicated that the word had several meanings, so its intrinsic meaning was “somewhat obscure”. It was uncertain whether it meant something different from “expenditure”. The word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation. (*Joffe & Co (Pty) Ltd v CIR,* 1946 AD 157 (13 SATC 354).)

The Rhodesian Income Tax Appeals Special Court concluded that the word “loss” meant an outgoing of some kind and not simply a diminution in the value of an asset (*ITC 1218,* (1974) (36 SATC 212)). The term “diminution” means, *inter alia,* the reduction in size or extent (Oxford Reference Online, 2005).

The analysis above suggests that, without an actual transaction taking place in respect of the hedged item, the tax treatment of the hedging instrument would not follow the tax treatment of the hedged item. The analysis is further supported by similar principles contained in *ITC 1498,* 1989 (E) (53 SATC 260) (refer to Chapter 4.5).

If the principles of a hedge were applied to an insurance policy, the underlying asset would be the hedged item and the insurance policy would be the hedging instrument. The insurance payments, although paid monthly, would ensure that the hedging instrument was in place for the period that the taxpayer required it. The monthly payments would be deducted in terms of section 11(a) but upon an event where compensation for loss accrued, the premiums would be recouped in terms of section 8(4)(a) and the recoupment would be included in terms of paragraph (n) of the gross income definition in terms of section 1.

The loss of the asset would be considered as a disposal in terms of paragraph 11 of the Eighth Schedule and the compensation accrued would be included in the calculation of the proceeds in terms of paragraph 35(1) of the Eighth Schedule. The recoupment would be deducted from the proceeds in terms of paragraph 35(3)(a) of the Eighth Schedule. The base cost of the asset would have to be reduced in terms of paragraph 20(3)(a), with the insurance premiums claimed in terms of section 11(a).

In the case where Company ABC held the MTN SSF until maturity, the amount of profits accrued is R3 454. The total losses incurred until maturity are R4 285. The losses are not considered part of the amount in terms of the interpretation of the phrase “amounts received or accrued” in the gross income definition.

Refuge in terms of section 11(a) must therefore be considered. No amount may be deducted if the taxpayer is not carrying on a trade in terms of section 11. Company ABC is not carrying on a trade as a derivative dealer nor is it a share trader. This means that the trade requirement in respect of the expenditure or loss from the SSF is not met, which means that no deduction is allowed in terms of section 11. Further, no amount may be deducted if it is capital in nature in terms of section 11(a). Even if Company ABC meets the trade requirement, its intention per its *ipse dixit* for entering into the hedge is capital in nature. The requirement that the losses not be capital in nature is thus not met, which means that no deduction is allowed in terms of section 11.

The future is considered an asset in terms of the Eighth Schedule and at the date of maturity, it becomes extinct, which is considered a disposal in terms of paragraph 11. This means that the provisions of the Eighth Schedule apply. The proceeds are zero because the profits of R3 454 are included, but are then excluded in terms of paragraph 35(1) and 35(3)(a) respectively. The base cost is equal to the expenditure actually incurred to bring an asset into existence in terms of paragraph 20(a), which is the total loss of R4 285. The capital loss in terms of paragraph 4 is therefore equal to R4 285, determined as the amount of base cost that exceeds the proceeds. In summary, the profits are subject to normal tax and the losses may be used against capital gains made in the year of assessment. Comparing this analysis to the analysis of the insurance policy that acts as a hedge, it is clear that the two scenarios are not dealt with in the same way. This leads to an absurdity, which, in consideration of the enactment as a whole, is clearly not what the Legislature intended.

Although an actual transaction in respect of the hedged item is required in terms of the principles above, it leads to an anomaly that is clearly not intended. A transaction designated to save a taxpayer’s capital may nevertheless be on capital account (*ITC 1283,* 1978 (41 SATC 36)).

The MTN shares form part of the income-earning structure of Company ABC and are therefore considered capital in nature. Based on the above analogies, the hedging relationship connotes the capital nature of the hedged item to the hedging instrument.

4.8 THE RELEVANT PROVISIONS OF THE EIGHTH SCHEDULE

The paragraphs above explained the meanings of the terms used in the gross income definition. In the circumstances where the amount received or accrued is capital in nature, it means that the amount falls outside of the definition of gross income. However, this does not mean that the amount is not subject to tax. The provisions of the Eighth Schedule must therefore be considered.

4.8.1 Application of the Eighth Schedule

Paragraph 2 of the Eighth Schedule refers to the terms “asset”, “disposal” and “resident”. What are the meanings ascribed to these terms by the Eighth Schedule?

In terms of paragraph 1 of the Eighth Schedule, an “asset” is any property of whatever nature, including any right or interest in such property. The property may be movable or immovable, corporeal or incorporeal, excluding currency. Coins made of gold or platinum are considered assets in term of paragraph 1 of the Eighth Schedule.

Company XYZ will not be discussed in this section of the chapter because its transactions are subject to normal tax.

Company ABC held a right in terms of a contract, i.e. MTN SSF to receive cash or 100 MTN shares. Cash and shares are considered property and the MTN SSF connotes a right in this property, which means that the SSF is an asset in terms of paragraph 1 of the Eighth Schedule.

The SSFO held by Company ABC is a right in terms of a contract to obtain an SSF, which is an asset, so the SSFO is considered to be an asset in terms of paragraph 1 of the Eighth Schedule.

In terms of paragraph 1 of the Eighth Schedule, a "disposal" is any act, event, forbearance or operation of law envisaged in terms of paragraph 11 of the Eighth Schedule, and includes any deemed disposals envisaged in terms of the provisions of the Schedule. The act, event, forbearance or operation of law that results in the creation, variation, transfer or extinction of an asset is a disposal in terms of paragraph 11 of the Eighth Schedule.

The scenario in which the MTN SSF and the SSFO are sold on 29 May 2009 is a disposal in terms of paragraph 11 of the Eighth Schedule. The scenario in which the MTN SSF is held until maturity means that the contract becomes extinct, which is considered to be a disposal in terms of paragraph 11 of the Eighth Schedule. The scenario in which the option was not exercised is considered a disposal in terms of paragraph 11.

Chapter 1.5 states that this study is limited to the taxation of a resident company of South Africa, which is a resident as envisaged in terms of paragraph 2 of the Eighth Schedule.

If all the above elements are present, the provisions of the Eighth Schedule apply. The provisions of the Eighth Schedule apply to Company ABC because it is a resident holding assets that were disposed of in the year of assessment.

4.8.2 Calculation of the taxable capital gain

The taxable capital gain in the case of a company is equal to 50% of the net capital gain in terms of paragraph 10 of the Eighth Schedule. The net capital gain is the amount by which the aggregate capital gain exceeds any assessed capital loss for the previous year's assessment in terms of paragraph 8 of the Eighth Schedule. A capital gain is the amount by which the proceeds from disposal exceed the base cost of the asset in terms of paragraph 3 of the Eighth Schedule. A capital loss is the amount by which the base cost of the asset exceeds the proceeds from disposal.

The base cost of an asset is determined in accordance with part 5 of the Eighth Schedule, while the proceeds from a disposal are determined in accordance with part 6 of the Schedule.

It is stated in paragraph 35(1) that the proceeds from the disposal of an asset by a person are equal to the amount received by, accrued to or in favour of that person with respect to that disposal. The phrase “the amount received by or accrued to, in favour of” are used in the gross income definition (refer to Chapter 4.4) and the terms used bear the same meaning as in the gross income definition (refer to Chapters 4.4.1 and 4.4.2).

Based on the analysis in Chapters 4.5 to 4.8.1 the MTN SSF and SSFO are considered capital in nature in the hands of Company ABC.

In the case of the scenario in which the SSF is sold,

- the proceeds from disposal equal R3 004.05 in terms of paragraph 35(1) of the Eighth Schedule;
- the expenditure actually incurred equals R3 551 in terms of paragraph 20(a) of the Eighth Schedule; and
- the capital loss available for set off against capital gains equals R546,95 in terms of paragraph 4 of the Eighth Schedule.

Further, in the case of the scenario in which the SSFO is held until maturity:

- the proceeds from disposal equal R3 454, in terms of paragraph 35(1) of the Eighth Schedule;
- the expenditure actually incurred equals R4 285 in terms of paragraph 20(a) of the Eighth Schedule; and
- the capital loss available for set off against capital gains equals R831, in terms of paragraph 4 of the Eighth Schedule.

Where a taxpayer acquires or disposes of an asset as a result of the exercise of an option contract, that taxpayer must disregard any capital gain or capital loss determined in respect of the exercise of that option, in terms of paragraph 56 of the Eighth Schedule. The expenditure actually incurred in respect of the acquisition of the option should be included in the base cost of that asset in terms of paragraph 20(1)(c)(ix) of the Eighth Schedule.

In the case where the SSFO is sold:

- the proceeds from disposal equal R277, in terms of paragraph 35(1) of the Eighth Schedule;
- the expenditure actually incurred equals R508, in terms of paragraph 20(a) of the Eighth Schedule; and
- the capital loss available for set off against capital gains equals R236, in terms of paragraph 4 of the Eighth Schedule.

In the case where the SSFO is not exercised and expires:

- the proceeds from disposal equal R272, in terms of paragraph 35(1) of the Eighth Schedule;
- the expenditure actually incurred equals R513, in terms of paragraph 20(a) of the Eighth Schedule; and
- the capital loss available for set off against capital gains equals R241, in terms of paragraph 4 of the Eighth Schedule.

4.9 SUMMARY

The analyses above indicate that it is important to understand the market mechanics of SSFs and SSFOs in order to determine the tax treatment of these derivatives in the South African context in terms of the Act (refer to Chapter 2). Although the Act does not provide specific legislation on how to treat SSFs and SSFOs for tax purposes, the starting point is the gross income definition in terms of section 1. Understanding the principles that relate to the gross income definition is paramount in determining the tax treatment of transactions not specifically dealt with in terms of the provisions of the Act. After considering the gross income definition, the provisions of the Eighth Schedule should also be considered.

Although the Act does not define a hedge or a hedging transaction, the above analyses indicate that a hedge may change the tax characterisation from an implied revenue transaction to a capital transaction. It is therefore important to understand the key characteristics of a hedge when determining the tax treatment of SSFs and SSFOs (refer to Chapter 3).

In Chapter 5, the tax treatment in respect of the examples used in this chapter is considered in the United Kingdom context in terms of the DLC.

A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

CHAPTER 5
TAXATION OF SSF AND SSFO TRANSACTIONS IN THE UNITED KINGDOM

5.1 INTRODUCTION

This chapter focuses on the treatment of profits or losses in respect of SSFs and SSFOs in terms of the DCL, bearing in mind the principles set out in Chapters 2 and 3. The DCL provisions are contained in Part 7 of the Corporation Tax Act 2009, promulgated in the United Kingdom. Taxation of derivatives may differ depending on the taxpayer's intention (Lindsay, 2003:169). The chapter therefore focuses on two possible intentions, namely the intention to:

- trade in SSFs and SSFOs; and
- use SSFs or SSFOs for hedging purposes.

The analysis in this chapter is based on the example of the transactions entered into by Companies XYZ and ABC (refer to Chapter 4.2). The accounting period for Company XYZ and Company ABC is for the 12-month period ending on 31 July 2009.

For the purposes of this chapter, the companies are incorporated in the United Kingdom which means that they are residents in terms of section 14 of the Corporation Tax Act 2009 and are taxed on their worldwide profits in terms of section 5 of that Act. This allows for a comparison of the results of the tax treatment of SSFs and SSFOs in South Africa and the United Kingdom. However, the example demonstrates transactions and the employment of capital in South Africa, which could be considered a deemed source of South Africa and therefore subject to tax in South Africa (*CIR v Black,* 1957 (3) SA 536 (A) (21 SATC 226); *Overseas Trust Corporation Ltd v CIR,* 1926 AD 444 (2 SATC 71)).

Based on the above analysis, the companies are subject to tax in both countries and refuge against the double taxation may be found in the double taxation agreement between South Africa and the United Kingdom. However, such an investigation is

beyond the scope of this study. For the present purpose, the profits and losses resulting from the transactions of the derivatives in South Africa are not considered a deemed source of South Africa.

5.2 SCOPE OF THE DCL

In terms of section 570 of the DCL, the following elements must be present in order for the provisions of the DCL to apply:

- a company;
- a derivative contract; and
- profits and losses arising from the derivative contract.

Diagram 1 (refer to Annexure B) illustrates the interactions of the relevant sections extracted from the DCL. The paragraphs that follow consider the requirements of each element and apply them to the facts contained in the example of the transactions of Company XYZ and Company ABC.

5.2.1 Company

Company XYZ and Company ABC are residents of the United Kingdom in terms of section 14 of the Corporation Tax Act 2009, because they are incorporated in the United Kingdom.

The Income and Corporation Taxes Act 1988 contains no provisions similar to those contained in the DCL relating to derivative contracts. In terms of section 6 of the Income and Corporations Taxes Act 1988, the income tax provisions contained in the Income and Corporations Taxes Act 1988 do not apply to companies that are residents of the United Kingdom, because they are taxed in terms of the provisions contained in the Corporations Tax Act 2009.

Based on the analysis above, individuals are not taxed in terms of the DCL when entering into derivative contacts nor are there provisions similar to those of the DCL contained in the Income and Corporation Taxes Act 1988. This difference raises the question as to how profits or losses relating to derivative contracts are treated for tax purposes in the hands of an individual in the United Kingdom. However, this study focuses only on the tax treatment of SSFs and SSFOs in the hands of a company

(refer to Chapter 1.5). The taxation of SSFs and SSFOs in the hands of an individual in the context of South Africa and the United Kingdom may be an important topic for future studies, because it may add value base to the fact that it considers the taxation of more than one group of taxpayers.

5.2.2 Derivative contract

In terms of section 576 of the DCL, a contract is derivative contract if

- it is a relevant contract in terms of section 577 of the DCL;
- the accounting conditions apply in terms of section 579 of the DCL; and
- the underlying is not considered excluded property in terms of section 589 of the DCL.

A relevant contract is:

- an option in terms of section 580 of the DCL;
- a future in terms of section 581 of the DCL; or
- a contract for differences in terms of section 582 of the DCL.

An option in terms of section 580 of the DCL excludes any option contract for which the settlement method is only in cash with no option of physical delivery of the underlying item. The SSFO into which Company XYZ and Company ABC entered allows for either settlement method (refer to Chapter 4.2.3). The SSFO, in respect of the MTN SSF, is considered an option in terms of section 580 of the DCL, which is thus considered a relevant contract in terms of section 579 of the DCL.

A future in terms of section 581 of the DCL is a sale of property, delivery of which is to be made at a specified future date and at an agreed-upon price. If the settlement method of the future contract allows for only cash settlement, then it is not considered a future in terms of 581. The MTN SSF into which Company XYZ and Company ABC entered is not considered a future in terms of section 581 of the DCL because the settlement method allows for cash settlement only.

A “contract for differences” in terms of section 583 is a contract entered into to make a profit or avoid a loss and the value fluctuates because it refers to an index. Moreover, there is no requirement in respect of the settlement method. It excludes contacts that are options or futures in terms of section 580 and section 581 of the

DCL respectively. The MTN SSF is therefore a contract for differences in terms of section 583 of the DCL, because its value fluctuates with reference to the MTN share price index, and it is not considered a future in terms of section 581 of the DCL.

Based on the analysis above, the SSFO and the MTN SSF are relevant contracts in terms of section 577 of the DCL.

The accounting condition requirement in terms of section 579 of the DCL requires that the relevant contract be treated as a derivative for accounting purposes. The SSFO and MTN SSF are treated as derivatives for accounting purposes (refer to Chapter 2.3), so it complies with the aforementioned requirement.

In terms of section 589 of the DCL, an excluded property is shares in a company subject to the provisions set out in section 591. In terms of section 591, where a relevant contract is entered into for a non-trading purpose and relates to a hedging relationship in respect of an asset of the company that consists of shares, then the relevant contract is not a derivative contract in terms of section 576. The definition of a hedging relationship (refer to Chapter 3.3.4) in terms of section 707 of the DCL has the following elements:

- a designation as a hedge;
- a hedging in respect of a particular financial risk exposure;
- the risk exposure could affect profit or loss; and
- the hedged item is recognised as an asset or liability for accounting purposes.

Company XYZ entered into the SSFO and MTN SSF for trading purposes, so the SSFO and MTN SSF are not considered excluded property in terms of section 589, read with section 591 of the DCL.

Company ABC designated the SSFO and SSF as a hedge against an expected future decline in the value of their 100 MTN shares that are recognised as an asset in the accounting records. In addition, the sale of the 100 MTN shares at the declined price would have affected the profit or loss of Company ABC. Based on the above analysis, a hedging relationship in terms of section 707 of the Corporation Tax Act 2009 exists. Company ABC did not enter into the SSFO and SSF for purposes

of trade. The SSFO and MTN SSF are therefore considered excluded property in terms of section 589, read with section 591 of the DCL.

Based on the analysis above, the SSFO and SSF in the hands of Company XYZ are considered derivative contracts in terms of section 576 of the DCL. The SSFO and SSF in the hands of Company ABC are not considered derivative contracts in terms of section 576 of the DCL.

5.2.3 Profits and losses arising from a derivative contract

The provisions concerning the profits and losses in terms of section 570 will be considered only for Company XYZ, because Company ABC did not meet the requirements discussed above.

In terms of section 595 of the DCL, the credits and debits referred to in section 572 of the DCL are equal to the credits and debits recognised in terms of generally accepted accounting practices. In terms of IAS 39 (IFRS, 2009:2003), the transaction in the SSFO and SSF are recognised in the accounting records on the day that the initial margin is paid into the margin account. The SSFO and SSF are measured at fair value on the date of initial recognition and subsequent measurement. Any changes in the fair value after initial recognition are accounted for in profit or loss (IFRS, 2009:2010, 2015 & 2022).

In terms of section 595, the sum of the credits and debits of the derivative contracts and related transactions, plus expenses in the relevant accounting period, represent the profit or loss that must be brought in to account for tax purposes. The relevant accounting period in the United Kingdom context is similar to the year of assessment in the South African context. The transactions in the example fall therefore within the accounting period of Company XYZ.

The sum of the debits and credits in Table 2 and Table 3 (refer to Annexure A) in the case of disposing of the derivatives on 29 May 2009 and holding the derivatives until maturity are set out below.

Derivative	Profit/(Loss)		Reference
	29 May 2009	18 June 2009	
SSF	(R546,95)	(R831,00)	Column F in Table 2
SSFO	(R231,00)	(R241,00)	Column N in Table 3

5.2.4 Amounts subject to tax in terms of the DCL

From the analysis above, the profits or losses relating to the transactions in the derivatives by Company XYZ are subject to tax, because they are included in the taxable profits of the company in terms of section 573 of the DCL read together with section 49(d) of the Corporate Tax Act 2009. The paragraphs that follow consider the taxation of the profits and losses of Company ABC relating to its transactions in derivatives.

5.3 DERIVATIVES FALLING OUTSIDE OF THE DCL SCOPE

Generally, when a company falls out of the provisions of the DCL and does not enter into the derivative for trading purposes, the profit or loss would be included in the determination of its capital gains, on which corporation tax is payable (Lindsay, 2000:210). In terms of section 143 of the Taxation of Chargeable Gains Act 1992, financial futures and qualifying options that are traded on a recognised futures exchange are considered assets.

It is the practice by Inland Revenue that the term “financial future” includes futures that are settled in cash or by physical delivery (Lindsay, 2000:210). Index options that are automatically excised if certain conditions are met are considered as falling under financial futures for United Kingdom capital gains tax purposes (Lindsay, 2000a:23). In terms of the SAFEX rules, index options are automatically exercised if it is in the money on maturity date (JSE Equity Options Brochure, n.d.:9). Therefore,

the SSFO in respect of the MTN SSF are considered financial futures for tax purposes in the United Kingdom.

Based on this analysis, the SSFO and MTN SSF in the hands of Company ABC are considered assets for United Kingdom capital gains purposes because they fall out of the provisions of the DCL.

Receipts or payments under the terms of the contract, or otherwise, that settle any obligations in full or in part related to the contract are considered a consideration or incidental cost respectively for the disposal of an asset (Lindsay, 2009b:210).

The losses made by Company ABC in respect of the MTN SSF on disposal and maturity amount to R779,05 and R831 respectively. These amounts are considered allowable losses in terms of section 8 of the Taxation of Chargeable Gains Act 1992. In addition, the losses made by Company ABC in respect of the SSFO on disposal and abandonment of R231 and R241 respectively would be considered allowable losses in terms of section 8 of the Taxation of Chargeable Gains Act 1992.

Allowable losses in the current or previous year are set off against the total chargeable gains, and any excess allowable loss would be carried over to the next year in terms of section 8 of the Taxation of Chargeable Gains Act 1992.

5.4 SUMMARY

The analyses above indicate that it is important to understand the market mechanics of SSFs and SSFOs in order to determine the tax treatment of these derivatives in the United Kingdom (refer to Chapter 2). The DCL contains specific legislation on how to treat SSFs and SSFOs for tax purposes; the starting point is to determine whether a contract is considered a derivative contract in terms of section 576 of the DCL. It is also important to understand the accounting principles applied to account for derivatives in a company's accounts, because the tax treatment follows the accounting treatment (refer to Chapter 2.3 and Chapter 3).

If an SSF or an SSFO is not entered into for trading purposes, it is important to consider the exclusions contained in terms of section 589 and section 591 of the DCL when deciding whether the provisions of the DCL apply or not. Should an SSF

or an SSFO fall outside the scope of the DCL, the provisions contained in section 143 of the Taxation of Chargeable Gains Act 1992 should be considered.

The DCL defines a hedging relationship which may influence the tax treatment of SSFs and SSFOs in the United Kingdom (Lindsay, 2009a:23). However, the intention to enter into an SSF and an SSFO for trading purposes or not is an important factor to consider, because the DCL specifically refers to how transactions for trading and non-trading will be treated for tax purposes.

The above analyses indicate that a hedge may change the tax characterisation from an implied revenue transaction to a capital transaction. This means that it is important to understand the key characteristics of a hedging relationship defined in terms of section 707 of the DCL.

In Chapter 6, a comparison is made between the tax treatment of SSFs and SSFOs in the contexts of South Africa and the United Kingdom.

A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

CHAPTER 6
COMPARISON OF THE TAX TREATMENT OF AN SSF AND AN SSFO IN SOUTH AFRICA AND THE UNITED KINGDOM

6.1 INTRODUCTION

This chapter compares the tax treatment of an SSF and an SSFO by South Africa and the United Kingdom with reference to the results of the examples in Chapters 4 and 5. This chapter will focus on the net effect for tax in respect of the amounts included in the taxable income and taxable profit on which companies' tax and corporation tax will be charged. The companies' tax and corporation tax amounts to 28%.

6.2 SSF AND SSFO FOR TRADING PURPOSES

Company XYZ entered into the SSF and SSFO for purposes of its trade. The taxable income and income on which corporation tax is charged (refer to Chapter 5.2.3) in respect of South Africa and the United Kingdom are reflected below.

Derivative	South Africa	United Kingdom	Difference
Disposal on 29 May 2009 Profit/(Loss)			
SSF	(R546,95)	(R546,95)	Zero
SSFO	(R231,00)	(R231,00)	Zero
Held until maturity 18 June 2009			
SSF	(R831,00)	(R831,00)	Zero
SSFO	(R241,00)	(R241,00)	Zero

The loss calculated for purposes of South African tax is based on the amounts included in gross income (refer to Chapter 4.4.1), less the sum of the losses incurred

for the period 1 April 2009 to 29 May 2009 and 18 June 2009 respectively (refer to column F in Table 2 and column K in Table 3) in terms of section 11(a) of the Act.

The comparison above indicates that there is no difference in the tax treatment by the two countries in respect of SSFs and SSFOs entered into for trading purposes.

6.3 SSF AND SSFO FOR NON-TRADE PURPOSES

Company ABC entered into the SSF and SSFO to serve as hedge and for non-trading purposes. The capital losses (refer to Chapter 4.8.2) and allowable losses (refer to Chapter 5.3) available for set off against capital gains and chargeable gains respectively are set out below.

Derivative	South Africa	United Kingdom	Difference
Disposal on 29 May 2009 Profit/(Loss)			
SSF	(R546,95)	(R546,95)	Zero
SSFO	(R231,00)	(R231,00)	Zero
Held until maturity 18 June 2009			
SSF	(R831,00)	(R831,00)	Zero
SSFO	(R241,00)	(R241,00)	Zero

The comparison above indicates there is no difference in the tax treatment by the two countries in respect of SSFs and SSFOs entered into for purposes of a hedge and with a non-trading intention.

6.4 NON SPECIFIC LEGISLATION VESUS SPECIFIC LEGISLATION

SSFs and SSFOs are taxed according to the general principles of the Act in the South African context because there are no specific provisions that deal with the taxation of SSFs and SSFOs in the Act (refer to Chapter 4.9). In contrast, SSFs and SSFOs in the United Kingdom context are taxed according to the specific provisions contained in the DCL (refer to Chapter 5.4). Based on the analysis above, there are

no differences in terms of the net tax effect in respect of the tax treatment in the two countries, because both of them tax the SSFs and SSFOs according to the intention of the taxpayer. Both countries tax the profits and losses from SSFs and SSFOs according to the accrual or incurral principles respectively.

Considering the extent of the discussion on whether or not the SSF or SSFO entered into by Company ABC should be considered capital in nature or not is time consuming and complex (refer to Chapter 4.5 to 4.7). Moreover, the onus of proof rests with Company ABC to prove that the amounts received are capital in nature in terms of section 82 of the Act. Comparing this to the ease of application of the provisions in the DCL, it indicates that there is a lack of direction in South Africa in relation to the tax treatment of derivative contracts.

Rudnicki (2003:114) indicates that a comprehensive framework is required to provide for the tax treatment of derivatives in South Africa, and that this framework should include a definition of a derivative and a hedge.

6.5 SUMMARY

From the analysis above, there are no differences in respect of the tax treatment of SSFs and SSFOs by South Africa and the United Kingdom. However, the fact that there are no differences does not mean that specific legislation dealing with derivatives is not essential from the South African perspective. Derivative transactions and hedges are complex in nature and the information available in respect of the tax treatment is indicative rather than decisive.

In Chapter 7 the valuation methods appropriate to valuing SSFs and SSFOs are discussed.

A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

CHAPTER 7
VALUATION OF AN SSF AND AN SSFO

7.1 INTRODUCTION

This chapter focuses on the valuation of SSFs and SSFOs. The assumptions and limitations related to the valuation method are discussed. In this chapter the question of whether the tax charge or benefit has an effect on the value of the SSF and SSFO is also investigated.

The losses reflected in Chapter 6.2 may be deducted from profits for tax purposes, lowering the company's tax charge and resulting in a cash outflow that is less than it would have been if the losses had been disallowed as a deduction. This reduction is considered a tax benefit (refer to Chapter 1.1). The losses reflected in Chapter 6.3 may only be deducted from capital gains and if there are no capital gains in the current year they may be carried over to the next. There is no cash flow effect until the losses are utilised, which raises the question of whether it could be considered a tax benefit.

7.2 VALUATION OF SSF

In Chapter 4.2.2, the following formula was used to determine the fair value of the MTN SSF on 29 May 2009:

$$FVF = C + (C \times (r/100 \times t/365)) - (D/(1+r/100) \times (v-p)/365)$$

Where

- FVF is the fair value of the SSF;
- C is the current market price of the share;
- r is the annual borrowing rate;
- D is the dividend likely to be received during the life of the SSF;
- v is dividend payment date; and
- p is the future settlement date (JSE, 2009e).

The “r” may also be the risk free rate of return. The “D” may be the dividend yield of the underlying share (Corria, Flynn, Uliana & Wormald, 2003:18-9).

When entering into a MTN SSF by taking up a long position (refer to Chapter 2.2.1) the holder agrees to buy 100 MTN shares at an agreed price at a future date. This means that because one is buying in the future, interest is earned on the funds in the interim, but one foregoes the income from the asset until taking delivery. The price is therefore the future value of the current price less the future value of the income not obtained because of not holding the underlying asset (Corria *et al.*, 2003:18-9). If a short position is taken up and the holder holds the underlying shares, then by selling only in the future the holder loses the interest that he would have made if he had sold the shares and invested the funds. In addition, the dividend payment might not happen before the disposal in the future, which means that the holder would forego the dividend income.

The value of a future is also influenced by the demand and supply of futures contracts. Futures prices can diverge from their fair value calculation owing to different market perceptions that shift the demand and supply of future contracts (JSE, 2009e).

Based on the analysis above, no provision for tax is made because tax is the result of an accrual of a receipt or an incurral of a loss which becomes apparent only after the daily mark-to-market. Tax is a percentage of the value and future movements in the value of the SSF as it accrues or incurs, which relates specifically to the holder of the SSF and influences no other market participants. This indicates that the tax charge or benefit plays no role in the valuation of a future.

7.3 VALUATION OF AN SSFO

A number of factors influence an SSFO:

- the share price
- the exercise price or strike price;
- the interest rate;
- the time until maturity; and
- the volatility of the share price (Corria *et al.*, 2003:18-5).

A pricing option model on which the JSE bases the calculation of the value of a SSFO is referred to as the Black-Scholes Model represented by the following formula in respect of a call option:

$$P_0 = P_sN(d_1) – E/e^{rt} \times N(d_2)$$

Where,

- P_s represents the current share price;
- E represents the strike price of the option;
- *e* represents 2,71828;
- r represents the risk-free interest rate compounded;
- t represents the time in years left until maturity; and
- N(d) represents the normal probability density function.

In the case of a put option the following formula applies:

$$P_0 = E/e^{rt} \times N(-d_2) – P_sN(-d_1)$$

The formula is based on the following assumptions:

- the underlying share price has a constant volatility;
- the efficient market hypothesis applies;
- the market is risk-neutral; and
- delta hedging is done continuously.

The assumptions are also the weaknesses in the model, because the volatility of the underlying share price changes over time and adjustments in this regard are necessary. The efficient market hypothesis states that markets are liquid and all players have equal access to information. That is in the ideal world. However, markets are not always liquid. An example is the current economic crisis due to the collapse of the property market in America early in 2008. Information must be purchased and not all players can afford it. The market is not risk-neutral; all investments have a risk factor and return in relation to that risk.

Based on the analysis above, no provision for tax is made because tax is the result of an accrual of a receipt or an incurring of a loss which only becomes apparent after the daily mark-to-market. Tax is a percentage of the value and future movements in

the value of the SSFO as it accrues or incurs, which relates specifically to the holder of the SSFO and influences no other market participants. It indicates therefore that the tax charge or benefit plays no role in the valuation of an index option.

7.4 SUMMARY

The analysis above indicates that the tax charge or benefit plays no role in the valuation of an SSF or an SSFO. However, a taxpayer's tax expense increases or decreases according to an increase or decrease in the tax charge or benefit. The inflow and outflow of cash as it relates to tax effectively increases or decreases a taxpayer's wealth (refer to Chapter 1.1). This means that, in theory, an investment that effectively mirrors the risk and returns of the SSF or SSFO but the returns are not subject to tax has a higher value because there is no outflow of cash in the form of a tax expense. This in turn influences the taxpayer's investment decision.

In Chapter 8, the core research questions (refer to Chapter 1.2) are discussed based on the analyses in Chapters 2 to 7.

A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

CHAPTER 8
CONCLUSION

8.1 INTRODUCTION

In Chapter 1.1, the principles of measuring wealth were discussed. They indicated that taxation decreases wealth and it may be important to understand the tax treatment of profits and losses at the time when the investment decision is being considered. This was the basis for the following two core research questions (refer to Chapter 1.2):

- how are SSFs and SSFOs taxed in South Africa and the United Kingdom; and
- will taxation affect the value of these financial instruments?

8.2 TAXATION OF AN SSF AND AN SSFO IN SOUTH AFRICA AND THE UNITED KINGDOM

In Chapter 2.1 it was indicated that South Africa and the United Kingdom use the same definitions for accounting purposes but not for tax purposes. In order to understand how to tax SSFs and SSFOs, knowledge of the market mechanics of futures and index options is required, which was discussed in Chapter 2. The key characteristics of SSFs and SSFOs were measured against the definition of a derivative for accounting purposes in order to understand how profits and losses relating to the SSFs and SSFOs are treated for accounting purposes. It was determined that SSFs and SSFOs are derivatives for accounting purposes (refer to Chapter 2.3).

In Chapter 3, the key characteristics of a hedge were determined. These are: risk reduction, designation and correlation. It was also indicated that the Act does not define a hedge but the United Kingdom defines a hedging relationship in terms of section 707 of the DCL. The correlation characteristic of a hedge is not included in the definition of a hedging relationship in terms of section 707 of the DCL.

In Chapter 4, an understanding of the market mechanics of futures and index options, in particular SSFs and SSFOs, was used to determine how SSFs and SSFOs are taxed in South Africa. South Africa has no specific legislation for dealing with the taxation of SSFs and SSFOs, but the starting point is the gross income definition in section 1 of the Act. Thereafter, the provisions of the Eighth Schedule should be considered. When determining the taxation of SSFs and SSFOs, it is important to take into consideration the intention of the taxpayer, both subjectively and objectively.

In Chapter 5, an understanding of the market mechanics of futures and index options, particularly SSFs and SSFOs and the provisions of the DCL, was applied in order to determine the tax treatment of these derivatives. In the instances where the scope of the DCL did not apply to the SSFs and SSFOs, the provisions set out in the Taxation of Chargeable Gains Act 1992 were considered, in particular section 143 of the aforementioned act.

It is understood from the analysis carried out in Chapters 4 and 5 that a hedge or hedging relationship may change the tax characterisation from an implied revenue transaction to a capital transaction in the South African and United Kingdom contexts. An understanding of the key characteristics of a hedge (refer to Chapter 3) is crucial if a hedging transaction is to be identified and understood, as well as the intention of the taxpayer subjectively and objectively in the South African context. It is important to understand the definition of a hedging relationship in terms of section 707 of the DCL read together with the other provisions of the DCL in the United Kingdom context.

In Chapter 6, the tax treatment relating to the example of Company XYZ and Company ABC (refer to Chapters 4 and 5) in South Africa and the United Kingdom were compared, and it was noted that, according to the net tax effect, there is no difference between the tax treatment in these two countries in respect of SSFs and SSFOs.

Based on the above analogy, the question arises as to whether a premise could be constructed to indicate that there is no difference between the tax treatment of SSFs

and SSFOs in South Africa and the United Kingdom, basing this on the net tax effect.

It is important to consider the weaknesses of inductive reasoning as a research method because of Hume's problem (Oxford Reference Online, 2009b). Hume's problem, illustrated with the premise that all swans are white, is flawed, seeing that black swans were discovered in Australia. The premise should, in fact, have been that all swans observed before the discovery in Australia were white, indicating that not all swans that ever lived were observed to be white. Goodman's paradox supports the analysis (Oxford Reference Online, 2009c). Going by this, it is very risky to construct such a premise because the example is only one instance of SSF and SSFO transactions with specific facts and circumstances. More research is required using a hypothetic-deductive method rather than an inductive method as a method of research.

8.3 TAXATION EFFECT ON THE VALUE OF AN SSF AND AN SSFO

In Chapter 7, the valuation models used by the SAFEX indicated that tax was not considered to be an influencing factor. In other words, taxation does not affect the value of SSFs and SSFOs. However, if a taxpayer has an opportunity to make an investment that is similar in risk and rewards to that of an SSF or SSFO, and the related profits are not subject to tax, it may influence his decision. However, the down-side would be that, if the investment made losses, these would not be deductable in terms of section 23(f) of the Act, because the profits are not deductable in the South African context.

8.4 CONCLUSION

Based on the analyses in this study, SSFs and SSFOs are taxed in South Africa in terms of the general provisions of the Act and in the United Kingdom in terms of the provisions of the DCL and Taxation of Chargeable Gains Act 1992. The intention of taxpayers in both countries determine whether the SSFs and SSFOs are taxed in terms of the provisions relating to normal tax or capital gains tax. Further, the taxation do not affect the value of SSFs and SSFOs. However, the tax expense decreases the wealth of the investor. A investor would therefore want to be taxed at the lowest tax rate to reduce the tax expense in order to increase his wealth.

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A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

ANNEXURE A

MARKET TRANSACTION DATA OF A MTN SSF AND SSFO

Table 2 MTN SSF

The SAFEX Equity Derivatives Market Statistics									
MTN Group Limited Cash Settled SSF (MTQQ)				Seller			Buyer		
	A	B	C	D	E	F	G	H	J
	Date	Price or Mark-to-Market	Change	Received / (Paid)	Balance of margin account	Profit/(Loss)	Received / (Paid)	Balance of margin account	Profit/(Loss)
Initial Margin	01-Apr-09	109.20	-	-1,092.00	1,092.00	-	-1,092.00	1,092.00	-
Mark-to-Market	02-Apr-09	113.69	4.49	-449.00	1,092.00	-449.00	449.00	1,541.00	449.00
Mark-to-Market	03-Apr-09	108.99	-4.70	470.00	1,562.00	470.00	-449.00	1,092.00	-470.00
Mark-to-Market	06-Apr-09	108.84	-0.15	15.00	1,577.00	15.00	-15.00	1,092.00	-15.00
Mark-to-Market	07-Apr-09	105.85	-2.99	299.00	1,876.00	299.00	-299.00	1,092.00	-299.00
Mark-to-Market	08-Apr-09	106.83	0.98	-98.00	1,778.00	-98.00	98.00	1,190.00	98.00
Mark-to-Market	09-Apr-09	108.56	1.73	-173.00	1,605.00	-173.00	173.00	1,363.00	173.00
Mark-to-Market	14-Apr-09	111.70	3.14	-314.00	1,291.00	-314.00	314.00	1,677.00	314.00
Mark-to-Market	15-Apr-09	109.44	-2.26	226.00	1,517.00	226.00	-226.00	1,451.00	-226.00

The SAFEX Equity Derivatives Market Statistics									
MTN Group Limited Cash Settled SSF (MTQQ)				Seller			Buyer		
	A	B	C	D	E	F	G	H	J
	Date	Price or Mark-to-Market	Change	Received / (Paid)	Balance of margin account	Profit/(Loss)	Received / (Paid)	Balance of margin account	Profit/(Loss)
Mark-to-Market	16-Apr-09	107.54	-1.90	190.00	1,707.00	190.00	-190.00	1,261.00	-190.00
Mark-to-Market	17-Apr-09	108.03	0.49	-49.00	1,658.00	-49.00	49.00	1,310.00	49.00
Mark-to-Market	20-Apr-09	107.04	-0.99	99.00	1,757.00	99.00	-99.00	1,211.00	-99.00
Mark-to-Market	21-Apr-09	102.87	-4.17	417.00	2,174.00	417.00	-119.00	1,092.00	-417.00
Mark-to-Market	23-Apr-09	104.90	2.03	-203.00	1,971.00	-203.00	203.00	1,295.00	203.00
Mark-to-Market	24-Apr-09	111.67	6.77	-677.00	1,294.00	-677.00	677.00	1,972.00	677.00
Mark-to-Market	28-Apr-09	115.90	4.23	-202.00	1,092.00	-423.00	423.00	2,395.00	423.00
Mark-to-Market	29-Apr-09	113.84	-2.06	206.00	1,298.00	206.00	-206.00	2,189.00	-206.00
Mark-to-Market	30-Apr-09	112.28	-1.56	156.00	1,454.00	156.00	-156.00	2,033.00	-156.00
Mark-to-Market	13-May-09	108.38	-3.90	390.00	1,844.00	390.00	-390.00	1,643.00	-390.00
Mark-to-Market	21-May-09	118.74	10.36	-752.00	1,092.00	-1,036.00	1,036.00	2,679.00	1,036.00
Mark-to-Market	28-May-09	120.03	1.29	-129.00	1,092.00	-129.00	129.00	2,808.00	129.00

The SAFEX Equity Derivatives Market Statistics									
MTN Group Limited Cash Settled SSF (MTQQ)				Seller			Buyer		
	A	B	C	D	E	F	G	H	J
	Date	Price or Mark-to-Market	Change	Received / (Paid)	Balance of margin account	Profit/(Loss)	Received / (Paid)	Balance of margin account	Profit/(Loss)
Mark-to-Market	29-May-09	115.83	-4.20	420.00	1,512.00	420.00	-420.00	2,388.00	-420.00
Mark-to-Market	04-Jun-09	117.33	1.50	-150.00	1,362.00	-150.00	150.00	2,538.00	150.00
Mark-to-Market	15-Jun-09	123.17	5.84	-270.00	1,092.00	-584.00	584.00	3,122.00	584.00
Mark-to-Market	17-Jun-09	118.51	-4.66	466.00	1,558.00	466.00	-466.00	2,656.00	-466.00
Mark-to-Market	18-Jun-09	117.51	-1.00	100.00	1,658.00	100.00	-100.00	2,556.00	-100.00
Settlement	18-Jun-09	-	-	1,658.00	-	-	2,556.00	-	-
Mark-to-Market	19-Jun-09	-	-	-	-	-	-	-	-
Total profit/(loss)						**-**			**831.00**
									(Source: JSE, 2009a & 2009b)

Table 3 SSFO in respect of the MTN SSF

Safex Equity Derivatives Market Statistics: SSFO on MTN SSF Expirery 18 Jun 2009					Seller				Buyer			
A	B	C	D	E	F	G	H	J	K	L	M	N
Date	Option trade premium	Futures Price	Vol	Closing Premium (MtM)	Premium variance	Initial margin	Variance on initial margin	Cash flows in/(out)	Premium variance	Initial margin	Variance on initial margin	Cash flows in/(out)
01-Apr-09	241	109	53	241	-	390	-390	-390	-	110	-110	-110
02-Apr-09		114	53	203	38	330	60	98	-38	90	20	-18
03-Apr-09		109	53	269	-66	390	-60	-126	66	110	-20	46
06-Apr-09		109	53	258	11	390	-	11	-11	110	-	-11
07-Apr-09		106	53	308	-50	430	-40	-90	50	130	-20	30
08-Apr-09		107	53	285	23	410	20	43	-23	120	10	-13
09-Apr-09		109	53	250	35	380	30	65	-35	110	10	-25
14-Apr-09		112	53	181	69	320	60	129	-69	80	30	-39
15-Apr-09		109	53	209	-28	350	-30	-58	28	100	-20	8
16-Apr-09		108	53	234	-25	380	-30	-55	25	110	-10	15

Safex Equity Derivatives Market Statistics: SSFO on MTN SSF Expirery 18 Jun 2009					Seller				Buyer			
A	B	C	D	E	F	G	H	J	K	L	M	N
Date	Option trade premium	Futures Price	Vol	Closing Premium (MtM)	Premium variance	Initial margin	Variance on initial margin	Cash flows in/(out)	Premium variance	Initial margin	Variance on initial margin	Cash flows in/(out)
17-Apr-09		108	53	222	12	370	10	22	-12	110	-	-12
20-Apr-09		107	53	224	-2	380	-10	-12	2	110	-	2
21-Apr-09		103	53	298	-74	450	-70	-144	74	150	-40	34
23-Apr-09		105	53	246	52	410	40	92	-52	120	30	-22
24-Apr-09		112	53	141	105	300	110	215	-105	70	50	-55
28-Apr-09		116	53	86	55	220	80	135	-55	50	20	-35
29-Apr-09		114	53	100	-14	250	-30	-44	14	50	-	14
30-Apr-09		112	53	111	-11	270	-20	-31	11	60	-10	1
13-May-09		108	53	96	15	280	-10	5	-15	60	-	-15
21-May-09		119	53	10	86	90	190	276	-86	10	50	-36
28-May-09		120	53	3	7	50	40	47	-7	-	10	3

Safex Equity Derivatives Market Statistics: SSFO on MTN SSF Expirery 18 Jun 2009					Seller				Buyer			
A	B	C	D	E	F	G	H	J	K	L	M	N
Date	Option trade premium	Futures Price	Vol	Closing Premium (MtM)	Premium variance	Initial margin	Variance on initial margin	Cash flows in/(out)	Premium variance	Initial margin	Variance on initial margin	Cash flows in/(out)
29-May-09		116	53	5	-2	80	-30	-32	2	10	-10	-8
04-Jun-09		117	53	1	4	30	50	54	-4	-	10	6
15-Jun-09		123	53	-	1	-	30	31	-1	-	-	-1
17-Jun-09		119	53	-	-	-	-	-	-	-	-	-
18-Jun-09		118	53	-	-	-	-	-	-	-	-	-
19-Jun-09		-	-	-	-	-	-	-	-	-	-	-
Total profit/(loss)								**241**				**-241**
(Source: JSE, 2009a & 2009g; JSE Equity Options Brochure, n.d.:10)												

A COMPARATIVE STUDY OF THE TAXATION OF FUTURES AND INDEX OPTIONS

ANNEXURE B

DIAGRAM 1 ILLUSTATION OF THE INTERACTION OF THE RELEVANT SECTIONS EXTRACTED FROM THE DCL