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A study of the fiscal effects of financial discounting transuctions including zero coupon bonds in South Africa and the United Kingdom

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The problem is compounded by a comment by Centlivres CJ in Sub-Nigel Ltd v CIR.[14] He stated that a merchant should show in his accounts for the year prior to the commencement of his business the expenditure incurred during that year in purchasing his stock. That expenditure would be carried forward into the next year as an assessed loss and would not be deductible in the later year under the general deduction formula. These comments indicate a different approach to that adopted in practice.[16]

It is beyond the scope of this thesis to examine these anomalies in any further detail.[17] It is sufficient to note that where a bill, note or bond forms part of a person's trading stock, it will be brought into account at its cost price in the person's trading account. The opening stock, together with any acquisitions during the year of assessment, will be deductible. The closing stock held and not disposed of at the end of the year of assessment will be regarded as gross income.

The meaning of the words 'held and not disposed of' has not been determined by the courts. It would appear to cover the situation where a person has dominium in the stock even though he may have sold it under a contract of sale. Once delivery of the stock has been effected, ownership in it will have passed.[18]

Where a bill, note or bond is acquired during the year of assessment the value at which it is taken into account is its cost price. Section 22(3) and (5) of the

preceding year of assessment. However, where such trading stock did not form part of the trader's trading stock at the end of the immediately preceding year of assessment, then the amount which is taken into account is the cost price of the stock to the trader.[12]

Whilst s 22(1) and (2) contemplates that the values of opening and closing stock must be taken into account in the determination of taxable income, no indication is given as to how these amounts should be treated. These sub-sections do not provide for exceptional cases such as the disposal of trading stock other than by way of sale. If one applies normal accounting practice to s 22(1) and (2) then, in effect, stock on hand at the end of a year of assessment is treated as a receipt or accrual, and stock on hand at the beginning of the year of assessment is treated as a deduction.[13]

The theoretical basis of the acceptance of this practice as far as the Income Tax Act is concerned is by no means clear. Section 22(1) and (2) does not clarify the statutory position, and the practice which existed prior to its enactment has simply continued. Closing stock may only be deductible if it complies with the conditions set out in the general deduction formula. Opening stock may only be included in taxable income if it falls within the definition of gross income in s 1 of the Income Tax Act. In particular, there should be a receipt or accrual. The provisions of s 22 cannot be interpreted so as to override the basic provisions of the Income Tax Act affecting the deductibility of expenditure.[14]

Section 22(1) and (2) of the current Income Tax Act was incorporated into the Income Tax Act 31 of 1941 by s 6(*f*) of Act 55 of 1956. Prior to this the Income Tax Act did not make provision for bringing into account the opening and closing stocks in a trader's trading account. Nor did the Income Tax Act indicate the values at which such stock should be brought into account."

Section 22(1) specifies the amount which is taken into account in respect of the value of trading stock held and not disposed of by a trader at the end of a year of assessment.[9] The amount which is taken into account is the cost price to the trader of the trading stock. Where the trading stock consists of stock other than shares held by a company in any other company, the amount which is taken into account may be reduced by the amount by which the value of the trading stock has been diminished by reason of damage, deterioration, change in fashion, decrease in the market value or for any other reason satisfactory to the Commissioner.[10]

Section 22(2) specifies the amount which is taken into account in respect of the value of any trading stock held and not disposed of by a trader at the beginning of a year of assessment.[11]

Where trading stock formed part of the trader's stock at the end of the immediately preceding year of assessment, then the amount which is to be taken into account is the amount which was taken into account at the end of such

The second part of the definition relates to anything which either is being disposed of or which will be disposed of in the future. The first category thus covers things held at the beginning of the year of assessment and disposed of during that year. The second category covers things held throughout the year of assessment and which will thereafter be disposed of by the taxpayer [4]

The definition of trading stock is exhaustive even though it is prefaced by the word 'includes'. The second part of the definition is sufficiently widely worded so as to include a bill, note or bond which is not covered by the first part of the definition but which is held as trading stock for resale at a profit [5]. It should be noted that s 22 applies to stock held and not disposed of by the trader. It may well be that a trader may be regarded as holding stock even though it has not actually come into his place of business.[6]

The question which arises for consideration is whether a claim against a third party, which is what a note is, can form part of a person's trading stock. Cases such as Salisbury Board of Executors[7] deal with a different situation. It is submitted that the definition of trading stock is sufficiently wide so as to include claims against third parties and, in the circumstances, there is no reason not to include such claims as trading stock where appropriate.

one of loan It was, however, of importance where a bill, note or bond was acquired for resale, as the transaction is one of purchase and sale It will be seen that, whilst on the face of it, the effect of s 24J(9) is that s 22 can apply in both of these situations, in fact s 22 will only have application in the trading situation The reason for this is that s 22 is only applicable in a trading situation and applies to trading stock

Section 22 applies to trading stock Trading stock is defined as including anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for certain purposes The purposes cover manufacture, sale or exchange by the taxpayer or on his behalf Trading stock also includes the proceeds from the disposal of which forms or will form part of the taxpayer's gross income [2]

The definition falls into two parts First, anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for manufacture, sale or exchange by him or on his behalf Second, anything the proceeds from the disposal of which forms or will form part of his gross income [3]

The first part of the definition of trading stock will apply where a bill, note or bond is purchased by a taxpayer for the purpose of resale by him The second part of the definition will apply where a bill, note or bond is not purchased for resale but which subsequently becomes trading stock

9.1 INTRODUCTION

In this chapter there is a discussion of the provisions in the Income Tax Act dealing with trading stock insofar as they relate to the taxation of deep discount bonds. Section 22 of the Income Tax Act covers the taxation of trading stock. Section 24J of the Income Tax Act covers the taxation of instruments such as deep discount bonds. It contains provisions which affect the taxation of such instruments from the point of view of the trader such as a financial institution.

Whilst it is beyond the scope of this thesis to examine the provisions of s 22 of the Income Tax Act in detail, it is necessary briefly to consider the impact, if any, that s 22 has on the conclusions reached in respect of the general deduction formula.[1] In addition, there is a discussion of the provisions of s 24J insofar as they affect trading transactions involving financial instruments such as deep discount bonds.

9.2 SECTION 22

Section 22 of the Income Tax Act deals with trading stock. Prior to s 24J taking effect, s 22 was not relevant when considering the situation of a person issuing a bill, note or bond at a discount on its face value as this transaction is

248 at 394

249 D Davis & D Meyerowitz 'Reflections of the Ladysmith Case' (1996) 46 The Taxpayer 23

250 Randles Brothers at 396

251 Ladysmith at 243

252 at 240-3

253 See Davis & Meyerowitz at 26

254 Randles Brothers at 395-6, Davis & Meyerowitz at 24-6

233 at 193 and 196

234 at 193-4

235 at 194

236 ibid.

237 at 196-9

238 at 199

239 1996 (3) SA 942 (A). (1996) 58 SATC 229

240 at 234-6

241 at 236

242 at 237-40 and 242-3. The court referred to two principles. The first was expounded in Westminster to the effect that parties are entitled to arrange their affairs so as to remain outside the provisions of a particular statute. This was a general principle recognized in a number of South African cases such as Dadoo Ltd and others v Krugersdorp Municipal Council 1920 AD 530. The second was that applied in a number of South African cases, such as Kilburn v Estate Kilburn 1931 AD 501, in which the substance of a transaction is applied over its form.

243 at 241-3

244 1910 AD 302.

245 1941 AD 369.

246 1910 AD 302

247 Randles Brothers at 369

210 (1966) 28 SATC 1

211 at 1-2

212 at 3

213 at 1-7

214 at 4-5.

215 at 6

216 at 7.

217 See De Beers Holdings (Pty) Ltd v CIR (1986) 47 SATC 229 at 259

218 (1983) 45 SATC 241

219 at 254.

220 at 254 and 260.

221 at 263.

222 (1986) 47 SATC 229

223 at 247-50.

224 at 260

225 ibid.

226 (1989) 51 SATC 183

227 at 192.

228 at 195.

229 (1993) 55 SATC 185.

230 at 190

231 at 190-1.

232 at 192

192 V Shrubsall 'Case Notes. Ensign Tankers (Leasing) Ltd v Stokes' 1992 BTR 279 at 279-82.

193 Shrubsall at 283. The other cases mentioned by Lord Templeman were Religious Tract & Book Society of Scotland v Forbes 3 TC 415, Iswera v IRC (1965) 1 WLR 663, Simmons v IRC (1980) 1 WLR 1196, Coates (Inspector of Taxes) v Arndale Properties Ltd, Overseas Containers (Finance) Ltd v Stoker 1989 STC 364.

194 Shrubsall at 284

195 (1956) 20 SATC 390.

196 at 397-401

197 at 400-1.

198 (1962) 24 SATC 680.

199 40 TC 281.

200 8 TC 704.

201 Umtali Finance (Pty) Ltd v COT at 687-8.

202 at 690.

203 at 691.

204 CIR v Nemojim (Pty) Ltd (1983) 45 SATC 241 at 264

205 at 263.

206 (1962) 24 SATC 756.

207 at 757 and 759-60

208 at 759 and 763

209 at 761-2

169 Ashton at 489-90.

170 (1988) 3 All ER 495 (HL)

171 at 501.

172 at 501-2.

173 at 502.

174 at 542-4.

175 at 498-503, 513-30 and 535-44.

176 at 503-13 and 530-5.

177 at 516-23.

178 at 523.

179 at 523-4.

180 at 527.

181 Ashton at 497-8

182 Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) at 275-81

183 at 278-99.

184 at 278-94.

185 at 285

186 at 287.

187 at 288.

188 at 291

189 at 292.

190 at 294.

191 at 298-9

153 Furniss (Inspector of Taxes) v Dawson at 541. See also Monroe at 210-11

154 Furniss (Inspector of Taxes) v Dawson at 531-44

155 See R T Bartlett 'The Constitutionality of the Ramsay Principle' 1985 BTR 338 at 348-52.

156 Furniss (Inspector of Taxes) v Dawson at 532. See also the statement of Lord Keith in Craven (Inspector of Taxes) v White (1988) 3 All ER 495 (HL) at 479 on the principle enunciated in Ramsay, Burmah and Dawson.

157 1984 STC 637.

158 1985 STC 124.

159 Coates (Inspector of Taxes) v Arndale Properties Ltd at 638-9

160 Reed (Inspector of Taxes) v Nova Securities Ltd at 126-9

161 Coates (Inspector of Taxes) v Arndale Properties Ltd at 640-2.

162 See G MacDonald 'Current Notes. Coates v Arndale Properties Ltd. and Reed v Nova Securities Ltd. - En Route from Ramsay ' 1985 BTR 333 at 333-5

163 Reed (Inspector of Taxes) v Nova Securities Ltd at 126-32

164 See MacDonald at 333-5

165 Reed (Inspector of Taxes) v Nova Securities Ltd at 126-32

166 See MacDonald at 336-7.

167 See at 487.

168 1987 STC 217

FOOTNOTES

1 For a more detailed discussion, see B Hopkins A Study of the Provisions of Section 22 of the Income Tax Act - Excluding any Reference to Shareholders unpublished report presented to the Department of Accounting, University of Cape Town in partial fulfilment of the requirements for the Bachelor of Commerce (Honours) Degree (1975), G Muller Selected Benefits and Problems of Valuing Stock in South Africa unpublished essay presented to the Department of Accounting, University of Cape Town in partial fulfilment of the requirements for the Bachelor of Commerce (Honours) Degree (1980); 'Opening and Closing Stock in Trade' (1955) 4 The Taxpayer 21, 'Practice Note No 3, 2 September 1985 Income Tax: Valuation of Trading Stock with Special Reference to the Treatment of Overhead Excess and LIFO Reserves' (1985) 34 The Taxpayer 184; (1985) 34 The Taxpayer 227; 'Change of Intention: Value of Trading Stock' (1981) 30 The Taxpayer 99, 'Capital Becomes Income' (1975) 24 The Taxpayer 181, 'Valuation of Trading Stock' (1985) 24 ITR 270, 'Trading Stock' (1987) 26 ITR 43

2 See s 1 of the Income Tax Act 58 of 1962 s v 'trading stock'

bonds are particularly volatile. Fourth, if a non-trader issues a bond to a trader to which s 24J(9) applies, there is the situation where the issuer will be entitled to deduct the annual deemed expenditure on an ongoing basis. The trader will only be taxable on the sale or redemption of the instrument except in respect of price fluctuations at values below the cost to the trader of the instrument.

Section 24J provides that a company, whose business consists of dealing in instruments, may elect that the general provisions contained in s 24J(2) to (8) shall not apply to all such instruments. Section 24J(9) stipulates how a trader may elect this option and the rules relating thereto. The effect of an election under s 24J(9) is that the trader will apply a market value basis of valuing trading stock and will account for such stock, for income tax purposes, in terms of s 22.

The main points arising from these provisions are, first, that the election under s 24J(9) may only be made by companies. With respect, this restriction is open to criticism as there is no reason why individuals and other non-corporate taxpayers such as trusts should not also have this option. Second, the effect of adopting the market basis of valuing stock is that the trader will not be taxable on any increase in the value of the stock prior to its sale or redemption. If the market value of the stock decreases to a value below its cost, such decline will have the effect of reducing the trader's taxable income by such amount. If the stock subsequently increases in value, then to the extent that it appreciates in value to that of its cost to the trader, such increase will have the effect of increasing the trader's taxable income. Third, as economic conditions change, the yields to maturity and therefore the prices of bonds fluctuate. There are three main factors that affect the volatility of bonds. These are the coupon rate, the maturity date and the initial yield to maturity. An examination of the reasons for the fluctuations indicates that prices of long-term zero coupon

purposes. The trader will only be taxable on the increase in the value of the instrument on its sale or redemption

9.4 CONCLUSION

Section 22 of the Income Tax Act covers the tax treatment of trading stock Section 22 applies, inter alia, where a financial instrument is purchased for resale and where an instrument is not purchased for resale but subsequently becomes trading stock. Section 22(1) stipulates that the trader must account for stock held and not disposed of at the end of the year of assessment at the lower of cost or market value. Section 22(2) stipulates how a trader should account for stock held and not disposed of at the beginning of the year of assessment. Where the stock formed part of the trader's trading stock at the end of the immediately preceding year of assessment, the amount which is to be taken into account is the amount which was taken into account at the end of such preceding year of assessment. However, where such trading stock did not form part of the trader's trading stock at the end of the immediately preceding year of assessment, the amount which is taken into account is the cost price of the stock to the trader. Stock on hand at the end of a year of assessment is treated as a receipt or accrual, and stock on hand at the beginning of the year of assessment is treated as a deduction

initial yield to maturity of a bond. If the yield increases from 2 to 3% per annum, the price of a zero coupon bond will reduce by 17.7%. If the yield increases from 8 to 12% per annum, the price of a zero coupon bond will decrease by 51.7%.[35]

It is therefore clear that there are a number of factors that can affect the market price of bonds, particularly zero coupon bonds. From an income tax point of view, a financial trader is in an advantageous position if it is accounting for the instruments on a market value basis as it will not be required to account for deemed interest income in respect of the discount element of the instruments in terms of s 24J(1) to (8). Where the market value of the instruments held as trading stock declines to a value less than the cost thereof to the trader, the trader will be entitled to reduce the value of its stock for the purposes of s 22. If the market value of the stock increases, such increases will be included in the trader's income to the extent that the value of the stock increases to the value equivalent to the cost of the stock to the trader.

In effect, therefore, the trader taxable on the market value basis will generally be taxable on the instruments which are held as trading stock when the instruments are sold or redeemed. Where a non-trader issues a bond at a discount on its face value and it is acquired by the trader as trading stock, the issuer will be entitled to deduct the annual accruals from its income for tax

The coupon rate of a bond is the interest rate payable on the face value of the instrument. If the coupon rate is lower, the greater will be the change in the price of the bond for a given change in the yield to maturity. For example, assume a bond has a yield to maturity of 6% per annum and that interest rates change so that the market requires a yield of 9% per annum. If the coupon rate on the bond is 12%, the price of the bond will drop by 24.5%. On the other hand, if the coupon rate is 0%, the price of the bond will drop by 42.8%. It is therefore clear that the higher the coupon rate on a bond, the less the price of the bond will fluctuate with changes in interest rates. Conversely, zero coupon bonds will be much more price volatile than high interest coupon bonds when interest rates fluctuate.[13]

Where there is a given change in the yield to maturity of a bond, this will have a progressively greater affect on the price of the bond the greater the period to maturity of the bond. For example, if the yield to maturity of a zero coupon bond increases from 6% per annum to 9% per annum, the price of the bond will vary depending on the period to maturity of the bond. If there are five years to the maturity of the bond, the price of the bond will reduce by 13%. If the bond will only mature after 30 years, the price of the bond will reduce by 56.7%.[14]

Where the initial yield of a bond either increases or decreases by a fixed percentage, there is a correlation between the initial yield and the percentage change in the price of the bond. For example, assume a 50% increase in the

The market value of a deep discount bond is determined by using the formula to determine compound interest. Thus, the following formula is used:

$$S = P(1 + i)^n$$

In this formula S is the redemption amount, n is the number of periods (normally years) to maturity, i is the rate of compound interest (normally annual) and P is the present value of the bond. For example, assume that i, the annual interest rate, is 4%, the period, n, is ten years and that the P, the present value, is R1 000.[41]

The redemption amount would be determined as follows.

$$S = P(1+i)^n$$

$$S = 1000(1 + 0.04)^{10}$$

$$S = 1000(1.04)^{10}$$

$$S = 1480.244$$

Whilst it is beyond the scope of this thesis to examine the mathematical determination of the pricing and yield of a bond, it is interesting to note some of the factors affecting the price volatility of bonds. As economic conditions change, the yields to maturity and therefore the prices of bonds fluctuate. There are three main factors that affect the volatility of bonds. These are the coupon rate, the maturity date and the initial yield to maturity.[42]

submitted that the same situation should apply to s 24J(9) Alternatively, it is submitted that s 24J should only apply to companies Another option would be to follow the approach adopted in the recent changes to the legislation affecting financial instruments in the United Kingdom where it applies to individuals with transactions above a certain financial limit.

The next point to note is that where a trader in financial instruments is granted approval to adopt the market basis of valuing its trading stock, it will account for the stock for income tax purposes in terms of s 22 The effect of this is that the instruments will be brought to account for tax purposes at their cost when purchased. Thereafter, they will be accounted for at the lower of cost or market value Thus, if the market value of an instrument falls after acquisition, this will have the effect of reducing the trader's taxable income If, in a subsequent year of assessment, the market value of the instrument increases, the trader's taxable income will increase to the extent that the market value increases to a value equivalent to the trader's cost of the instrument. If the market value of the instrument increases to a value greater than its cost to the trader, this will not, per se, result in an increase in the trader's taxable income The reason for this is that, for the purposes of s 22, the trader will account for it at the lower of cost or market value Thus, if the market value is higher than the cost, the trader will elect to account for it at its cost

to have been withdrawn by the Commissioner with effect from such year of assessment In these circumstances, an appropriate adjustment must be made to the company's taxable income during such year of assessment. The adjustment relates to all the instruments held by the company which are valued on the market basis of valuation and which are held and not disposed of or redeemed by the company at the end of such year of assessment The adjustment applies to all interest which would have been deemed to have been incurred or accrued to the company had it never applied the market basis of valuation to its instruments. Account must be taken of all amounts which have been included in or deducted from the company's income during such years of assessment. However, these provisions shall not have the effect that an amount is included in or deducted from the company's income more that once [28]

There are two matters which must be borne in mind when considering s 24J(9) The first is that any references to payments or consideration include payments or consideration other than in cash.[29] The second matter is that any decision by the Commissioner in the exercise of his discretion is subject to objection and appeal [30]

In considering the effect of the application of s 24J to trading stock, the first point to note is that s 24J(9) only applies to companies With respect, there is no basis for limiting the application of this section only to companies The other sections in s 24J apply to individuals as well as companies and, it is

the year of assessment in which it takes place, and all succeeding years of assessment.[24]

The market value in relation to which a company has made an election is determined in accordance with commercially accepted practice. This basis of valuation must be applied by the company consistently in respect of all such instruments for financial reporting purposes to the company's shareholders.[25] Where a company has made an election for an instrument to be valued on a market basis, that basis will continue to apply in respect of that instrument until the date of its transfer or redemption.[26]

Where the Commissioner is satisfied that the approval which he granted for a company to apply the market basis of valuing its instruments was obtained by the company by fraud or as a result of a misrepresentation or failure to disclose a material fact by the company, he must withdraw his approval. His withdrawal of approval must only be made if he is satisfied that in the light of the full facts the approval should not have been granted by him. The withdrawal of the Commissioner's approval applies with effect from the date of the granting of such approval.[27]

Where a company no longer complies with the requirements of s 24J(9) dealing with the approval for the company to use the market basis of valuation in respect of its instruments, the approval granted by the Commissioner is deemed

Section 22 provides a means for bringing into account negotiable instruments originally acquired for capital investment purposes but which were, subsequent to acquisition, converted into trading stock. In addition, it provides an equitable means for accounting for negotiable instruments acquired for no consideration. An application of s 22 has the effect of only permitting the deduction of the cost of acquisition of trading stock in the year of assessment in which the stock is sold.

9.3 SECTION 24J

Section 24J provides that a company, whose business consists of dealing in instruments, may elect that the general provisions contained in s 24J(2) to (8) shall not apply to all such instruments. This provision only applies to companies and includes companies that deal in short selling of instruments.[23]

The election by the company must be made in writing and should be accompanied by a statement. This statement must set out full details of the methodology which it will apply to determine the market value of the instruments. The election will not take effect until the Commissioner has approved, first, the methodology that the company will apply to determine these market values, and, second, the manner in which such market value will be taken into account in determining the company's taxable income during any year of assessment. The election will be binding on the company in respect of

Income Tax Act contains provisions dealing with the cost of trading stock. These provisions are not of relevance to trading stock which consists of bills, notes or bonds as it is understood that it is the practice to bring such instruments into account at their actual cost.

Section 22(4) provides that where trading stock has been acquired for no consideration or for a consideration which is not measurable in terms of money, it is deemed to have been acquired at a cost equal to its current market value.[19] The practice of Inland Revenue is to permit as a deduction the fair market value of trading stock acquired for no consideration or for a consideration which is not measurable in money. The date at which the stock is valued is the date of its acquisition.[20] It should be noted that this section does not cover stock acquired for inadequate consideration.

In considering the impact of s 22 on the deductibility of the cost of a bill, note or bond, it should be appreciated that the accounting methods which are implied in s 22 may be adopted in exceptional circumstances. The provisions of s 22 cannot be interpreted so as to override the provisions of the general deduction formula.[21] In addition, the fact that s 22 does not apply in respect of a bill, note or bond does not preclude an enquiry as to whether the general deduction formula is applicable.[22]

provision for granting relief to a company issuing a deep gain security This can make it unattractive to issue a bond with an uncertain redemption value, such as a limited price index bond This type of bond offers investors inflation-proofing up to a maximum limit Issuers will receive no deduction for the inflation-proofing element in the return [15]

10.5 CONVERTIBLE SECURITIES

Where a company issues a convertible security after 8 June 1989, the discount element is chargeable to tax when it is transferred or redeemed prior to maturity [16] A convertible security falls within these provisions if it is quoted on a recognized stock exchange, gives the holder a single option for early redemption, contains a right for its commission into equity shares in the issuing company and would, but for these provisions, be a deep discount security or a deep gain security [17]

If the holder of a qualifying convertible security exercises his option of redemption prior to maturity he will be chargeable to tax on all or part of the proceeds [18]

group of companies[39] or where a close company has issued a security which is at any time beneficially owned by a participator in a company, an associate of a participator or a company controlled by a participator [40]

No deduction may be claimed where the sole or main benefit that might be expected to accrue to the company from the issue of the security is the obtaining of a reduction in tax liability by means of that deduction [41]

Where a deep discount security is redeemed before the redemption date by the issuing company, the deduction allowed at redemption is the amount paid by the company on redemption less the aggregate of the issue price and any accrued income.[42] Where the issue price of the security together with any accrued income exceeds the amount paid by the company on redemption, such excess is chargeable to tax under schedule D case VI in the accounting period in which the security is redeemed [43]

10.4 DEEP GAIN SECURITIES

Where the amount payable on the redemption of a deep gain security could constitute a deep gain, such gain is chargeable to tax on the disposal or redemption of the security [44] There is, however, no

10.3 DEEP DISCOUNT SECURITIES

A discount is deductible only if the expenditure was incurred wholly and exclusively for the purposes of trade. Where a company has issued a deep discount security, the income element in respect of that security, for any income period ending during or at the end of that accounting period, is allowed as a deduction for corporation tax purposes.[25]

In order to obtain the deduction the company must ultimately bear the discount payable on redemption; the income element should not otherwise be deductible; it must exist wholly or mainly for the purpose of carrying on a trade; the security must be issued wholly and exclusively to raise money for purposes of a trade carried on by it; and it must be an investment company.[26]

The company issuing a deep discount security may not claim a deduction where, on redemption of the security, any part of the amount payable is treated as a distribution of the company for the purposes of s 209(2)(*d*) and (*e*) of the Income and Corporation Taxes Act of 1988.[27] In this situation, the deduction may only be made when the security is redeemed. Similar provisions apply where the issuing company is beneficially owned by an associated company[28] or a fellow member of a

In 1984 legislation was introduced which provided relief to two types of companies adversely affected by the general rule.[22] Relief was given to an investment company which issues a bill of exchange at a discount on its fact value and a trading company which raises funds by issuing a bill at a discount on its face value and utilizes the funds for capital expenditure. The amendments apply to bills of exchange that are payable on or after 1 April 1983

The amendment provides that discount expenditure is deductible from profits as a charge on income. The deduction may be made in the period in which the bill is paid. Thus, the expenditure is not deductible on the accrual basis over the period that the bill is in existence. It is only deductible on a cash basis when the bill is paid.[23]

The deduction may be made only if four conditions are met. First, the bill must be drawn by a company on a United Kingdom bank and it must be discounted by a United Kingdom bank or discount house. Second, the discount should not be charged to capital. Third, the bill should be held to redemption and the discount should be borne by the company. The final condition is that the company must exist wholly or mainly to carry on trade, its funds must be utilized wholly and exclusively for the purposes of trade, or the company is an investment company.[24]

existence an asset or advantage for the enduring benefit of a trade, it was of a capital nature.[16] In Tucker v Granada Motorway Services Ltd[17] the approach adopted was to ascertain the asset on which the money was expended. Where the asset is a capital asset, the cost of acquiring it will be of a capital nature, whereas expenditure incurred in maintaining it will be of a revenue nature.

These requirements for the deduction of expenditure make it clear that discounting expenditure is deductible where it is of a revenue nature and is wholly and exclusively laid out or expended for the purposes of trade. In these circumstances the deduction is given on the accrual basis.[18] It is thus spread over the period of the instrument. However, in applying the general rule, a non-trading company will not be able to claim the deduction.[19] Thus, a holding company or an investment company will not be able to deduct discounting expenditure.[20] In addition, a trading company will not be able to deduct discounting expenses where the monies raised from the issue are not used for a trading purpose. The effect of this is that where the monies raised are used to acquire a subsidiary company or where the funds are capitalized, the discounting expenses relating to it will not be deductible in terms of the general rule.[21]

word has provided a certain amount of clarity. Thus, where a person does something which is capable of producing a profit and his intention is to make a profit, he is carrying on a trade.[9] It has been held that trade denotes operations of a commercial character where goods or services are provided for reward.[10] Expenditure incurred as part of a tax avoidance scheme will not have been incurred for the purpose of a trade.[11] It is beyond the scope of this thesis to examine the meaning of trade further.[12] It should, however, be noted that there are a number of factors which are taken into account in determining the meaning of the word trade. These include the subject-matter of the realization, the length or period of ownership of the asset, the frequency or number of similar transaction, supplementary work relating to the property realized, the circumstances of realization and motive.[13]

The discounting expenditure incurred by A is not deductible if it is of a capital nature.[14] Two tests were used in earlier cases. The first drew a distinction between fixed and circulating capital. Fixed capital takes the form of assets, such as shares or machinery, which produce income. Circulating capital constitutes capital which is circulated in the business in order to produce a profit. An example would be money which is used to acquire trading stock.[15] The second test was the enduring benefit test. Where expenditure was made not once and for all but in order bring into

the purpose was to further the trade carried on by A, he will have satisfied the purpose requirement. In certain cases, the determination of the purpose test will involve a subjective enquiry. Thus extraneous evidence, such as minutes of meetings, will assist in substantiating A's evidence as to his intent.[3] The fact that discounting expenditure may be incurred to earn future profits should not affect the claim for its deduction.[4]

The discount expenditure must have been wholly and exclusively incurred for the purposes of A's trade. There is, therefore, a requirement that the expenditure is incurred only for a trading purpose and not also for a non-trading purpose.[5] If the expenditure is incurred for a purpose which does not relate to the taxpayer's trade, the expenditure will not be deductible. The enquiry is, however, a factual one.[6] Where expenditure is incurred for both a trading and a non-trading purpose, a portion of the expenditure may be deductible where the portion relating to the trading purpose is divisible from the rest of the expenditure and it clearly relates to that purpose.[7]

Trade is defined as including every trade, manufacture, adventure or concern in the nature of trade.[8] This definition does not give a clear indication as to the meaning of trade. Case law on the meaning of the

10.2 STRAIGHT DEBT INSTRUMENTS

The term straight debt instrument is used in this section to indicate the issue of a bill, note or bond at a discount on its face value. It does not include deep discount securities, deep gains securities and convertible securities which are discussed in subsequent sections in this chapter.

Assume A issues a post-dated promissory note to B at a discount on its face value. The questions which arise are whether A may claim the discount as a deduction in the calculation of his taxable profits and, if so, at what stage.

The general rule is that, in computing the profits or gains chargeable under schedule D case I, a discount for short-term finance will only be deductible if it is wholly and exclusively laid out or expended for the purposes of the trade.[1] Whilst it is beyond the scope of this thesis to examine this rule in detail, the effect of this rule on the deductibility of a discount by A must be noted.

The discount expenditure must have been incurred for the purposes of A's trade in order for it to be deductible. This is a factual enquiry, and one must ascertain the object or purpose of the discount expenditure.[2] If

10 DEDUCTIBILITY IN THE UNITED KINGDOM

10.1 INTRODUCTION

In chapter 6 there was a detailed discussion on the taxation of discounting profits in the United Kingdom. The types of discounting transactions considered in that chapter were, first, the issue of a post-dated bill, note or bond at a discount on its face value, and second, where a person acquires a bill, note or bond at a discount on its face value and subsequently sells or redeems it at a profit.

In this chapter, the type of transaction considered is where a post-dated bill, note or bond is issued at a discount on its face value. The position is examined from the point of view of the issuer of the instrument.

There is an examination of the tax position of the issuer of a bill, note or bond. It is beyond the scope of this thesis to examine the general principles relating to the tax position of the issuer of the instrument. The position in respect of other types of financial securities is considered such as deep discount securities, deep gains securities and convertible securities. Finally, there is a brief discussion of the recent changes to the law relating to the taxation of financial instruments.

30 s 24J(11).

31 L R Rosen Investing in Zero Coupon Bonds (1986) at 9-16, S Homer & M Leibowitz Inside the Yield Book (1972) at 21-30 and 111-88

32 Rosen at 26-7, Homer & Leibowitz at 43-56.

33 Rosen at 28-30, Homer & Leibowitz at 49-51

34 Rosen at 28-9, Homer & Leibowitz at 44.

35 Rosen at 30-2, Homer & Leibowitz at 43-56

16 Sub-Nigel Ltd v CIR at 589-91.

17 See Hopkins, (1955) 4 The Taxpayer 21

18 See A S Silke, C Divaris & M L Stein Silke on South African Income Tax 10ed (1982) at para 8 111

19 The market value is that which in the opinion of the Commissioner was the current market price of the trading stock on the date on which it was acquired by the taxpayer.

20 See Silke, Divaris & Stein at para 8.113.

21 See CIR v Nemojim (Pty) Ltd at 265.

22 See De Beers Holdings (Pty) Ltd v CIR (1986) 47 SATC 229

23 s 24J(9)(a)

24 s 24J(9)(*b*).

25 s 24J(9)(*c*).

26 s 24J(9)(*d*).

27 s 24J(9)(*e*).

28 s 24J(9)(*f*).

29 s 24J(10)

3 De Beers Holdings (Pty) Ltd v CIR (1986) 47 SATC 229 at 255-6

4 at 256.

5 ibid For a discussion of the meaning of trading stock prior to the introduction of s 22, see R v McKenzie 1938 TPD 469 at 471

6 See R v McKenzie at 471.

7 (1941) 12 SATC 1

8 CIR v Nemojim (Pty) Ltd (1983) 45 SATC 241 at 265.

9 This applies in determining the taxable income derived by a person during a year of assessment from carrying on a trade other than farming.

10 The diminution in the amount must be in an amount that the Commissioner thinks just and reasonable.

11 This applies in the determination of the taxable income derived by a person from the carrying on of a trade other than farming.

12 CIR v Nemojim (Pty) Ltd at 265-6

13 ibid.

14 ibid. See also Gerber v CIR (1989) 51 SATC 187 at 194

15 (1948) 15 SATC 381

such expenditure where the funds raised were used for a non-trading purpose. In 1984 this position was changed to a certain extent. Relief was given to an investment company issuing a bill at a discount. In addition, relief was given to a trading company issuing a bill at a discount and using the funds raised for capital expenditure. In terms of the relief given, discount expenditure was deductible from profits and the deduction was allowed in the period in which the bill was paid. A number of conditions had to be satisfied. The most important of these was that the bill must have been drawn by a company on a United Kingdom bank and it must have been discounted by a United Kingdom bank or discount house.

In 1984 specific legislation was introduced covering the taxation of deep discount securities. Where a company had issued a deep discount security, the income element of it was deductible for corporation tax purposes in the relevant income period. However, in order to obtain the deduction, the company must have complied with certain stipulated conditions. Where a deep discount security was redeemed by the issuing company, the deduction allowed at redemption was the amount paid by the company at redemption less the aggregate of the issue price and any accrued income. If the issue price together with the accrued income

to the percentage movement in the retail price index between the two times.[91] A security will be an excluded index-linked security if the amount payable on redemption is linked to the value of chargeable assets. An amount will be linked to the value of chargeable assets if it is equal to an amount determined by applying a relevant percentage change in the value of the assets to the amount for which the security was issued. The relevant percentage change in the value of the chargeable assets refers to the percentage change in the value of the assets or in any index of the value of such assets over the relevant period. The relevant period is either the period between the issue of the security and its redemption or any other period in which that period is comprised. In the latter case, the period will differ from the first period for purposes of giving effect to a valuation in relation to rights and liabilities under the security.[92]

Where a gilt-edged security is exchanged by a person for strips of that security, there will be two consequences. First, the security will be deemed to have been redeemed at the time of the exchange. The redemption will be deemed to have taken place at its market value. At the same time the person will be deemed to have acquired each strip. He will be deemed to have acquired each strip for the amount which bears the same proportion to the market value as is borne by the market value of the strip to the market values of all the strips exchanged for the security.[93] Conversely, there will be

Incorporated Council of Law Reporting for England and Wales 6 TC 477, J P Hancock v General Reversionary & Investment [illegible] 7 TC 358, Rowntree & Co Ltd v Curtis (HM Inspector of Taxes) 8 TC 678, B W Noble Ltd v Mitchell (HM Inspector of Taxes) 11 TC 372, Anglo-Persian Oil Co Ltd v Dale (HM Inspector of Taxes) 16 TC 253, Associated Portland Cement Manufacturers Ltd v Kerr (HM Inspector of Taxes) 27 TC 103, Cooke (HM Inspector of Taxes) v Quick Shoe Repair Service 30 TC 460

6 Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes) 33 TC 491

7 Lochgelly Iron & Coal Co Ltd v IRC 6 TC 267

8 s 83(2)(*f*) of the Income and Corporation Taxes Act of 1988

9 Ericksen v Last 4 TC 422

10 IRC v Livingston 11 TC 538 at 542, Ryall v Hoare 8 TC 521

11 Ransom (Inspector of Taxes) v Higgs 50 TC 1

12 For a full discussion on the meaning of trade, see Simon's Taxes 3 ed (1983) at para B3 2

13 Simon's Taxes at para B3 212

Brewery Co Ltd 5 TC 568, Usher's Wiltshire Brewery Ltd v Bruce 1915 AC 433, Union Cold Storage Co Ltd v Jones (HM Inspector of Taxes) 8 TC 725, IRC v The Scottish Central Electric Power Co 15 TC 761, Southern (HM Inspector of Taxes) v Borax Consolidated Ltd 23 TC 597, Marshall Richards Machine Co Ltd v Jewitt (HM Inspector of Taxes) 36 TC 511. There is a group of cases that applied the principles laid down in Strong & Co of Romsey Ltd v Woodifield (Surveyor of Taxes) 5 TC 215. These cases include IRC v E C Warnes & Co Ltd 12 TC 227, IRC v Alexander von Glehn & Co Ltd 12 TC 232, Smith's Potato Estates Ltd v Bolland (HM Inspector of Taxes) and Smith's Potato Crisps (1929) Ltd v CIR 30 TC 267, Atherton (HM Inspector of Taxes) v British Insulated & Helsby Cables Ltd 10 TC 155, Rushden Heel Co Ltd v Keene (HM Inspector of Taxes) and Rushden Heel Co Ltd v IRC 30 TC 298 IRC v Dowdall O'Mahoney & Co Ltd 33 TC 259, Morgan (HM Inspector of Taxes) v Tate & Lyle Ltd, Boarland (Inspector of Taxes) v Kramat Pulai Ltd, IRC v Kramat Pulai Ltd, IRC v Southern Malayan Tin Dredging Ltd, IRC v Malayan Tin Dredging Ltd 1953 ChD 601, IRC v Carron Co 45 TC 18. A third group of cases dealing with trade covers the deductibility of various types of lump-sum payments. These cases include Valiambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes) 5 TC 529, Ounsworth (Surveyor of Taxes) v Vickers Ltd 6 TC 671, J W Smith (Surveyor of Taxes) v The

FOOTNOTES

1 s 74(*a*) of the Income and Corporation Taxes Act of 1988 See also, The Tax Treatment of Capital Market Instruments Worldwide (September 1987) at 4.

2 Strong & Co of Romsey Ltd v Woodifield (Surveyor of Taxes) 5 TC 215; Robinson (HM Inspector of Taxes) v Scott Bader Co Ltd 1981 STC 436

3 Watney Combe Reid & Co Ltd v Pike (Inspector of Taxes) 1982 STC 733

4 Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes) 5 TC 529

5 Mallalieu v Drummond (Inspector of Taxes) (1983) 2 All ER 1095 (HL) It is beyond the scope of this thesis to examine the meaning of 'purposes of trade' There are a number of cases that have considered this issue See, for example, the United Kingdom cases discussed in chapter 8 In addition there are other cases that have dealt with this ' ue Cases involving brewing companies include Brickwood & Co v Reynolds (Surveyor of Taxes) 3 TC 600, Smith (Surveyor of Taxes) v Lion

The legislation was complex and inhibited the development of the financial markets Thus, in 1995 Inland Revenue issued a consultative document and a press release relating to tax reform in respect of gilts and bonds These proposed reforms have now been incorporated into new legislation In terms of the new rules, companies issuing bonds are entitled to deduct interest and discounts on an accruals basis Thus, companies must compute the interest and discount which has accrued during the period in question and this amount is deductible in calculating the company's profit or loss for tax purposes Price indexed bonds will be treated in the same way as ordinary bonds Thus, issuers are entitled to deduct the full amount of their costs The United Kingdom approach is similar to that adopted in s 24J in South Africa in that interest and discounting expenses are deductible on an accruals basis

exceeded the amounts paid by the company on redemption, such excess was chargeable to tax as non-trading income

Legislation was introduced in 1989 to deal with the taxation of deep gains securities However, from the point of view of the company issuing the securities, there was no provision for granting relief to such a company when it issued a deep gain security

In 1990 legislation was introduced dealing with the taxation of convertible securities The securities that were affected were those issued after 8 June 1989 A convertible security qualified for these provisions if it was quoted on a listed exchange, gave the holder a single option for early redemption, obtained a conversion right in respect of equity shares in the issuing company and would, but for these provisions, have constituted either a deep discount or a gains security Where the holder exercised his option of early redemption, the issuing company could have deducted the excess of the amount paid on redemption over the issue price in the computation of its corporation tax liability The deduction was allowed for the accounting period in which the redemption took place It should, however, be noted that no deduction was allowed when redemption took place on maturity or where the security was converted to shares

provisions covering the situation where strips of a gilt-edged security are consolidated into a single gilt-edged security by way of exchange. Each strip will be deemed to have been redeemed at the time of the exchange at its market value. The person exchanging the strips will be deemed to have acquired the security for the aggregate of the market values of the strips which have been exchanged.[54] A person who holds a strip on 5 April in any year of assessment and does not redeem or transfer it on that day will be deemed to have transferred it on that day. He will be deemed to have transferred it at its market value and to have acquired it for the same value the next day.[55]

10.7 CONCLUSION

Prior to the enactment of legislation dealing with the deduction of discounting expenditure, a discount in respect of short-term finance was deductible only if it was wholly and exclusively laid out or expended for the purposes of trade. In addition, it was not be deductible if it was of a capital nature. In these circumstances, the deduction was allowed on the accrual basis. In terms of this general rule, a non-trading company was not able to deduct discounting expenditure. Thus, a holding or investment company could not deduct discounting expenditure in terms of this general rule. In addition, a trading company could not deduct

change in the authorized accounting method at the beginning of an accounting period, certain assumptions will be made These assumptions will be that the company has ceased to be a party to the loan relationship with effect from the end of the immediately preceding period and again became a party to the relationship with effect from the beginning of the current period, the new relationship is separate from the previous one, the amount payable on the termination of the previous relationship and the commencement of the new one is a fair value, and the amount payable will become due when the relationship changes In this situation, there is an accounting of the debits and credits and the net amount will be brought into account from when the change of the method takes effect [29]

The accruals basis of accounting only will be used to ascertain the interest relating to certain types of instruments in respect of which there is a loan relationship. The types of such instruments are certain kinds of convertible securities and certain securities linked to the value of chargeable assets [30] In the case of an index-linked gilt, an adjustment will provide for the credits and debits to be accounted for as non-trading items The adjustment will be made wherever the security gives credits or debits by reference to the value of the security at two different times and there is a change in the retail price index between those two times The adjustment is effected by taking the value of the security at the earlier time This value is adjusted by reference

change in the authorized accounting method at the beginning of an accounting period, certain assumptions will be made. These assumptions will be that the company has ceased to be a party to the loan relationship with effect from the end of the immediately preceding period and again became a party to the relationship with effect from the beginning of the current period, the new relationship is separate from the previous one, the amount payable on the termination of the previous relationship and the commencement of the new one is a fair value, and the amount payable will become due when the relationship changes. In this situation, there is an accounting of the debits and credits and the net amount will be brought into account from when the change of the method takes effect.[49]

The accruals basis of accounting only will be used to ascertain the interest relating to certain types of instruments in respect of which there is a loan relationship. The types of such instruments are certain kinds of convertible securities and certain securities linked to the value of chargeable assets.[50] In the case of an index-linked gilt, an adjustment will provide for the credits and debits to be accounted for as non-trading items. The adjustment will be made wherever the security gives credits or debits by reference to the value of the security at two different times and there is a change in the retail price index between those two times. The adjustment is effected by taking the value of the security at the earlier time. This value is adjusted by reference

In terms of the new rules, companies issuing bonds will be entitled to deduct interest and discounts on an accruals basis Thus, companies will compute the interest and discount which has accrued during the period in question and this amount will be deductible in calculating the company's profit or loss for tax purposes.[44] Price indexed bonds will be treated in the same way as ordinary bonds. Thus, issuers will be entitled to deduct the full amount of their costs.[45] Where there is a loan relationship in respect of which a company is a party, the debits and credits will, where appropriate, be treated as expenses of that trade and will be deductible in the computation of the company's profits.[46] Where a company has non-trading debits or both non-trading debits and credits and the debits exceed the credits, the company will have a non-trading deficit in respect of its loan relationships. The company will be entitled to set off its deficit against any profits for the deficit period, treat it as eligible for group relief or set it off against profits from earlier accounting periods Alternatively, the deficit could be carried forward to be set off against non-trading profits in the immediately following deficit period. If there is still a deficit remaining, such deficit can be treated as a carried-forward debit.[47] The debits and credits that will be brought into account will be on the basis of normal accounting practice Authorized accounting methods will include an accruals basis of accounting and a mark-to-market basis of accounting.[48] Where, in a loan relationship, there is a

In this situation, the company which issued the security may deduct the excess of the amount paid on redemption over the issue price in the computation of its corporation tax liability. The deduction is allowed for the accounting period in which the redemption takes place.[39] The amount deducted is treated as a charge on income under s 338(3)(*h*) of the Income and Corporation Taxes Act of 1988. No deduction is allowed where the redemption takes place on maturity or where the security is converted to shares.[40]

Where the company issuing the security carries out oil extraction activities, the deduction can only be made against oil extraction profits if the securities were issued to provide funds to meet expenditure incurred on those activities.[41]

10.6 TAX REFORM

In 1995 Inland Revenue issued a consultative document and a press release relating to tax reform in respect of gilts and bonds.[42] These proposed reforms have now been incorporated into new proposed legislation.[43]

In order to determine the tax treatment of discounting profits in South Africa, it is necessary to examine such treatment in the context of the definition of 'gross income' in s 1 of the Income Tax Act 58 of 1962. In addition, it is necessary to examine the effects of s 24J on receipts and accruals. The most important matters that need to be examined are the questions of receipt or accrual including the effects of s 24J, source, and the nature of the profits.

The most important issue arising out of an examination of the meaning of receipt or accrual is that of accrual. This is of particular importance in the case of a deep discount bond. The reason for this is that the holder of such a bond may have acquired it in terms of an original issue at a considerable discount on its face value. The redemption proceeds will only be payable to him a number of years after the date of issue. It is therefore material whether the holder is taxable on his profits at the outset, over the period of the bond until its maturity, or at maturity. An examination of early cases which considered the meaning of 'accrue' indicates a certain amount of uncertainty. Either accrue meant 'to be entitled to' or 'due and payable'. Whilst it is submitted that the preferable meaning should have been the latter, the Appellate Division in People's Stores held it to mean the former.[1] The Appellate Division not only held that 'accrue' means 'to be entitled to' but that where a person is entitled to a payment in the future he should account for the debt at its present value. Whilst this decision is open to criticism, it must be accepted as correctly reflecting the position as

14 Simon's Taxes at para B3 1241

15 Ammonia Soda Co Ltd v Chamberlain (1918) 1 ChD 266

16 Atherton (HM Inspector of Taxes) v British Insulated and Helsby Cables Ltd

17 1979 STC 393

18 The Tax Treatment of Capital Market Instruments Worldwide at 3

19 ibid.

20 ibid.

21 The argument that discounting expenditure is deductible under s 75(1) and (2) of the Income and Corporation Taxes Act of 1988 as an expense of management is unlikely to succeed. The reason is that the discounting expenses will generally be regarded as an expense of financing the company's investments and not of managing them. See London County Freehold & Leasehold Properties Ltd v Suite 24 TC 412

22 See s 42 of the Finance Act of 1984 now incorporated into s 78 of the Income and Corporation Taxes Act of 1988

23 ibid

Where B is the holder of an instrument such as a bill, note or bond and he negotiates it to C, the transaction between B and C will be treated as one of purchase and sale Thus, any profit made by C where he either resells or redeems the instrument will be treated as a profit arising from the disposal of the instrument, and not interest

It is essential in examining the meaning of the source of a discounting profit to distinguish between the issue of a post-dated bill, note or bond at a discount and its subsequent negotiation Where the instrument is issued at a discount, the transaction is substantially one of loan Having established the nature of the transaction, it is necessary to determine its originating cause The originating cause is the employment of capital by the holder of the instrument Case law is not consistent with this approach and if one were to apply the criteria laid down in Lever Bros.' the source of the receipt would be the originating cause which would be the work done by the taxpayer to earn it Therefore the supply of credit by the holder of the instrument would be the service which the holder performs and it would be in return for this service that the discounting profit would be payable to the holder of the instrument on its redemption

Where a post-dated instrument is negotiated at a discount, the transaction is one of purchase and sale The originating cause of the profits arising from such a

section. Derivatives such as options, warrants and futures in gilts and bonds should be covered by s 24J. The definition of an instrument covers any form of interest-bearing arrangement. It is not clear whether such definition includes derivatives. It would appear that derivatives such as options, warrants and futures are not interest-bearing arrangements and do not appear to be included in the definition of an instrument.

If one applies the analysis of the financial effects of the yield to maturity return to s 24J, it is clear that in the case of a zero coupon bond, the effect of this basis of yield is that the effective yield is in fact greater than the nominal yield. It is in fact the revised yield to maturity. The effect of taxing discounts on the basis of the yield to maturity is more punitive than the taxation of conventional coupon bonds applying a similar rate of tax. The reason for this is that in the case of a discounted bond, the holder is taxed on a notional accrual and the income in respect of which he is being taxed will only be received by him when the bond is sold or redeemed. In the case of a conventional bond, the interest coupons in respect of which the holder is being taxed are received prior to the tax being payable. This latter problem adversely affects discounts, particularly zero coupon bonds. The tax is payable in respect of gross income which has not yet been received. Thus, the effect of s 24J on zero coupon bonds is to make them less attractive to tax paying investors. This will, presumably, discourage the issue of such bonds unless other factors outweigh these disadvantages.

it is a decision of the Appellate Division. The Income Tax Act was then amended so that, in this situation, the debt should be accounted for at its nominal value.[1] The effect on discounting transactions of the decision in People's Stores and the amendment to the Income Tax Act was that the holder of a post-dated financial instrument issued at a discount on its face value was taxable on the discounting profit when the instrument was issued. Clearly, this situation was inequitable and open to criticism.

In 1995, s 24J was enacted. It provides for the taxation of income and expenses arising from the issue and trading of financial instruments at a discount on their face value. The legislation deals primarily with the timing of the incurral and accrual of such expenditure and income. The legislation provides for the income to be spread over the period from the date of acquisition of the instrument to the date of disposal of maturity of the instrument. This is achieved by applying the yield to maturity basis of calculation over the term of the instrument. The legislation permits the application of alternative bases of calculation of the accrual of the income. However, the wording of the legislation is not clear, particularly with regard to when one can apply alternative bases of calculation, and when an alternative basis of calculation is acceptable. It should be noted that s 24J does not apply to shares. Possibly, it is arguable that certain types of redeemable preference shares should be included in s 24J and that certain types of equity linked bonds should be excluded from this

11 CONCLUSION

Two basic types of discounting transactions have been considered in this thesis. The first is one in which a person issues a post-dated instrument, such as a promissory note, at a discount on its face value and the recipient holds it until maturity. In the second transaction a person acquires a post-dated instrument, such as a bill, note or bond, at a discount on its face value and disposes of it at a profit. Whilst no distinction is drawn in South Africa between discounts relating to straight debt instruments and deep discount bonds, such a distinction is made in the United Kingdom.

Where A issues a bill, note or bond to B at a discount on its face value, the transaction is, in substance, one of loan. Thus B will be treated as having lent A the consideration paid by him. When the instrument is redeemed by A at the maturity date, B will receive its face value. The difference between the consideration paid by B for it and its face value will be treated as interest. Where a bill, note or bond is negotiated at a discount on its face value, the discounting is, in effect, a sale of a claim against a third party with an implied guarantee by the seller of payment of the claim at maturity date.

54 s 95(3) of the Finance Act of 1996. See also para 14(3) of sch 13 of the Finance Act of 1996. Section 95(4) provides that references to market values relate to the values at the time of the exchange. Section 95(5) and (6) covers the possibility of the Treasury making regulations to determine the market values.

55 para 14(4) of sch 13 of the Finance Act of 1996. Paragraph 14(5) and (6) provides for the possibility of the Treasury making regulations relating to strips and the manner of determining their values.

51 s 94(1)-(3) of the Finance Act of 1996. Section 94(4) provides that percentage adjustment is determined by reference to the difference between the indices in the months in which the two times fall. An index-linked gilt is defined in s 94(5) as any gilt determined wholly or partly by reference to the retail price index.

52 para 13 of sch 13 of the Finance Act of 1996. Paragraph 13(6) specifies that an asset is a chargeable asset in relation to any security if any gain accruing to any person on a disposal of that asset would be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act of 1992. Paragraph 13(6) stipulates that where it is being determined that the gain would be a chargeable gain, three assumptions are to be made. First, that the asset is an asset of the person in question. Second, that the asset is not one the disposal of which would for income tax purposes be treated as a disposal in the course of that person's trade, profession or vocation. Third, that the chargeable gains that might accrue under that Act should be disregarded.

53 s 95(2) of the Finance Act of 1996. See also para 14(2) of sch 13 of the Finance Act of 1996.

41 para 25 of sch 10 to s 56 of the Finance Act of 1989 and s 494 of the Income and Corporation Taxes Act of 1988

42 See The Taxation of Gilts and Bonds and Inland Revenue The Taxation of Gilts and Bonds press release issued on 10 July 1995

43 ss 80-105 of the Finance Act of 1996

44 The Taxation of Gilts and Bonds at 8

45 at 15.

46 s 84(4) of the Finance Act of 1996.

47 s 83 of the Finance Act of 1996. In terms of s 83(4) the deficit cannot be used to create a loss. Section 83(5) provides that a non-trading deficit of a charitable company can only be used to offset against profits or be carried forward. Section 83(6) requires that a claim to offset the debits against profits must be made within two years following the end of the deficit period

48 ss 85-6 of the Finance Act of 1996

49 s 86 of the Finance Act of 1996

50 ss 92 and 93 of the Finance Act of 1996. See chapter 6 for a detailed discussion of these provisions

31 para 5(6) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

32 para 11(1) and (3) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

33 para 11(5) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

34 paras 5 and 6 of sch 11 to s 94 of the Finance Act of 1989 See also chapter 6

35 Inland Revenue The Taxation of Gilts and Bonds consultative document issued in 1995 at 7-8

36 para 12 of sch 10 to s 56 of the Finance Act of 1989 See also chapter 6

37 para 2 of sch 10 to s 56 of the Finance Act of 1989

38 paras 12(2) and 13 of sch 10 to s 56 of the Finance Act of 1989

39 para 25 of sch 10 to s 56 of the Finance Act of 1989

40 Simon's Taxes at para D 2 217

24 ibid.

25 para (1) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

26 para 5(3) and (4) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988. It should be noted that, in terms of para 5(3)(c) only one of the last three conditions needs to be satisfied.

27 para 5(5) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988.

28 As defined in s 416 of the Income and Corporation Taxes Act of 1988

29 para 9 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988. In terms of para 9(3) two companies are deemed to be nembers of a group of companies if one is a 51% subsidiary of the other or both are 51% subsidiaries of a third company.

30 para 10 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988. In terms of para 10(5) when determining whether a person is carrying on a business of banking and is a participator in a company for the purposes of this paragraph, any securities of the company acquired by such person in the ordinary course of his business shall be disregarded

14 Simon's Taxes at para B3 1241

15 Ammonia Soda Co Ltd v Chamberlain (1918) 1 Ch D 266

16 Atherton (HM Inspector of Taxes) v British Insulated and Helsby Cables Ltd

17 1979 STC 393

18 The Tax Treatment of Capital Market Instruments Worldwide at 3

19 ibid

20 ibid

21 The argument that discounting expenditure is deductible under s 75(1) and (2) of the Income and Corporation Taxes Act of 1988 as an expense of management is unlikely to succeed. The reason is that the discounting expenses will generally be regarded as an expense of financing the company's investments and not of managing them. See London County Freehold & Leasehold Properties Ltd v Suite 24 TC 412

22 See s 42 of the Finance Act of 1984 now incorporated into s 78 of the Income and Corporation Taxes Act of 1988

23 ibid

incurred in respect of dividend-stripping transactions. Another provision which must be considered is s 23(*h*) which, inter alia, prohibits the deduction of domestic or private expenses.

Where an instrument is purchased for resale then, if the transaction is part of a profit-making operation, the expenditure incurred will have been incurred in the carrying on of a trade. The expenditure incurred in acquiring the instrument will have been incurred at the stage when there is an absolute liability to pay for it. Where the profit earned on the disposal of the instrument is of a revenue nature, then clearly the discounting expenses will have been incurred in the production of income. Section 22 of the Income Tax Act provides a means for bringing to account negotiable instruments originally acquired for capital investment purposes but which were subsequently converted into trading stock. This provision also enables the trader to bring into account negotiable instruments acquired for no consideration and forming part of his trading stock.

Section 24J provides that a company, whose business consists of dealing in instruments, may elect that the general provisions contained in s 24J(2) to (8) shall not apply to all such instruments. Section 24J(9) stipulates how a trader may elect this option and the rules relating thereto. The

advantage If he carries on a trade, his motive for doing so is irrelevant This approach is, with respect, a correct and practical one In applying the concept of trade in South Africa, it should be appreciated that the requirement that expenditure be wholly and exclusively incurred for the purposes of a taxpayer's trade has now been removed Expenditure is deductible to the extent that it is incurred for this purpose Thus, situations in which expenditure was previously disallowed because it did not satisfy the wholly and exclusive requirement may now have a different result In addition, the courts will be faced with the difficult task of apportioning the expenditure in certain circumstances The criteria for doing so will need to be developed For example, if one considers the facts in Mallalieu, the question which arises is whether Mallalieu would be able to deduct her expenditure under the present law It is submitted that her expenditure on her court garments would not be disallowed in terms of s 23(*g*) However, a portion of her expenditure could be disallowed as her expenditure could possibly only have been incurred for the purpose of her trade It is, therefore, possible that an apportionment could take place In addition, it is also necessary to consider some of the other prohibitions contained in s 23 For example, s 23(*f*) prohibits the deduction of expenditure incurred in respect of amounts received or accrued which do not constitute income as defined In South Africa this section was invoked by the Commissioner to disallow expenditure

submitted that there are three broad stages in the development of tax avoidance and trading. The first is the Westminster approach in which it is accepted that taxpayers are entitled to order their affairs so as to minimize their liability for tax.[9] The second approach is that of Ramsay/Dawson.[10] This approach involves, first, construing each transaction as part of the whole and, second, regarding the only legal consequences arising as those that flow from all the transactions taken as an indivisible whole. The emphasis is on the unbroken and predestined chain from start to finish. The third approach was that developed in Challenge/Ensign.[10] The new dimension which was added in the approach of the House of Lords in Ensign was that the series of transactions was analysed and the true effect of the transactions was determined. The parties were taxed according to the true effect of these transactions. The self-cancelling intermediate steps were ignored. Thus, the taxpayer was not deprived of the beneficial effects of a scheme merely because it was entered into with fiscal motives.

In South Africa, an important case in which the issue of trading with a fiscal intent was Burgess, which was considered by the Appellate Division.[11] The court held that if a taxpayer pursues a course of conduct which constitutes the carrying on of a trade, he does not cease carrying on the trade merely because one of his purposes, or even his main purpose, is to obtain a tax

expenditure in question should relate to the carrying on of that trade. Section 23(g) contains a negative requirement to the effect that monies will only be deductible to the extent that they have been laid out or expended for the purposes of trade. Until recently, s 23(g) prohibited the deduction of expenditure not wholly and exclusively laid out or expended for the purpose of trade.

The two important cases which considered the wholly and exclusive requirement were Pick 'n Pay[6] and Solaglass.[7] It is submitted that in both the cases the majority should have applied a subjective approach similar to that adopted in Bentleys. In Pick 'n Pay it is respectfully submitted that there was sufficient evidence to indicate that the taxpayer envisaged a philanthropic effect and not a philanthropic purpose. In Solaglass, it is respectfully submitted that the benefiting of the group should have been regarded as either an effect of the expenditure or as one of the taxpayer's trade purposes. In addition, both the judgments have been criticized in that they applied a profits test in determining whether the expenditure in question was part of the taxpayers' trading activities.

There have been a number of cases in the United Kingdom that have considered the issue of trading in order to obtain a fiscal advantage. It is

acceptable in all circumstances, and it is submitted that the legislation should be changed accordingly

In order to be deductible, discounting expenses should be incurred in the production of income This should be the case where the funds raised from the issue of the instrument are utilized in the issuer's income earning operations In these circumstances the act enta ; the expenditure will have been incurred with the purpose of earning income Therefore, the expenses attendant upon the issue of the instrument, such as discounting expenses, are incurred in the production of income

The discounting expenses should also be of a revenue nature in order to be deductible by the issuer In this regard, where the money raised by the issuer is used as part of his working capital or to fund his working capital, it should be of a revenue nature The position is not so clear where the proceeds from the issue are used to acquire a capital asset to be used in the business. It can be argued that discounting expenses in respect of funds used to acquire capital assets are not so closely connected with the capital assets that they are of a capital nature

Section 11 of the Income Tax Act contains a positive requirement that in order for that section to apply, a person should carry on a trade and the

an alternative method should not 'differ significantly' from that achieved by applying the yield to maturity basis of valuation It is not clear what would constitute a significant difference

There are a number of issues which arise as a result of applying an alternative basis of calculation The first issue is whether one basis of calculation is acceptable in some circumstances and not acceptable in other circumstances The second issue is that it is not clear how high the percentage variation should be before it becomes unacceptable to the Commissioner It is clear from the examples that annual variations to the yield to maturity of the annual accruals applying the weighted capital method of valuation are greater than the variations applying the straight-line basis of valuation in certain circumstances This raises the question whether the straight-line basis of valuation is acceptable in this situation It is submitted that, referring to some of the examples, it would be difficult to argue that the straight-line basis of valuation is not acceptable This raises the issue whether a basis of valuation should be acceptable in certain circumstances and not acceptable in other circumstances It is submitted that it is not desirable for a basis of valuation only to be acceptable in certain circumstances as this leads to uncertainty A basis of valuation should either be acceptable or not It is submitted that there is no valid reason why the straight-line basis of valuation should not be

are those based on the weighted outstanding capital and interest, a straight-line spreading of interest and that calculated by applying the rate and instalments in terms of the relevant agreement

The weighted capital method of calculation is an application of the following formula

$$\frac{\text{Total interest} \times \text{Monthly balances}}{\text{Total monthly balances}}$$

The straight-line method of calculating the accruals involves an equal allocation of the interest over the period involved The actual interest calculation and the calculation based on the yield to maturity have the same results It is stated in the Explanatory Memorandum that the weighted capital method and the calculation by applying the rate and instalments in terms of the agreement are acceptable as methods of calculation However, it is also stated that the straight-line method of calculation is not acceptable The authority for this statement is, presumably, contained in the definition of the alternative method in s 24J(1) of the Income Tax Act Paragraph (c) of the definition stipulates that the method should achieve a result in relation to the timing of the accrual and the incurral of interest that does not differ significantly from the yield to maturity basis of calculation It is respectfully submitted that this definition is not sufficiently clear Paragraph (c) of the definition of alternative method stipulates that the result of an application of

decisions are open to criticism on a number of grounds Later decisions of the Special Court allowed the issuers to deduct the discount expenditure when the instruments were issued It is submitted that these decisions are correct After these later decisions s 24J was enacted to regulate the taxation of discounting transactions

Section 24J has changed the position concerning the deduction of discounting expenses The issuer may now deduct the discount expenses on an accruals basis The yield to maturity basis is used to calculate the annual deductions that may be claimed by the issuer It is possible for the issuer to adopt a different basis for calculating the amounts which he is deemed to have incurred on an annual basis

The annual deductions are calculated on the basis of the yield to maturity The second basis is to calculate the interest by applying an alternative method The meaning of alternative method is defined It is a method of calculating interest in relation to any class of instrument It must, however, conform with generally accepted accounting practice, be consistently applied in respect of all instruments for all financial reporting purposes and the result in respect of the accrual of income and the incurring of expenditure should not differ materially from that resulting from an application of the formula In the Explanatory Memorandum three alternative methods are referred to These

Having examined the tax treatment of discounting profits received by or accrued to the holder of a bill, note or bond, it is also necessary to discuss the position of the issuer of the instrument. In this regard, the question arises whether the expenditure incurred by the issuer is deductible, and, if so, at what stage. It is also necessary to consider the position of a person who acquires an instrument at a discount on its face value and disposes of it at a profit.

When an instrument is issued, the most important issue is when the expenditure may be deducted. Once again, this is of particular relevance in the case of a deep discount bond where there may be a long period between the date of its issue and the date of its maturity. A deep discount bond is a form of promissory note and, in fact, it constitutes by definition an unconditional liability to pay its face value on maturity date. Thus, prior to the enactment of s 24J there were strong arguments to the effect that the discounting expenses were incurred when the instrument was issued.

There were some decisions in the Special Court that were conflicting.[1] The earlier decisions disallowed the issuers' claims to deduct the discounting expenditure at the time of issuing the instruments. These

and revenue nature. The tax consequences arising from the sale or redemption of an instrument depend on its type and the investor's circumstances. It is possible for certain receipts or accruals to be of a capital nature. Thus, where a reasonable commercial rate of interest is charged and an additional sum is payable to compensate for the capital risk, or where a discounting profit is made on a long-term bond such as Eskom stock, there may be circumstances where the proceeds will be of a capital nature. The receipts or accruals of most other types of instruments are likely to be of a revenue nature.

Section 24J only covers the accrual and incurral of certain defined amounts. It is therefore submitted that it is theoretically possible to argue that if a discounting profit is of a capital nature the annual accruals as determined by s 24J are not taxable in the hands of the investor. However, in practice this is unlikely to be the case. If an investor acquires an instrument as a long-term investment, it will be very difficult for him to prove in the year of acquisition that he acquired the instrument for investment purposes. Many of these factors which indicate whether a receipt is of a capital or revenue nature relate to events which take place after acquisition of the asset. Therefore, the argument to the effect that the provisions of s 24J apply regardless of the nature of the discounting profit is valid even in the situation in which an instrument is sold prior to maturity.

apportion the source of income However, if the capital is not invested in the business, the place where the capital is employed may change Thus, if the holder of the instrument is utilizing surplus funds in his business to acquire an instrument, the source of the gain made on redemption of the instrument will not necessarily be the place where he is carrying on his main business The source of the gain should be the place where he employed his surplus funds in acquiring the instrument from its maker

If, however, one applies the principles laid down by Watermeyer CJ in Lever Bros.[4] the source of the profit made by the holder of the instrument is the originating cause of the profit The originating cause is the supply of credit by the holder and its location involves a factual enquiry

Where a post-dated instrument is negotiated at a discount on its face value, the transaction is one of purchase and sale The originating cause will generally be the business of purchasing and selling the instruments and this will take the form of the employment of capital The source of the discounting profits will therefore be the place where the capital is utilized to earn the profits

Capital receipts or accruals are not be included in the definition of gross income It is, therefore, important to distinguish between receipts or accruals of a capital

transaction will generally be the business of purchasing and selling credit instruments and this will generally take the form of the employment of capital

Once the source of discounting profits has been determined, it is necessary to locate such source. In the case of an original issue discount the source of the profit is its originating cause This should be the employment of capital by the holder of the note. In order to locate where the capital is employed, one must determine the business in which the capital is employed Accordingly, it is important to determine the dominant cause or essence of the business or activity which produces the gain or profit. In doing so, regard should not be had to activities if they do not form part of the essence of the business Once the essence of the business has been ascertained, one must determine how the money is used in the business.

If the money is used in the profit-making activities of the business, the source of the profit remains the capital employed in the business. If the holder of the instrument is carrying on a business of making discounting profits from the acquisition and disposal of such instruments then one should ascertain all the activities which form part of the essence of the business. The place where these activities are carried on will be the place where the business is carried on. If these activities take place in more than one place, it may be necessary to

bond is not covered by specific legislation. Revenue considers that the discount relating to it is chargeable to tax as income of the lender when it is paid on redemption.

As far as deductibility is concerned, where a company has issued a deep discount bond, the income element of the bond is deductible for corporation tax purposes in the relevant income period. The company, however, must comply with certain stipulated conditions in order for such expenditure to be deductible.

It is therefore clear that an investor will only be taxed on any discount profit made by him in respect of a deep discount bond when such profit is realized. The portion of the gain relating to market fluctuations will generally be of a capital nature and not taxable. In the case of a financial trader, Revenue argues that the deep discount rules are not applicable. Thus, Revenue argues that the general principles apply to such persons. Therefore, the trader will argue that the discounting profit is taxable on a realization basis whereas Revenue will argue that the trader is taxable on an accruals basis. If the principles laid down in Willingale apply, the trader will be taxable on the realization basis. If not, Revenue will seek to tax such profits on an accruals basis.

taxable on a receipts basis Revenue's response was to interpret the decision in Willingale narrowly

In 1984 specific legislation was enacted dealing with the taxation of deep discount bonds. In terms of this legislation, a deep discount bond is defined as a redeemable security that a company issues at a discount of either more than 15% of its redemption value or more than 0,5% per annum over the term of the security Thus, a ten year bond issued at a discount of 5% or more of its redemption value will constitute a deep discount bond. The discount is treated in the hands of the holder of the bond as income and accrues on a compound basis. It is taxable when the bond is disposed of or redeemed Where the holder of the security is a trader, Revenue endeavours to tax the income element of the discount as it accrues instead of on its disposal or redemption. The accruing income is determined on the basis of a specified formula.

The profit on the sale of a deep discount bond has two elements The first is the portion relating to the discount and the second is a gain or loss resulting from fluctuations in market interest rates or other related factors This latter gain or loss is generally treated as being of a capital nature except in the hands of the financial trader Where a deep discount

to a non-trading company or a trading company utilizing the funds raised for non-trading purposes. The Finance Act of 1984 provided a certain amount of relief for these types of companies and the deduction is available to them if certain specified conditions are met

In the case of deep discount bonds, there were certain problems relating to their taxation. Prior to 1984, there was uncertainty as to when there was a deep discount bond, particularly where an interest coupon rate attached to it. Where an investor acquired a bond at a discount, he could only receive a discount if he redeemed the bond. Thus, if the bond was sold, he would argue that he had received a capital gain. Frequently a compromise was reached with Revenue in these types of disputes in terms of which a portion of the profit would be allocated as a discount and the rest of the profit would be treated as a capital gain. It was, however, accepted that if an investor was taxable on his profit, he was taxable on a receipts basis

The total discounting profit was clearly taxable in the hands of the trader. Revenue argued that the profit was taxable on an accruals basis, whilst the trader argued that it was taxable on a receipts basis. In Willingale[12] the majority in the House of Lords held, inter alia, that the profits were

definition of gross income was that the discounting profit accrued to the holder of the financial instrument at the time when it was issued to him Thus, prior to the enactment of s 24J, the position in South Africa was in fact worse than the common law position in the United Kingdom. The effect in South Africa of s 24J is to apply an accruals basis to the taxation of discounting profit except in the case of a corporate trader In practice an investor will receive no recognition of the fact that his discounting profit is of a capital nature in the accrual periods prior to that in which the instrument is transferred. Therefore it is submitted that the position in South Africa in applying the accruals basis to taxing discounting profits and the lack of recognition of the capital nature of the discounting profits of an investor are inequitable. Whilst the common law position in the United Kingdom was not entirely equitable, it was more equitable than the position in South Africa

Having discussed the tax treatment of the person acquiring a straight debt instrument, it is necessary to examine the position of the issuer of the instrument. The general rule is that a discount for short-term finance will only be deductible if it is wholly and exclusively laid out or expended for the purposes of trade and if the funds are utilized for a revenue purpose In these circumstances, the discounting expenditure is deductible on an accruals basis over the period of the instrument This rule will not apply

Where the face value of a post-dated promissory note is index linked and a reasonable commercial rate of interest is charged on it, it is possible that the increased profit arising from the indexation of the principal is of a capital nature. Where the profit is of a revenue nature, it will be chargeable to income tax at the time of its sale or redemption. In South Africa it would be difficult to argue that the increased profit arising from the indexation of the principal is of a capital nature. The South African approach is perhaps inequitable as such increased profit resulting from the indexation of the principal relates to the preservation of the underlying capital value and, as such, should be of a capital nature.

Where a financial trader, such as a bank or financial institution, acquires a straight debt instrument at a discount, the trader will be taxable on the sale or redemption of the instrument. It is submitted that a realization basis of taxing discounts is equitable as the tax on the profit is payable at a time when the taxpayer actually receives or becomes entitled to receive the profit. Prior to the enactment of s 24J in South Africa the position was determined by the Appellate Division decision in CIR v People's Stores (Walvis Bay) (Pty) Ltd and the proviso to the definition of gross income in s 1 of the Income Tax Act that was inserted by s 2(1)(*a*) of the Income Tax Act of 1990. The effect of this decision and the legislative amendment to the

different from that which has been adopted in South Africa where an original issue discount is regarded as a transaction of loan, and the discount as akin to interest. The approach is similar in the case of the purchase and sale of a financial instrument. In this case, the discounting profit is treated as a trading profit in both countries. It is submitted that the approach adopted in South Africa to the classification of a discounting profit is preferable as it accords with the substantive position.

A clear distinction is drawn in the United Kingdom between straight debt instruments and deep discount bonds. Where an investor acquires a straight debt instrument there are a number of circumstances in which the discounting profit may be of a capital nature and other circumstances in which the profit may be of a revenue nature. If the nature of the transaction is not clear from the contract and the maturity date is a short period after the issue date, the profit will probably be assumed to be interest. Where a post-dated promissory note is issued at a discount on its face value and, in addition, a reasonable commercial rate of interest is payable on the face value of the instrument, the situation is such that the profit could represent a capital gain. This type of transaction would be regarded as akin to a loan in South Africa. As stated above, this approach has the attraction of reflecting the substance of the transaction.

the source of B's profits could be the place where he carries on the business of purchasing and selling financial instruments which could be situated in South Africa On the other hand, C could be carrying on a business unrelated to the purchasing and selling of financial instruments He could have utilized his surplus funds outside South Africa to acquire the note from A As a result, whilst B's profit would be taxed in South Africa, C's would not be taxable One should also bear in mind the effects of s 24J as discussed above If the holder is a company that is holding the note as part of its trading stock, the holder may only be taxable on its discounting profits on sale or redemption

In the United Kingdom, a clear distinction may be drawn between straight debt instruments and deep discount bonds Discounts are distinguishable from interest Discounts in respect of straight debt instruments are chargeable to income tax under either schedule D case III or case I Schedule D case III applies in respect of annual profits or gains accruing to residents in respect of discounts However, where the annual profits or gains from discounts arise from carrying on a trade within the United Kingdom, then schedule D case I applies No distinction is made between the issue of a post-dated instrument issued at a discount on its face value and the purchase of an instrument prior to maturity date This approach is

be taxable in South Africa for this reason If the note is a long-term credit instrument, such as Eskom stock, it may in certain circumstances be possible to argue that the profit is of a capital nature and therefore not taxable. However, if A fulfils the requirements of the general deduction formula, his expenditure will be deductible even though B is not taxed on the profits made by him.

Having examined the position of the tax treatment in South Africa of an original issue discount, one should also consider the tax treatment resulting from the sale of an instrument In this instance, assume in the above example that B sells the instrument to C who presents it for payment at its maturity

In these circumstances similar criteria would be applied in ascertaining C's tax position as would apply in determining B's tax position It should, however, be appreciated that the positions of B and C could be different. Thus B could be a financial trader and C a long-term investor Therefore, in the case of certain types of long-term instruments, the sale proceeds could be of a revenue nature in B's hands and the redemption proceeds could be of a capital nature in C's hands The source of the profits made by C could differ from those made by B Thus, for example,

income and expenses are taxable on an accruals basis However, if an alternative basis of calculation is used, the income and expenses will not match. The discrepancies are unlikely to be too great Where the holder is a trader, the situation is clearly different The trader will only be taxed on its discounting profits on sale or redemption of the instrument. Thus, there could be the situation where the issuer may deduct the discounting expenses over the period of the instrument whereas the trader is only taxable on the profit when the instrument is sold or redeemed.

There may be circumstances in which B is not taxable on the discounting profits when the note is redeemed. For example, if one applies the supply of credit test to the source of profits, it may be possible to ensure that B advances the funds to A outside South Africa Alternatively, if A is a natural person who is not resident nor carrying on business in South Africa, or if A is a company which is managed and controlled outside South Africa, s 10(1)(*h*A) of the Income Tax Act may apply In considering this provision, it should be borne in mind that in terms of general law and s 24J the discounting profits arising from an original issue are regarded as interest. A would be exempt from normal tax in South Africa provided the provisions of s 10(1)(*h*A) are met Alternatively, if the source of the profits was outside South Africa, the profit would not

on the sale or redemption of the instrument except in respect of price fluctuations at values below the cost to the trader of the instrument

Having briefly reviewed the tax treatment in South Africa of discounting transactions, it is necessary briefly to discuss the effect of discounting transactions between two taxpayers in South Africa Assume that A issues a post-dated promissory note to B at a discount on its face value The tax consequences to both parties will not necessarily be matched As far as timing is concerned, it could be strongly argued that, prior to People's Stores and the enactment of s 24J, the receipt or accrual in B's hands took place at redemption If it was accepted that accrual took place when the note was issued, and this would have been the case after People's Stores, B should have been taxable on his profit based on the present value of the face value of the instrument However, after the change to the Income Tax Act, B was taxable on the profit based on the face value of the instrument at the time of issue of the note. A, on the other hand, could have argued strongly that the discounting expenditure was only incurred by him when the note was issued

The position has now changed since the enactment of s 24J On the face of it there is a matching of the timing of income and expenses Both

Third, as economic conditions change, the yields to maturity and therefore the prices of bonds fluctuate. There are three main factors that affect the volatility of bonds. These are the coupon rate, the maturity date and the initial yield to maturity. The coupon rate of a bond is the interest rate payable on the face value of the instrument. If the coupon rate is lower, the greater will be the change in the price of the bond for a given change in the yield to maturity. If the coupon rate is higher, the less the price of the bond will fluctuate with changes in the yield to maturity. Thus, zero coupon bonds will be much more price volatile than high interest coupon bonds when interest rates fluctuate. Where there is a given change in the yield to maturity of a bond, this will have a progressively greater affect on the price of the bond the greater the period to maturity of the bond. Where the initial yield of a bond either increases or decreases by a fixed percentage, there is a correlation between the initial yield and the percentage change in the price of the bond. It is therefore clear that there are a number of factors that can affect the market price of bonds, particularly zero coupon bonds.

Fourth, if a non-trader issues a bond to a trader to which s 24J(9) applies, the situation arises where the issuer will be entitled to deduct the annual deemed expenditure on an ongoing basis. The trader will only be taxable

effect of an election under s 24J(9) is that the trader will apply a market value basis of valuing trading stock and will account for such stock, for income tax purposes, in terms of s 22.

The main points arising from these provisions are, first, that the election under s 24J(9) may only be made by companies. With respect, this restriction is open to criticism as there is no reason why individuals and other non-corporate taxpayers such as trusts should not also have this option.

Second, the effect of adopting the market basis of valuing stock is that the trader will not be taxable on any increase in the value of the stock prior to its sale or redemption. If the market value of the stock decreases to a value below its cost, such decline will have the effect of reducing the trader's taxable income by such amount. If the stock subsequently increases in value, then to the extent that it appreciates in value to that of its cost to the trader, such increase will have the effect of increasing the trader's taxable income. The reason for this is that the basis of valuation of trading stock is the lower of cost or market value.

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9 W T Ramsay Ltd v IRC 1981 STC 174, Eilbeck (Inspector of Taxes) v Rawling 1981 STC 174, and Furniss (Inspector of Taxes) v Dawson (1984) 1 All ER 530 (AC)

10 IRC v Challenge Corp Ltd 1986 STC 548 and Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) (1992) 2 All ER 275 (HL) at 280

11 Burgess v CIR (1993) 55 SATC 185

12 1978 STC 75

FOOTNOTES

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

2 The proviso was inserted by s 2(1)(*a*) of Income Tax Act 1990, effective as from 1 July 1962 and applicable in respect of all amounts accrued on or after that date.

3 CIR v Lever Bros & Unilever Ltd (1946) 14 SATC 1

4 ibid.

5 ITC 1485 (1990) 52 SATC 337; ITC 1496 (1991) 53 SATC 229; ITC 1587 (1995) 57 SATC 97; ITC 1588 (1995) 57 SATC 148

6 CIR v Pick 'n Pay Wholesalers (Pty) Ltd (1987) 49 SATC 132

7 Solaglass Finance Co (Pty) Ltd v CIR (1991) 53 SATC 1

8 IRC v Duke of Westminster 1936 AC 1

substantive nature of this type of share and has merit. Preference shares are treated as equity instruments in s 24J in South Africa and are not therefore taxable on the accruals basis. Possibly the South African approach should be reviewed as it is submitted that the United Kingdom approach is preferable. Such an approach should also be taken in the case of convertible securities. If such securities are likely to be converted to equity they should be treated as ordinary shares. In South Africa the approach should be similar to that adopted in the United Kingdom. Shares that give the holder a proprietorial interest in the company should not be covered by s 24J and shares which do not should be covered by s 24J.

Finally, it is clear that there are certain aspects of the new rules in the United Kingdom that have merit and highlight areas that could be applied in South Africa in order to improve s 24J. In addition, there are aspects of s 24J which could be adopted in the United Kingdom which could make the new rules simpler and more equitable.

It is important for the rules to be flexible in order for the market to develop This flexibility exists in the legislation in both countries

The new rules in the United Kingdom deal specifically with certain types of instruments such as those creating manufactured interest and deep gain securities It is submitted that has the effect of making the rules more complex and could lead to amendments as schemes are developed to take advantage of the distinctions contained in the legislation In this regard, the approach adopted in s 24J is preferable in that it does not distinguish between different types of instruments

The rules in the United Kingdom apply to various types of loan instruments and non-equity shares such as certain building society and preference shares The effect of these rules insofar as they apply to preference shares is that gains and losses relating to them are of an income nature Issuers may deduct any preference share coupons subject to the rule that excess returns are treated as distributions It is submitted that preference shares should either be treated as loan or equity instruments If they are treated as loan instruments, no distinction should be made between distributions and excess income The full coupon should be treated as akin to interest It is further submitted that the treatment of preference shares as loan instruments gives effect to the

applicable in South Africa where the rules contained in s 24J apply to all holders. Corporate traders have the advantage in South Africa of being able to account for trading stock in the normal manner and not on the accruals basis. Apart from this distinction and the fact that an income instrument can only be held by non-corporate holders, there is no distinction in s 24J between corporate and non-corporate holders. It is submitted that the United Kingdom approach should be adopted in South Africa so that the smaller non-corporate holders are not faced with the complex provisions of s 24J

The new rules in the United Kingdom give recognition to indexed gilts and certain types of linked loans. For example, in the case of an index-linked gilt credits and debits relating to the indexation are accounted for as non-trading items. No such distinction is made in s24J of the South African Income Tax Act. Whilst the approach adopted in the United Kingdom is equitable in that it has the effect of not taxing inflationary gains it does make the rules more complex.

Both the United Kingdom and South African rules enable the development of a strips market. The rules in the United Kingdom have specific rules covering strips whereas the general provisions of s 24J apply to strips in South Africa

The yield to maturity basis of valuing ongoing accruals in South Africa does create certain problems. The most important are that it does not take account of market fluctuations in the value of the instrument, that the financial effect of this basis is prohibitive in the case of discounting transactions and the taxation of discounts, particularly zero coupon bonds, has the effect of discouraging the issue of these types of instruments. The alternative bases of valuation of accruals is unclear. There can be timing differences between issuers and holders of instruments where different bases are adopted. Where the holder is a financial trader holding the instrument as part of its trading stock, tax on the discounting profit will only be payable when the instrument is sold or redeemed. Where the issuer adopts a yield to maturity or alternative basis of valuation, there will be a timing difference between the deductions claimed by the issuer and the accrual of income in the hands of the trader. It is submitted that there is no reason for such a situation to apply only to corporate financial traders and not individual financial traders.

The distinction in the United Kingdom between corporate and non-corporate holders of financial instruments has the advantage of being practical and realistic. Non-corporate holders below a certain threshold continue to pay tax on interest on the current basis. This approach is preferable to that

where possible, sought to distinguish the facts from those in Willingale and tax the trader on an accruals basis The issuer, as a general rule , deducted the discounting expenditure on an accruals basis

New rules have been promulgated in the United Kingdom They apply to companies with effect from 1 April 1966 and to the private investors affected by the rules with effect from 6 April 1966 They deal with all types of loan transactions. The new rules still draw a distinction between the position of the trader and the investor

It is interesting to note that the basis of taxing discounting profits in South Africa under s 24J, namely the accruals basis, is similar to the proposed changes in the United Kingdom The approach in the United Kingdom regarding small investors is commendable Although the rules in the United Kingdom are being simplified, it is considered that they are too complicated for the small investor Unfortunately in South Africa there appears to be no effort to exclude the small investor apart from the definition of an income instrument which applies to accrual of income This approach by the government in South Africa is questionable when one has regard to its apparent problems in administering the Income Tax Act

non-trading purposes would only have been able to deduct discounting expenditure if certain stipulated conditions were met.

In the case of a financial trader, it could have been strongly argued that, if its circumstances fell within the facts of Willingale, it should also have been taxed on a receipts basis. In this situation, there could also have been a timing difference in the tax treatment of the trader and the issuer. Where an investor acquired a deep discount bond, generally, a portion of the profit on sale or redemption of the bond would have been taxable and a portion would have been a non-taxable capital profit. The taxable portion would only have been taxable on a receipts basis. The issuer would generally have been able to deduct the discounting expenditure on an accruals basis over the period of the bond until its maturity. The position was similar to that of straight debt instruments where the issuer was an investment or holding company using the funds raised for non-revenue purposes.

Where a financial trader acquired a deep discount bond, the tax treatment of the discounting profit was similar to where the trader acquired a straight debt instrument. Thus, on the authority of Willingale, the trader argued that the profits were taxable on the receipts basis. Revenue,

period of the ownership Where there is no income tax charge the normal capital gains tax rules apply

The law in the United Kingdom is currently being changed It is accepted that the rules relating to the taxation of discounting transactions have become too complicated. It is intended to tax such transactions on an accruals basis

It is, therefore, apparent that the tax treatment of discounting transactions in the United Kingdom is fairly developed and complex Where an investor acquired a straight debt instrument at a discount, there were circumstances in which he could argue that the discounting profit was of a capital nature. Where the discounting profit was of a revenue nature, he would have been taxable on it on a receipts basis. Revenue argued that a financial trader, on the other hand, would have been taxable on its discounting profits on an accruals basis. The discounting expenses were deductible on an accruals basis over the period of the instrument. Thus, there were timing advantages where a straight debt instrument was issued to an investor The investor would have been taxable on a receipts basis whilst the issuer would only have been able to deduct the discounting expenses on an accruals basis It should be appreciated that an investment or holding company and a trading company raising funds for

value of the security issued under the prospectus constituted deep gain securities. Second, the terms of a qualifying indexed security were varied by agreement so that they were no longer excluded as deep gain securities, and, third, an event took place after the issue of a qualifying convertible security in terms of which it ceased to be excluded as a deep gain security

In 1990 legislation was introduced in order to tax the discount element on a transfer or early redemption of a qualifying convertible security Such security is one which is quoted on a recognized stock exchange, grants the holder a single option for early redemption, carries a right to convert the security into equity shares in the issuing company and would, but for the legislation, constitute a deep discount or deep gain security

Income tax is chargeable either where the holder transfers the security at a time when at least one option for early redemption is still open or where he redeems his security by exercising an option for early redemption An income tax charge arises where the security is redeemed at maturity

The amount of the income tax charge is the lesser of the amount obtained on transfer or redemption or the total income element in the discount for the

The issuer of a deep discount bond will be able to deduct the discount expenditure over the period of the bond until maturity and, in certain circumstances, a deduction may also be made by an investment company and a trading company where the funds raised are used for non-trading purposes.

In 1985 measures were introduced to combat a tax planning device known as coupon-stripping. This enabled an investor to defer his tax liability until the relevant securities matured.

In 1989 legislation was introduced to levy an income charge under schedule D case III or IV in respect of deep gain securities. The charge arose on the transfer or redemption of the security on the full amount of the gain realized. In the circumstances no charge for capital gains tax arose. The legislation included provisions covering the situation where a security did not constitute a deep gain security at the time of issue but, upon the occurrence of subsequent events, it was deemed to be a deep gain · ity.

The events which gave rise to a security being deemed to be a deep gain security were, first, the issue of further securities under the same prospectus as the original security with the result that at any time more than half of the

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