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A critical analysis of the South African Income Tax Act with regards to the taxation of financial instruments: in particular derivatives

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A research report submitted to the faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation).

A critical analysis of the South African Income Tax Act with regards to the taxation of financial instruments: In particular derivatives

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Declaration

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Mohale Maoke

30 April 2020

Abstract

The past two decades has seen the rise in popularity and usage of derivative instruments. During this period, financial engineering has advanced by leaps and bounds. Corporates use some form of financial innovation which includes the use of derivative instruments in their tax planning. The use of derivatives instruments results can result in a set of complex taxing problems. This includes but is not limited to problems in identifying the characteristic of the derivative income. This has often brought about the question of whether global tax authorities have been kept up with the advancements in derivative instruments. This increase in popularity has not gone unnoticed in South Africa which has resulted in a several academic studies undertaken regarding the challenges that emanate from the usage of these derivative instruments from a taxation perspective (Jabulani Masondo, 2009; Annette Wanyana Oguttu, 2012; Rohan Kruger, 2015, to name a few). South Africa since then enacted significant legislation for the taxation of financial instruments as well as anti-avoidance provision.

The aim of this research is to review the taxation of financial instruments, in particularly derivatives in terms of Income Tax Act 58 of 1962 ("the ITA") in the context of practical examples. The research will use the application of the general taxation principles, anti-avoidance provisions and case law on the taxation of derivative instruments.

Key words: gross income; general deduction formula, financial instruments; derivative instruments, taxable income, sections 11(*a*), 23(*g*), 24I, 24K, 24L, 24JB, Income Tax Act.

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Table 1: Definition of key terms used in this document

Key term	Definition
Authorised Users	A person authorised by a licensed exchange to perform one or more securities services in terms of the exchange rules, and includes an external authorised user, where appropriate. [1]
Cash settlement	In case of a cash settled derivative contract, the settlement of the contract does not involve any delivery of the underlying, but it is rather net settled in cash.
Credit risk	The risk that a loss will be experienced because of default by the counterparty in a derivatives transaction. [2]
Derivative	A derivative is defined as a financial instrument whose value depends on the values of other, more basic, underlying variables. These underlying variables are often the prices of traded assets. [3] A derivative is thus merely a contract between two or more parties. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes.
Exchange traded market	A derivatives exchange is a market where standardised derivative contracts defined by the exchange are traded by individuals. [4]
Financial instruments	The South African Income Tax Act, 58 of 1962 defines derivative financial instruments in section 1 of the ITA as follows: "financial instruments" includes –

[1] Financial Markets Act, No. 19 of 2012. Available at *http://www.gov.za/sites/default/files/gcis_document/201409/36121a.pdf* [Accessed: 30 April 2020], p 12.
[2] Hull, J.C., 2012.*Options futures and other derivatives* Pearson Education Limited, Global Edition, p. 802.
[3] Ibid, p. 1
[4] Ibid, p. 2

	b) any purchase or resale agreement, forward purchase agreement, forward sale agreement, futures contract, option contract or a swap contract; c) any other contractual right or obligation the value of which is determined directly or indirectly with reference to i. a debt security or equity; ii. any commodity as quoted on an exchange; or a rate index or a specified index
Fixed-for-floating swap	This a contractual agreement between two parties in which one party swaps the interest cash flows of a fixed-rate loan, with those of floating-rate loan held by another party. The principal of the underlying loans is not necessarily exchanged. [5]
Forward	A forward contract is defined as an agreement that gives rise to an obligation to either buy or sell an asset at a specific date in the future for certain price. It is traded in the over the counter ("OTC"). The buyer assumes a long position and agrees to buy an asset on a specified future date for a specified price. The seller assumes a short position and agrees to sell an asset on a specified future date for a specified price. [6]
Future	A futures contract is similar to a forward, in that it is an agreement to buy or sell an asset at a specific date in the future for certain price. Futures contract differ in certain aspects to a forward contract, as they are traded on an exchange. In order to make trading

[5] Investopedia, L.L.C., 2016. *Available online at* *https://www.investopedia.com/terms/f/fixed_floatswap.asp* [Accessed; 30 April 2020]
[6] Hull, J.C., 2012.*Options futures and other derivatives*, Pearson Education Limited, Global Edition, p.5

	viable, certain features of a futures contract are standardised. [7]
Future price or forward price	A forward price or future price is a price that is agreed upon between parties to trade a specific asset at a specific date in the future.
Hedge	A hedge is a trade that is designed to reduce risk that is associated with the underlying asset. This is achieved when a hedging instrument results in a price movement that is highly inversely correlated to the value of the hedged item. [8]
Impermissible tax avoidance	An arrangement or transactions whereby: • The sole or main purpose of the arrangement is or was to obtain a tax benefit; • The arrangement is abnormal, lacks commercial substance, or has create rights and/or obligations which are not at arm's length. An action undertaken by the taxpayer to escape legal obligations by fraudulent or other illegal means. [9]
Long Position	A position involving the purchase of the asset. [10]
Marking to market	The practice of accounting for instruments by revaluing (fair value) them so that they reflect the current market price.[11]
Options	Option contracts are derivative contracts that gives the holder the right but the not the obligation to choose whether or not to buy or sell an underlying asset at a pre-agreed price at some point or points in the future.

[7] Ibid, p. 7
[8] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*, LexisNexis Butterworths: Durban p. W-3, ..
[9] Haupt, P., 2020.*Notes on South African Income Tax 2020*, H & H Publications: Roggebaai, p. 641
[10] Hull, J.C., 2012.*Options futures and other derivatives*, Pearson Education Limited, Global Edition, , p.5
[11] Ibid p. 810

	Option contracts are traded both on the exchange as well as in the over-the-counter market. [12]
Repo rate	The repo rate is set by the Reserve Bank's Monetary Policy Committee and is the rate at which it lends money to the country's commercial banks.
Par value	The principal amount of an asset. i.e.: current Spot price of a share. [13]
Physical delivery	In the case of contract, the holder will either have to take receipt of the underlying from the counterparty or vice versa depending on whether they are long or short the contract.
Prime rate	The lowest rate of interest at which money may be borrowed commercially.
Pull to par	The reversion of an underlying asset to its par value. [14]
Short Hedge	A hedge where a short futures position is taken. [15]
Short Position	A position assumed when traders sell an underlying asset that they do not own. [16]
Spot	Spot price is defined as the current market price at which an asset is bought or sold for immediate payment and delivery.
Swap	A swap is defined as an agreement to exchange cash flows in the future. The swap agreement defines the dates when the cash flows are to be paid and the manner in which they will be calculated. Swap are traded over-the-counter market. An interest rate agreement is an example of a swap where one party agrees to exchange a fixed rate for a floating rate. [17]

[12] Ibid, p. 7
[13] Ibid, p. 811
[14] Ibid p. 812
[15] Ibid, p. 813
[16] Ibid
[17] Ibid, p. 815

Tax avoidance	A legitimate means used by taxpayers to arrange their tax affairs so as to pay the minimum amount of tax .[18]
Tax evasion	An action undertaken by the taxpayer to escape legal obligations by fraudulent or other illegal means. [19]
Tenor	Term of the contract to maturity.

[18] IRC v Duke of Westminster 1936 AC. 1; 19 TC 490
[19] Haupt, P., 2020.*Notes on South African Income Tax 2020,* , H & H Publications: Roggebaai, p. 638

List of abbreviations and acronyms

Table 2: Abbreviations and acronyms

Abbreviation	Meaning
CBOE	The Chicago Board Options Exchange (CBOE) is an exchange used for trading standardised options contracts, including stock options, Leaps, interest rate options, foreign currency options, and index options.[20]
CGT	Capital gains tax (the tax on capital gains computed in terms of the Eighth Schedule to the Income Tax Act)
GAAR	General Anti-Avoidance Rules (ss 80A-L of the Tax Act)
ITA	The South African Income Tax Act 58 of 1962
JSE	Johannesburg Stock Exchange
LSE	London Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OTC	Over the counter
SARB	South African Reserve Bank
SARS	South African Revenue Service
TAC	The Tax Advisory Committee, 20 July 1994. South Africa: Consultative document on the tax treatment of financial arrangements.

[20] Investinganswers.com. *Available online at* https://investinganswers.com/dictionary/c/chicago-board-options-exchange-cboe [Accessed; 30 April 2020]

Chapter 1

Introduction

This contribution seeks to review the South African income tax regime in dealing with financial instruments in particular derivatives and assess whether the existing framework is adequate to deal with taxation of these instruments.

A good tax system is benchmarked against the canons of taxation which were formulated by Adam Smith's in his book, The Wealth of Nations. The canon of equity, which is based on the concept of fairness, requires that a good tax system to impose tax based on each taxpayer's ability to pay principle. The canon of certainty which relates to the certainty around the timing, amount and which tax liabilities will be settled. Taxes should be levied in a manner or at a time that is most convenient to the taxpayer. A tax system should be economically efficient, and this will be achieved whereby a taxpayer's decision is not solely influenced by the tax outcome of taking one decision which has a greater tax benefit than the other course of action. Lastly a good tax system should be designed in such a manner that it is administratively efficient in that it will not result in unreasonable tax administration for both the taxpayer and the tax authorities.[21]

The principle of flexibility relates to a tax system that is easily modifiable in response to changes in economic circumstances. Although this principle does not form part of the original canons of taxation, however, it is recognised internationally as a key tax principle for modern taxation. [22]

The Tax Advisory Committee on financial arrangements indicated that the taxation of derivative instrument should comply with the canon of certainty, tax neutrality and flexibility.[23] Due to the fact that derivatives change on a daily basis, the principle of certainty outweigh the disadvantages of complexity which may be brought about by new legislation in pursuit of the flexibility principle.

[21] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke: South African Income Tax 2018*., LexisNexis, Durban' pp. 5-8

[22] Ibid

[23] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*, LexisNexis Butterworths: Durban' p. W-6-2,

An American hedge fund manager once said, “Derivatives in and of themselves are not evil. There is nothing evil about how they are traded, how they are accounted for, and how they are financed, like any other financial instrument, if done properly.” [24]

According to the Bank for International Settlement, as at December 2015, the size of the Over the counter (OTC) derivatives market measured by the total outstanding contracts amounted to $493 trillion. The South African OTC derivatives market, however, constitutes less than 1% of the total global OTC derivative market. Despite South Africa’s relatively small share of the global market, the OTC derivatives market plays a key role in the South Africa capital markets and its economy. According to a study that was commissioned by National Treasury and conducted by PricewaterhouseCoopers (PwC), as at June 2012 the total outstanding notional amounts for the OTC derivatives was valued at R27.7 trillion. This value is made up of interbank transactions between domestic and foreign banks, between domestic banks, and other non-financial participants including corporates. Interest rate derivatives constitutes a significant bulk of the OTC derivatives value with an estimated outstanding notional amount of R24.3 trillion followed by foreign exchange derivatives with an estimated outstanding amount of R3.3 trillion.

Derivative instruments can give rise to three types of cash flows, in particular:

- Cash flows that can be made or received at the outset of the transaction, such financing fees or premiums;
- Regular cash flows can be made over the period of the derivative, for instance periodic payments in terms of an interest rate swap agreements; and
- Cash flows on the maturity date of the transaction,

These derivative instruments can be classified into two categories: those that are forward-based and those that are option-based. They may be transacted on a stand-alone basis or embedded in other instruments, often known as structured products. The taxation of derivatives has been proven to be quite challenging due to the level of innovation, advancement and lack of understanding that is associated with these financial instruments. Derivative transactions have also often been linked to some form of tax arbitrage which has resulted in questions about the nature of the income that they generate. The South African tax dispensation has recently seen the introduction

[24] McCartin, T.J., 2015. A Derivative in Need: Rescuing US Security-Based Swaps from the Race to the Bottom.*Brook. L. Rev.*, *81*, p.361.

of new legislation together with the general anti-avoidance regulation to deal with derivatives.

1.1 The Statement of the Problem

This research will examine the adequacy of the South African tax treatment of derivatives as it currently stands. The general tax principles together with the specific anti-avoidance as well as general anti avoidance provision will be applied to basic derivatives. This analysis recognises the complexity associated with the taxation of derivatives emanates from the lack of the fundamental principles which are associated with derivatives. Accordingly, a review will be done to determine what are derivatives and then basic types of derivatives which exist will be identified. The enactment of s 24JB of the ITA and impermissible tax avoidance arrangements (s 80A to s 80L), together with case law of the enhanced South Africa's tax regime on the taxing of derivative instruments. Against this background the question that this research report hopes to address is whether the Income Tax Act and the existing judicial precedents are adequate to deal with the taxation of financial instruments specifically derivatives and whether there is a need for new provisions in the Act.

1.2 The sub problems

The first sub-problem is to establish a basic understanding of what derivative instruments are including their legal nature. In this regard, derivatives will be defined as well as identifying the two basic types of derivatives instruments that The OTC Derivatives Working Group has identified.

The second sub-problem is to understand how derivative are taxed in South Africa. As it stands currently, the South African tax is to include amounts in gross income on the earlier receipt or accrual. The ITA further has specific timing provisions which state when and how these instruments will be included in taxable income. A review is required of the application of the general tax principles and the specific provisions linked to the taxing of derivative instruments.

The third sub-problem that arises are the challenges that are brought about by the constant innovation in the financial markets especially with regards to derivative

instruments. The problem will be examined by considering the following but not limited types of innovations:

- Unintended consequences of new laws regulations, considering the recent addition of section 24JB.

The flexibility of derivatives to be able to be transacted in combination or stand alone and the flexibility they provide wherein the agreements have the ability to capture different settlements terms (i.e.: physical delivery versus cash delivery) can further complicate the taxation of derivative instruments.
The resultant question is to examine whether there is a need by SARS to enact more comprehensive legislation that will allow flexibility and capture all possible derivative scenarios.

1.3 Methods, procedures and techniques

In order to answer the research problem, this report undertakes to perform an extensive literature review and analysis on the taxation of derivative instruments in South Africa. Reference will be made using practical examples for illustrative purpose of the different uses of derivative instrument by considering the common types of derivative contracts.

The taxation of derivative instruments in South Africa will be considered in line with ITA general income tax principles, which include the definition of gross income together with specific provision that supplement or override this basis. This analysis will include consideration of the relevant judicial decisions and commentary. The purpose of this is approach is to obtain a complete understanding of the conceptual basis of the general tax principles as specific provisions that underpin the taxation of derivatives in South Africa. The research will be conducted in the form of a critical analysis on the taxation of derivative instrument in South Africa.

The sources of information that will be used for this research will include:

- Books
- The Income Tax Act and Explanatory Memoranda;
- Relevant case law;

- Statutes;
- journal articles and textbooks;
- Electronic databases;
- Electronic resources – internet;
- Publications;
- and any other publicly available documents or piece of reliable information relevant to the research.

All of the data used for this research is available in the public domain and therefore no ethical considerations will arise in relation to its use.

1.4 Scope and limitations

The objective of this research is to cover the taxation of financial instruments, in particular derivatives. It does not cover any other type of financial instruments. Only relevant aspects of the South African ITA are considered, and the focus is the general tax principles including capital gains tax, definition of gross income, general deduction formula as well as specific timing provision of sections 24JB, 24K, 24I and 24L. This research does not cover the taxation of derivatives in relation to non-residents taxpayers. Therefore, it is exclusively focused on the South African taxation principles in relation to residents. In the case of a non-resident taxpayer, the Double Taxation Agreements would need to be considered and whether or not the non-resident will be deemed to be an exclusively resident in another country for the purpose of taxation.
The research is only specifically focused on the South African income tax implications. The taxation of hybrid instruments, together with indirect taxes such as Value-Added Tax, Securities Transfer Tax and group provisions fall outside of the scope of this analysis.

1.4 Overview of the research report

The research is divided into five chapters.

Chapter one serves as the introduction of taxation in South Africa as well as providing the background to the focus area which is derivatives. The chapter will

further set out the problem statement, the goals of the research and the methodology that will be applied in order to achieve the stated goals. The discussion will further further provide a summary of the scope of the research as well as the limitations encountered.

Chapter two will provide a brief background to taxation in South Africa. In this chapter we will also define derivative and provide a brief historical background of derivatives. It will further examine the primary uses of derivatives in the global economy. This chapter examines practical examples of the most frequently used derivative contracts in the market. The chapter will close off by considering the interaction between derivatives and taxation.

Chapter three will provide an overview of the general tax principles in South Africa. The relevant definition of the gross income and the specific provisions that enhance or override the general tax principles with regards to the taxation of derivative instruments in terms of ITA will be reviewed. This discussion will cover the interplay of the specific timing provisions in terms of sections 24JB, 24K, 24I, 24L, the “gross income” definition, section 11(*a*) read together with section 23(*g*).

Chapter four will examine the adequacy of the existing framework, that is contained in the Income Tax Act and whether they are flexible enough to deal with the innovation brought by derivative instruments. A further analysis will also be made with regards to the history of some of the unintended consequences as a result of enactment of new tax laws in South Africa. The common law principles of substance over form will also be reviewed with specific discussion of sections 80A to 80L in how it addresses the taxation of derivatives instruments.

Chapter five will conclude the research by summarising the findings outlined in previous chapters, as well as any unresolved issues and problems which were identified, and where applicable, will propose solutions or areas for further clarification or amendment.

Chapter 2

History of taxation in South Africa as well as understanding derivatives and what they are used for.

This chapter will provide a brief background to taxation in South Africa. It will also define what derivatives are as well as providing a brief historical background of derivatives. It will further look into the three uses of derivatives in the global economy. This chapter will present practical examples of the most frequently used derivative contracts in the market. The chapter will then close off by considering the interaction between derivatives and taxation.

Allan Greenspan once famously said, “What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn’t be taking it to those who are willing to and are capable of doing so”.[25]

2.1 Brief history of taxation in South Africa

Taxation in South Africa has been around since the 1600s. The earliest documentation, was the imposition of transfer duty on property transferred by sale and customs taxes imposed on goods imported to the Cape Colony.[26] During this period, the taxes were imposed at a colonial level. Most of South Africa’s earlier taxes were inherited from Netherlands and Britain. Most of these taxes were subsequently nationalised in an attempt to simplify their requirements.[27]

Income tax has been levied since the 1800’s, however, the amendments that were made in the early 1900s transformed the tax system into the format that is known today.[28] Significant contributors to South Africa’s tax system were:

- the Franzsen Commission – issued two reports in 1968 as well as in 1970;
- the Margo Commission – issued a single report in 1986; and

[25] Goodman, P.S., 2008. Taking hard new look at a greenspan legacy. *The New York Times*, *9*. Available at: https://www.nytimes.com/2008/10/09/business/economy/09greenspan.htm [Accessed on 27 March 2020]l

[26] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 12

[27] De kock MH Economic History of South Africa Juta & Co. Ltd (1924) at 300

[28] Ibid

- the Katz Commission – issued nine interim reports between 1994 & 1999.

There have been significant changes since the Katz Commission in the South African tax system.[29] The Davis Tax Committee was established in 2013 in order to review whether or not the current tax policy framework facilitates 'inclusive growth, employment, development and sustainability'.[30]

2.2 Definition of derivative

Hull defines a derivative as a financial instrument whose value is dependent on the values of other, more basic, underlying variables.[31] The most commonly used underlying variables include an interest rate, a physical commodity, a company's equities, an equity index or a currency.[32] Parties to a derivative contract therefore have the ability to agree to reference almost any instruments.

The underlying variable or underlying asset can be described as the "cash market", which is a market for immediate delivery of a specific underlying variable from which the value of a derivative contract is determined from.[33]

The history of derivatives will be described briefly as well as practical examples of how these instruments are used in the South African economy. These examples will undertake to highlight the three general uses of derivatives which are:

- hedging;
- synthetic investment; or
- speculation.[34]

[29] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 12.
[30] Ibid
[31] Hull, J.C., 2012.*Options futures and other derivatives* Pearson Education Limited, Global Edition, p. 802.
[32] Ibid
[33] National Treasury "An Examination of the South African OTC Derivatives Market to Recommend Measures for Strengthening their Regulatory Oversight" available at http://bit.ly./1C9QVsr
[34] Brincker, E., 2007.Taxation principles of interest and other financing transactions. LexisNexis Butterworths. P. W-3.

“Weber 2008 elaborates on the fact that derivative contracts emerged as soon as humans were able to make credible promises.”[35] Derivatives have existed as long as man has existed. There is corroboration of the existence of derivative contracts which dates back as 4000BC in Mesopotamia time.[36]The fundamentals to a commercial agreement is the ability to document legally binding elements for parties to the contract.[37]One of the cornerstones to a commercial agreement is the ability to document fundamental elements of a transaction.[38] It therefore makes sense why the advent of writing on clay tablets coincided with the prototypical derivative contract for future delivery.[39]

The Chicago Board of Trade was established in the United States of America (US) in 1848. The objective was to provide US farmers with the ability to mitigate themselves against movement in prices and as a result, the price fluctuations of their bankers.[40]

“The futures market set a price for grain for the delivery of a standardised grade, at a later delivery date (Poitras,2006).”[41]

This platform provided the farmers with the ability transfer the price risk which is linked with ownership of the grain through "hedging".[42] Traders were also able to speculate on the fluctuation in prices linked to the grain. Both parties deduced that the selling and delivery of the grain was as equally as important to the ability to transferring price risk.[43].

During the 1980s, the rapid traction in the financial instrument market resulted in further evolution to derivatives.[44] The business schools during this era produced the pioneers of financial managers who had exposure to derivatives.[45]In the same decade, the global economy saw the introduction of formal exchanges, improvement in technology and marking-to-market of instruments in order to address credit risk. There was extensive usage of derivatives due to increased demand driven by small and big business alike. These instruments were mainly used for hedging and/or

[35] Greenbaum, M.J., 2011.*The use of derivatives in the mining sector: a comparative analysis of companies listed in South Africa, Australia and the UK* (Doctoral dissertation, University of Cape Town).
[36] Ibid.
[37] Ibid
[38] Ibid
[39] Ibid
[40] Ibid
[41] Ibid
[42] Ibid
[43] Ibid
[44] Ibid
[45] Ibid

speculative purposes in underlying assets such as interest rate, exchange rate and commodity risk. [46]

"In 1983, the Chicago Board Options Exchange (CBOE) saw the introduction of options on broad-based stock indexes. The CBOE launched the CBOE-100 Index, which was later renamed the Standard and Poor's 100 Index(S&P 100 Index), and on July 1, 1983, options trading on the S&P 500 Index was launched." [47]

Having considered a brief history of derivatives, we will now obtain an understanding of where these instruments are currently traded as well as their uses in the economy.

2.2 Where are derivatives traded?

The manner in which derivative contracts are traded allows for them to be split into two separately identifiable groups.[48]

2.2.1 Over-the-counter (OTC) derivatives

OTC derivatives are financial contracts that are not traded on a recognised exchange and can be customised in order to suit the needs of parties to the agreement.[49] These instruments are then directly booked between the parties to the contract.[50] International Swaps and Derivative Association (ISDA) has identified five primary differences between OTC derivatives and exchange traded derivatives.[51] This member based group further states that differentiates futures and swaps by This member based group further differentiates futures as contracts which are exchange traded and swaps as OTC instruments.[52]

These fundamental differences are noted below:

> Firstly, the terms of a futures contract—including delivery places and dates, volume, technical specifications, and trading and credit procedures, whilst standardised for futures are subject to negotiation for an OTC derivative such as a swap. Futures contracts are always traded on an exchange, while swaps are traded on a bilateral basis. Third, those who engage in futures transactions assume exposure by default to the exchange's clearinghouse; for OTC derivatives, the exposure is to default by

[46] Ibid
[47] Ibid
[48] Ibid
[49] Investopedia. 2020. Over the Counter Derivative. *Available online at* https://www.investopedia.com/ask/answers/052815/what-overthecounter-derivative.asp [Accessed on 30 April 2020].
[50] Greenbaum, M.J., 2011.*The use of derivatives in the mining sector: a comparative analysis of companies listed in South Africa, Australia and the UK* (Doctoral dissertation, University of Cape Town).
[51] Ibid
[52] Ibid

> the counterparty. Fourth, credit risk mitigation measures, such as regular mark-to-market and margining, are automatically required for futures but optional for swaps. Finally, futures are generally subject to a single regulatory regime in one jurisdiction, while swaps, although usually transacted by regulated firms—are transacted across jurisdictional boundaries and are primarily governed by the contractual relations between the parties. [53]

As stated in this chapter to the study, OTC derivatives are represented by a significant outstanding value globally.

2.2.2 Exchange-traded markets (ETMs)

ETM is a regulated platform that lists and trades standardised derivative contracts.[54] An example of this is the Johannesburg Stock Exchange (JSE) where standardised products that are being traded on the exchange include agricultural derivatives, currency derivatives, energy derivatives, equity derivatives, interest rate derivatives as well as metal derivatives.[55] As noted, the derivative contracts traded on the ETM are standardised and regulated and are thus not a focus of this study.

2.3 What is the primary purpose for derivatives:

Derivatives are primarily used to achieve three objectives. That is for hedging, speculation and/or arbitrage. Hedging is a risk management technique where the hedgers take a position which will result in a reduction in return volatility. Derivatives transaction can also provide a source of income through taking a speculative or arbitrage positions.[56] A speculative position is when one wishes to bet on the future price movements of as asset. Arbitrageurs are in the business of taking advantage of price discrepancy from a specific instrument.

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[53] Ibid

[54] Investopedia. 2020. Exchange Traded Derivative. *Available online at* https://www.investopedia.com/terms/e/exchange-traded-derivative.asp [Accessed on 30 April 2020].

[55] Johannesburg Stock Exchange, Products and Services. Available at https://www.jse.co.za/trade/derivative-market/equity-derivatives/reports [Accessed on 30 April 2020

[56] Oguttu, A.W. 2012. Challenges in taxing derivative financial instruments: international views and South Africa's approach. *SA Mercantile Law Journal*, *24*(4), pp.385-415. Available at: https://heinonline.org/HOL/LandingPage?handle=hein.journals/safrmerlj24&div=38&id=&page= [Accessed on 7 March 2020

2.3.1 Hedging

A taxpayer can enter into a derivative contract, where the value of the instrument entered into moves in an inverse proportion to the value of the underlying asset they actually own. When a platinum mining company is concerned about the fluctuations of the platinum price in the commodity market which will result in their earnings being volatile. Hedging transaction would then be entered into to mitigate against the commodity price fluctuations. In order to achieve this for example, the same mining company can enter into a derivative contract that will offset this commodity price risk. A practical application of this is stated as follows: a platinum miner has entered into a contract to sell 10 tons of platinum to a car manufacturer in 3 months' time. The selling price has been agreed by both parties to be based on the prevailing market price of platinum on the day of delivery. At the time of signing the contract, the prevailing spot price for platinum ore is a $1,010/oz which the price of platinum future for delivery in three months' time is $1,000. To fix the selling price of $1,000/oz, the mining company can enter into a derivative contract where they sell 10 tons of platinum derivatives that will mature in three months' time. The platinum miner would have effectively locked in a profit on day one and thus they have mitigated their earnings from fluctuations in the commodity price. The mechanics of how this is achieved will be demonstrated further on when this research report discuss examples using a specific type of derivative in section 2.4 below.

2.3.2 Speculation

A taxpayer can enter into a derivative contract, where they can effectively take a bet on the movement in the price of an asset. For example, if a taxpayer is of the view that the price of Brent crude oil will fall over in the next six months, then they will enter into six months derivative contract where they sell 100 oil futures contracts. Assuming that on day 1 the prevailing oil spot price is $100/barrel and one Brent crude oil derivative contract that matures in 6 months' time is trading at a future price of $105/barrel. The taxpayer will then enter into a derivative contract to sell Brent crude oil at $105/barrel for delivery in six months' time. If the spot price of the Brent crude oil in six months' time is $90/barrel, the taxpayer would have effectively locked in a selling price of $105/barrel on day 1, therefore resulting in a profit for them.

2.3.3 Arbitrage

An arbitrage trade involves locking in a riskless profit by buying and selling the same asset in two different markets. An example of this is that Investec is a dual listed stock as Investec's ordinary shares are listed on both the JSE as well LSE. At any given moment there could be a price discrepancy on the ordinary share price between the two exchanges. For example, if the spot price for an Investec stock listed on the LSE is currently quoted at R102/ share and then on JSE its currently trading at R100/share, a taxpayer can buy a 100 Investec shares on JSE and sell a 100 Investec shares on the LSE. Thus, resulting in a riskless profit R200 for the taxpayer. [57]

2.4 Types of derivative contract used in market

Explanatory Memorandum: Annexure C, which was which a study conducted by PwC, identifies two types of derivative instruments:

- Forward base – these are derivative agreements to exchange, where the parties to the contract agree to exchange an underlying asset for a specific price on a particular day in the future. The settlement can be done physical or a net cash flow. In a forward contract, parties can agree that on settlement date they can exchange the physical asset or net cash in the movement in the price of the underlying asset. Forwards based derivative instruments include, forward contracts.
- Options based – these derivative instruments provide the option holder the right but not the obligation to choose to buy or sell an underlying asset at a specific price at some point or points in the future.[58]

Having regard to two types of derivative instruments stated, as well the uses of derivative the research report will provide an example of a forward contract, a swap and an option.

[57] Hull, J.C., 2012.*Options futures and other derivatives*, Pearson Education Limited, Global Edition, , p.15

[58] National Treasury "An Examination of the South African OTC derivatives market to recommend measures for strengthening their regulatory oversight" Available at http://www.treasury.gov.za/legislation/bills/2012/FMB/Annexure%20C%20An%20examination%20of%20the%20OTC%20derivatives%20market%20(Skerrit).pdf [Accessed on 30 April 2020], p. 13

2.4.1 Forward contract and future contract

A forward contract and future contract are similar instruments with the major difference being that forward contract is traded in the OTC market and futures contract is traded on the ETM market. In the use of derivative contracts under the topic hedging, the example of the derivative that can be utilised is a commodity (platinum) future. The mining company would have entered into short futures contract with the JSE. On maturity date the derivative instrument will pull to par.[59] If the spot price of platinum on maturity of the futures contract is a $980/oz, then mining company will deliver the platinum to the buyer and receive $980/oz. Then from the futures contract they will also realise a gain of $20/oz being the difference between locked in futures price of $1000/oz and the spot price of $980/oz on maturity day. The platinum miner will have essential hedged the price of platinum as they effectively would receive $1000/oz (Sale of platinum $980/oz plus a gain on the future contract of $20/oz).

2.4.2 Swap

The majority of OTC derivative transactions are vanilla interest rate and foreign exchange rate swaps.[60] The research will provide an example of a “vanilla” interest rate swap. An interest rate swap transaction is an agreement where parties agree to exchange cash flow based on a notional principal amount (the notional amount is not actually exchanged). For example, Mzansi Gold Mine Ltd has issued R50m three-year bonds in the market at par value with a variable interest rate defined as prime plus 1%. The current prime lending rate is assumed to be 9%. Mzansi Gold Mine’s treasurer and management are concerned that the South African economy is entering into an interest rate hiking cycle and that the SARB will increase the repo rate over next two-year period. Mzansi management forecast that South African economy will be undergoing an interest rate hiking cycle which will result in the prime lending rate increasing by a further 4% or 400 basis points. This will result in an increase in Mzansi Gold Mines weighted average cost of capital (“WACC”). Thus, management would like to put a ceiling to the WACC at a maximum rate of 12.5%

[59] Refer to scope limitation for regarding the pull to par principle.

[60] National Treasury “An Examination of the South African OTC derivatives market to recommend measures for strengthening their regulatory oversight” Available at http://www.treasury.gov.za/legislation/bills/2012/FMB/Annexure%20C%20An%20examination%20of%20the%20OTC%20derivatives%20market%20(Skerrit).pdf [Accessed: 30 April 2020], p. 20

because beyond this rate their business will not be profitable. Mzansi management entered into a fixed-for-floating interest rate swap agreement with ABC Bank. In terms of the agreement, Mzansi Gold agrees to pay ABC Bank maximum interest of 12.25% based on a notional principal amount of R50m. prime plus 1% in exchange on a notional principal of R50m in exchange, while ABC Bank agrees to pay Mzansi Gold prime plus 1% based on a notional value of R50m.[61]

Assuming the prime lending rate increases at the beginning of year 1 by 2.5% (250 basis points) and in year 2 by a further 0.5% (50 basis points) then the impact on Mzansi profits will be as follows:

	Prime rate	Prime +1%	Fixed rate	Notional Principal	Floating interest rate paid to Mzansi Gold by ABC	Fixed interest rate paid to ABC Bank by Mzansi Gold	Mzansi Gold Net Gain
Year 1	11.50%	12.50%	12.25%	50 000 000.00	6 250 000.00	6 125 000.00	125 000.00
Year 2	12.00%	13.00%	12.25%	50 000 000.00	6 500 000.00	6 125 000.00	375 000.00

The above illustrates that Mzansi Gold mine has effectively cushioned their interest rate risk by entering into fixed-for-floating swap.

2.4.3 Options

There are two types of options. A person can buy into a call option of an underlying asset. This makes him the holder of the call. For example, a call option on listed equities will give the right to buy the listed equities for a certain period but not the obligation. The other type of option is called a put option. The seller of put option is called a writer of the put. A put option gives the holder a right to sell underlying asset by a specific date at a specific price.[62]

Thabang Zulu who is a novice investor purchased 100 ABC Limited ordinary shares 3 years ago. ABC Limited is a South African company that is listed on the JSE. The current spot price is R110 per share. Thabang would like to generate additional income over and above the annual dividend he receives from ABC Limited. He is of the view that ABC's share price will not rise above R117 in the next quarter. Thabang has recently saw that there is a R117 ABC call option maturing in the next quarter. He also noted that he can sell the call option and receive a call premium of R20 (R0.20 x 100

[61]. Investopedia, L.L.C., 2016. Available online at https://www.investopedia.com/terms/f/fixed_floatswap.asp [Accessed; 30 April 2020]

[62] Hull, J.C. 2012. *Options futures and other derivatives*. Pearson Education Limited: Global Edition p. 812

ABC shares). This represents an enhancement to his annual earnings. Thabang therefore sells the call option and receives R20 premium.[63]

Following ABC's annual financial statements presentation where they recorded higher than expected return, the company share price rises to R117 per share in the market. The buyer of the call option will exercise their right to buy and this will result in Thabang having to deliver his ABC shares and receive R117 for each of these 100 shares. He will have realised income of R7 per share from the sale of his shares plus a premium of R20. If the stock price does not rise above the R117 mark, Thabang would have realised an income of R20 representing the premium and still keep his shares.

2.5. Conclusion

Derivatives have a long history dating to the beginning of time. They can either be traded over the counter on through the exchange market. They have the following functions in the economy: they be used for risk management purposes or for speculation or arbitrage. They can take the form of forward based contracts or options-based contracts. Derivatives can be traded as a stand-alone, in combination or form part of a structured instrument.[64] Financial innovation and regulation have in the past co-evolved, however in recent times, the advancement of technology and financial innovation has resulted in the outpacing of the regulatory cycle.

[63] Investopedia, L.L.C., 2016. Available online at https://www.investopedia.com/terms/c/calloption.asp [Accessed 5May2020]

[64] Memorandum, E. and Annexure, C., An Examination of the South African OTC Derivatives Markets to Recommend Measures for Strengthening their Regulatory Oversight. Available at http://www.treasury.gov.za/legislation/bills/2012/FMB/Annexure%20C%20An%20examination%20of%20the%20OTC%20derivatives%20market%20(Skerrit).pdf [Accessed on 30 April 2020], p. 14

Chapter 3

Critical analysis of the South African Income Tax Act with specific regard to financial instruments in particular derivatives

3.1 Introduction:

The purpose of this chapter is to provide an overview of the general tax principles in South Africa and how these principles apply in the taxation of derivative instruments. The manner in which this objective will be met is by understanding what constitutes taxable income in terms of section 1 of the ITA. Then the research will further go through how taxable income is derived. This will be done discussing the gross income definition, the specific provisions that enhance or override the general tax principles, as well as the general deduction formula. This discussion's main focus will be how these principles set out in the ITA apply to the taxation of derivatives in South Africa.

3.2 Taxable Income

A person's tax liability is imposed by the Income Tax Act on their taxable income.[65] Section 5(1) of the ITA states that there shall be an income tax levied on "in respect of the taxable income received by or accrued to" a taxpayer during the year of assessment.

Section 1 of the ITA defines taxable income as follows:

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

The term "income" is defined in section 1 of the ITA as follows:

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

Thus, in order to determine the taxpayer's taxable income, the first step is to determine their gross income. [66]

[65] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, pp. 21-24.
[66] Hutton, S.J., 1998. The taxation of derivatives in South Africa. *The Taxpayer*, *47*(10), p. 164

3.3 Gross income

The ITA defines the term gross income as follows:

> in relation to any year of or period of assessment, means –
> *i)* In the case of any resident[67], the total amount, in cash or otherwise, received by or accrued to or in favour of such resident: or
> *ii)* In the case of any person other than a resident[68], the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,
> during such a year or period of assessment, excluding receipts of a capital nature.

When a taxpayer derives a gain from derivative transactions and this gain meets the definition of gross income in terms of the ITA, this gain will be taxable at normal rates in terms of section 5 ITA. However, if the gain generated from a derivative transaction is of a capital nature, it may be included in the taxpayer's income at CGT rate, if it constitutes a taxable capital gain for the taxpayer.

In terms paragraph 10 of the Eighth Schedule of the Act, the taxable capital gain for different types of taxpayers is stated as follows:

- 40% of 'net capital gain' for individuals, special trust, deceased estate, insolvent estate, or individual policy holders;
- 0% of 'net capital gain' if a taxpayer is the untaxed policyholder fund of an insurer;
- 0% of 'net capital gain' in any other case. E.g.: Company or close corporation. [69]

The provision of section 26A of the ITA, require a taxpayer to include the taxable capital gain that they have derived during the year of assessment in their taxable income. The nature of the gain derived from derived transactions needs to be determined because of the implication of its inclusion into taxable income. As such, it is important to distinguish the classification of the income generated form a derivative transaction. Is the income capital or revenue in nature?

3.3.1 Total amount in cash or otherwise

The courts have established that the total mount in cash or otherwise includes non-cash items. In *CIR v Lategan* **[70],** the court held the that word "amount" should be given a wider meaning than merely referring to money. Amount must also include the value of every property earned. The court further stated that in the instance where

[67] Refer to Chapter 6 – Scope Limitation of this research.
[68] Refer to Chapter 6 – Scope Limitation of this research.
[69] Haupt, P., 2020.*Notes on South African Income Tax 2020*. H & H Publications: Roggebaai. p. 662
[70] *Lategan v CIR* (1926), CPD 203, 2 SATC 16

the taxpayer acquires a right during the year of assessment to receive instalments of an amount in subsequent years, that the present value of the right should be included in the taxpayers' gross income.[71]

In *CSARS v Brummeria Renaissance*[72], the court concluded that the right to use the loan capital interest-free was a right with a determinable monetary value. The court also held that the test to determine whether a right has a monetary value was an objective test and thus not a subjective test.[73]

3.3.2 Received by or accrued to

The ITA does not define the phrase "received by or accrued to". Relevant cases will be used to define this.[74]

A taxpayer can either receive an amount during the year of assessment or accrue that amount. If an amount is neither received nor accrued, it will thus not be included in gross income. [75]

If the value of an asset appreciates (increases in value) over time, this does not imply that this value should be included in the taxpayers' gross income.

In a similar manner, opportunity cost forgone due to not investing money in a certain way also does not result in the taxpayer being required to include this opportunity cost in their gross income.

3.3.2.1 Meaning of received by

In the case of *Geldenhuys v CIR* **[76]**in order for it to qualify for purposes of the gross income definition, the court held that an amount will be physically received by the taxpayer only if it is "received by the taxpayer on their own behalf and for their own benefit". [77]

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[71] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, pp. 34-35.

[72] *CSARS v Brummeria Renaissance* (Proprietary) Limited & Others 69 (2007 SCA 99 RSA) (69 SATC 205)

[73] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 35

[74] Ibid, pp.35-36

[75] Ibid, pp.35-36

[76] *Geldenhuys v CIR* 1974 (3) SA 256 (C); 14 SATC 419

[77] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 36

In *Brookes Lemos Ltd v CIR*[78] as well as *Pyott Ltd v CIR* **[79],**the court held that, even if the taxpayer has an obligation to return money to a customer under an agreement with the customer, the amount can still be received by the taxpayer for their own benefit if the taxpayer receives the money as their own.[80]

In *CIR v Delagoa Bay Cigarette Co*[81], the court found that whether the business activities were legal or illegal, this was not the purposes of determining whether an amount received should be subject to tax. Thus, the court held that receipts and accruals from illegal activities are included in gross income.[82]

3.3.2.2 Meaning of accrued to

In *CIR v People's stores (Walvis Bay)* [83], the taxpayer, was a retailer of clothing. The taxpayer had a mixed income system, in that part of their sales was generated from cash and the other part was generated from extending credit to their customers. The credit sales were made under the six-month revolving credit scheme.[84] The customer under the scheme had to pay the taxpayer in six equal instalments. The court stated that an amount does not have to be due and receivable by the taxpayer for it to accrue to the taxpayer. An amount accrues to a taxpayer when he becomes "unconditionally" entitled to it.[85]

In *CIR v Witwatersrand Association of Racing Clubs*[86], the taxpayer decided to host a horse racing event for the benefit of two charities. The court held that the proceeds of the race were gross income as defined for the taxpayer, as he was not acting as an agent on behalf of the charities.[87]

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[78] *Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A)
[79] *Pyott Ltd v CIR* 1945 AD 128, 13 SATC 121
[80] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 36
[81] *CIR v Delagoa Bay Cigarette Co* Ltd 1918 TPD 391 394
[82] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 37
[83] *CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA353 (A), 52 SATC 9 21*
[84] *Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.Silke, South African Income Tax 2018. LexisNexis, p. 37*
[85] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 37
[86] *CIR v The Witwatersrand Association of Racing Clubs* (3) SA 291(A), 23 SATC 380
[87] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 38

In *Mooi v SIR* [88], an employer had granted share options to an employee who was a taxpayer. This option provided the taxpayer with the ability to purchase shares in the company at a specific price.[89] The option was exercised more than three years after it was granted. The court held, a right only accrues when the conditions are met, and the right can be exercisable. If no value can be attached to the right then the amount will not be included in the taxpayers' gross income.[90]

The purpose of the next section is to determine the nature of income. This is in order to classify this income as either being of a revenue or capital in nature.

3.3.3 Nature of Income

In order to distinguish between what is revenue or capital in nature in terms of the ITA, the courts have laid out legal precedent in order to determine the nature of the receipt. The courts have applied the notion of fruit versus tree in explaining what is revenue in nature versus what is capital in nature.

3.3.3.1 The "tree and fruit' analogy"

In its basic form, income is a product of capital and in the same way, fruit is the product of a tree.[91]

In *CIR v Visser*[92] **,**Maritz J stated the following:

> if we take the economic meaning of capital and income, the one excludes the other. Income is what capital produces or is something in the nature of interest or fruit as opposed to principal or tree.

Despite the principle appearing to be simple and straightforward form an economic perspective, the classification of fruit and tree is not always clear cut, and this is mainly because what is a tree for one taxpayer is a fruit for another. A commodity forward contract is fruit in the hands of an authorised user, whereas in the hands of a mining company this can be classified as a tree depending on the mining company's intention.

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[88] *Mooi v SIR*,, 1972 (1) SA 674, 34 SATC 1

[89] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 38

[90] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 38

[91] Takor, A.N.,*The importance of purpose in distinguishing capital from revenue-effect of the capstone judgement* (Doctoral dissertation).

[92] *CIR v Visser* 1937 TPD 77 (8 SATC 271)

3.3.3.2 Scheme of profit making

"An operation of business in carrying out a scheme of profit-making, is defined in plain language as being a situation where receipts and accruals are not fortuitous but designedly sought and worked for", as per Meyerowitz and Spiro.[93]
Where a taxpayer acquired an asset pursuant to a scheme of profit-making, then the proceeds that will be generated will classified as being on revenue account.[94] In a similar manner, if a taxpayer acquires property, however, the taxpayer's intention is not to generate income from the sale of the property but rather to earn income in the form of rent, then the scheme of profit making is conceivably different .[95] In the latter example, the proceeds that are received by the taxpayer will be of a capital nature.[96]In *Elandsheuwel Farming (Edms) Bpk v SBI* [97]the scheme was considered to be profit making and thus revenue was included in gross income.

The *CIR v Pick n Pay Employee Share Purchase* Trust[98] judicial decision is a significant point of reference with regards to the principle of profit making. The taxpayer, which was a trust, was established to continually purchase equities and on sell them to the employees when these employees become entitled to the shares. As a result of the trusts activities, it realised a profit due to the increase in market value from the time the shares were acquired to the time the employees purchased the shares.[99] In applying the scheme of profit making, the court stated that, the test should be an objective test and involve two components. The first, being to consider whether the taxpayer objectively conducted a business and the second test is to determine whether this was the overall intention of the taxpayer to generate a profit.[100]

In *COT v Booysens Estates Ltd*,[101] the court stated that :

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[93] David Meyerowitz and Erwin Spiro, Income Tax (1989) para 299.
[94] Masondo, J.S., 2009. *Taxation of derivative financial instruments: nature and timing of income and expenditure* (Doctoral dissertation, University of Pretoria, Pretoria
[95] Ibid
[96] Ibid
[97] *Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (A) at (118A), dangers in attributing an intention to a company
[98] *CIR v Pick n Pay Employee Share Purchase* Trust 1992 (4) SA 39 (A) (54 SATC 271)
[99] Haupt, P., 2020.*Notes on South African Income Tax 2020*. H & H Publications: Roggebaai p. 45, determination of scheme of profit-making
[100] Haupt, P., 2020.*Notes on South African Income Tax 2020*. H & H Publications: Roggebaai p. 45, determination of scheme of profit-making
[101] *COT v Booysens Estates Ltd* 1918 AD 576 (at 594)

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

In the judicial decision, *Overseas Trust Corporation Ltd v CIR* **[102]**, the court held :

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

The fundamental theme that the above case law highlight is that if a taxpayer manages to generate income from a scheme of making a profit, this income that has been generated would thus constitute gross income as defined by section 1 of the ITA.

Brincker states that the "receipts and accruals associated with speculation would be of an income or revenue nature", whereas "receipts and accruals" that are generated from synthetic investments and hedging transactions would be of a capital nature.[103]

Brincker further states that, most derivative transactions are entered primarily for speculative purposes, in which case the income that is derived from them will be considered have been generated from a scheme of profit making. [104]I agree with the Brincker's analysis in relation to derivative contracts.

3.3.4 Nature of income generated from hedging

A taxpayer enters into a hedging agreement in order to mitigate against an identified interest rate risk or foreign exchange rate risk and or price risk.[105] The fundamental element of the definition of a hedging transaction can be described as a transaction in which a taxpayer is already party to which could result in some form of return volatility for the taxpayer. For the purpose of simplicity, we will consider the practical examples as stated in section 2.3.1 as well as 2.4.1.

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[102] *Overseas Trust Corporation Ltd v CIR* 1926 AD 444 (2 SATC 71**)**

[103] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban. p. W-6-2

[104] Ibid

[105] The Tax Advisory Committee, 20 July 1994. South Africa: Consultative document on the tax treatment of financial arrangements, p 63

A practical application of this is stated as follows: a platinum miner has entered into a contract to sell 10 tons of platinum to a car manufacturer in 3 months' time. The selling price has been agreed by both parties to be based on the prevailing market price of platinum on the day of delivery. [106]At the time of signing the contract, the prevailing spot price for platinum ore is $1,010/oz while the price of platinum futures for delivery in three months' time is $1,000.[107] To lock in the selling price of $1,000/oz, the mining company can enter into a derivative contract where they sell 10 tons of platinum derivatives that will mature in three months' time. The platinum miner would have effectively locked in a profit on day one and thus they have mitigated their earnings from fluctuations in the commodity price. In order to achieve the inverse negative commodity price correlation, the mining company would have entered into short futures contract with the JSE. On maturity date the derivative instrument will pull to par.[108] If the spot price of platinum on maturity of the futures contract is a $980/oz, then mining company will deliver the platinum to the buyer and receive $980/oz. Then from the futures contract they will also realise a gain of $20/oz being the difference between locked in futures price of $1000/oz and the spot price of $980/oz on maturity day. The platinum miner will have essential hedged the price of platinum as they effectively would receive $1000/oz (Sale of platinum $980/oz plus a gain on the future contract of $20/oz).

After considering the above transaction, the question that comes up is what is the nature of the future profit (revenue or capital) generated from an ITA point of view? Case law will be used in order to answer the above critical question regarding the gain generated from a derivative.

In *CIR v Illovo Sugar Estates Limited* [109], the question under consideration was whether the proceeds received by the taxpayer for the loss incurred due to the usage by the military was of a capital or revenue nature.[110] The court held that the proceeds received by the taxpayer where of a capital in nature as it was compensation in lieu

[106] Investopedia, L.L.C., 2020. Available online at https://www.investopedia.com/ask/answers/06/futureshedge.asp [Accessed 5May2020
[107] Ibid
[108] Refer to scope limitation for regarding the pull to par principle.
[109] *CIR v Illovo Sugar Estates Limited* 1951 (1) SA 306 (N)
[110] Masondo, J.S., 2009. *Taxation of derivative financial instruments: nature and timing of income and expenditure* (Doctoral dissertation, University of Pretoria, Pretoria

of the loss incurred on the company's income producing machine.[111]Reference in this case was also made in, *ITC 1498.* The taxpayer had imported a printing press which formed part of their profit generating structure.[112] The taxpayer identified a foreign currency risk that arose due to importation of the printing press and thus entered into a derivative contract to hedge themselves against the currency devaluation.[113] "In this case, the Commissioner contended that the taxpayer had a profit motive in entering into the forward exchange contract and therefore the forward exchange contract independently should be judged as a profit-making venture."[114] The court held that the taxpayer entered into derivative contracts with the intention of hedging capital funding which and therefore this indicates that the gains derived were also of a capital nature.[115]

Brincker [116]highlights that a taxpayer should be meticulous when placing reliance on *ITC 1498*[117] when faced with the question regarding nature of the proceeds derived from hedging of a capital asset.[118] The intention of the taxpayer for entering into a hedging agreement is critical. The taxpayers intention in hedging a capital asset will be assessed as to the merits of this intention aligns with the holding of the underlying capital asset.[119] By following this approach, the taxpayer will be applying the same legal precedence which has been established over time in determining whether receipts are of a capital and/or revenue.[120] The taxpayers intention with regards to derivative transactions thus has to be established. [121]"Special hedging rules would match the tax treatment of the hedging instrument to that underlying transaction, position or asset. This means that if for example an underlying transaction is accounted for on a day-to-day basis, a derivative which was

[111] Ibid
[112] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban. p. W-8
[113] *ITC 1498* 53 SATC 260
[114] Masondo, J.S., 2009. *Taxation of derivative financial instruments: nature and timing of income and expenditure* (Doctoral dissertation, University of Pretoria, Pretoria
[115] Ibid
[116] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban. p. W-8
[117] *ITC 1498* 53 SATC 260
[118] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban. p. W-8
[119] Ibid
[120] Ibid
[121] Ibid

entered into as a hedge of that transaction would also be accounted for on a day-to-day basis." The objective of these rules is to accomplish an inversely correlated tax treatment.[122] This will then result in the taxation of the derivative and the underlying transaction being taxed as one transaction.[123] This would imply that if the underlying transaction is taxed over time, then the hedging instrument would follow suit.[124] The key determinant in a taxation of hedges is the relationship the derivative instrument to the underlying. If this relationship does not exist, then taxpayer will find it challenging in supporting their argument regarding how the proceeds from the hedge should be taxed.[125]

Bricker states that the key question for hedging transaction is to determine existence of a link between a hedging instrument and the underlying item.[126]

> Numerous requirements have been set over the years in order to determine in order to determine. For instance:
> a) Whether the percentage risk reduced by the hedge is acceptable (ranging between 80% to 120%);
> b) Whether the price fluctuations of the hedge are directly linked to the underlying asset;
> c) The quantity of goods sought to be hedged, as well as the price concerned;
> d) Whether the derivative is specifically designated as the hedge;
> e) Whether the changes in the value of the derivative and the underlying asset will have a high degree of correlation; and
> f) Whether the hedge is assessed on an ongoing basis.[127]

"One of the well-established tests to be applied in such cases is the test formulated in *Burmah Steam Ship Co Ltd v IRC*[128] of establishing whether the payment is intended to fill a hole in the taxpayer's profits or to fill a hole in his assets. The former is revenue while the latter is capital. The court applied the trading stock test and concluded that the trees were floating capital. This meant that the amount received by the taxpayer was of a revenue nature being a payment intended to fill a hole in

[122] Ibid
[123] Ibid
[124] The Tax Advisory Committee, 20 July 1994. South Africa: Consultative document on the tax treatment of financial arrangements, p 63
[125] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban. p. W-8
[126] Ibid
[127] Ibid
[128] *Burmah Steam Ship Co Ltd v IRC* (1931 SC 156)

the taxpayer's profits. This decision is considered to be correct, when applying one's mind to the fact that the trees were grown for the purpose of sale."[129]

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

3.4 Nature of expenditure and losses associated with derivatives

Section 11(*a*) of the Act reads as follows:

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

Section 11(*a*) read with section 23(*g*) can thus be described as the general deduction formula.[130] These sections, together with the relevant case law provides the rules and regulation that expenditure and losses must adhere to in order to qualify as a deduction for income tax purposes. In order to qualify for the taxpayer to qualify for the deduction the taxpayer must be "carrying on a trade". The onus of proof in terms of s 102 of the Tax Administration Act to verify that their activity constitutes a trade rests with the taxpayer. If the taxpayer is unable to provide proof that they incurred the expenses 'while carrying on a trade" the taxpayer will not be allowed to claim these expenses against their income in determining their taxable income.

Section 23(*g*) of the Act reads as follows:

> No deductions shall in any case be made in respect of the following namely-
> (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expanded for the purposes of trade

[129] Haupt, P., 2020.*Notes on South African Income Tax 2020*. H & H Publications: Roggebaai, p. 139
[130] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 114.

Section 23(*g*) therefore prohibits a taxpayer from claiming deductions from their income if those deductions were not laid for the purpose of the trade. This is known as the negative test while s 11(*a*) is known as the positive test.

In order to examine the possible interpretations of the phrases which are contained in the wording of section 11(*a*) read together with section 23(*g*), an analysis of the relevant case law is necessary to obtain an understanding of these phrases for the purpose of taxation of derivatives.

3.4.1 Expenditure and losses

In determining the meaning of the phrase "expenditure and losses", one has to refer to the courts' interpretation in *Joffe & Co (Pty) Ltd v CIR*[131] where it was held:

The word loss is used to *signify involuntary deprivation suffered by the loser, whereas expenditure usually meant a voluntary payment of money.*

In *Port Elizabeth Electric Tramway Co Ltd v CIR* **[132]**the court considered the in context meaning of the word losses that appeared to mean losses of floating capital employed in the trade which produces income.[133]

The Supreme Court of Appeal ("SCA") held that the terms "obligation" or "liability" and "expenditure" are not synonyms in *CSARS v Labat* (2011 SCA).[134] The SCA held that the words must be given their ordinary meaning and interpreted as referring to the action of spending funds; disbursement or consumption, and hence the use of the words of the amount of money spent.

[131] *Joffe & Co (Pty) Ltd v CIR* (1946)13 SATC 354,
[132] *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936) 8 SATC 13
[133] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 117.
[134] C*SARS v Labat* Africa. Limited (2010) 72 SATC 75

3.4.2 Actually incurred

The specific use of the words “actually incurred” rather than the words “necessarily incurred” widens the scope of deductible expenditure.[135] In *Port Elizabeth Electric Tramway Co Ltd v CIR,* [136]the found that actually incurred, includes unnecessary expenditure. The fact that one taxpayer may conduct their affairs in an inefficient or extravagant manner as compared to another making such expenditure unnecessary, but the fact is that the expenditure was incurred and therefore it is deductible.[137]

The court stated that “expenditure actually incurred” does not mean expenditure actually paid during the year of assessment in the *Caltex Oil SA Ltd v SIR* [138]. The court held that this term also implied that it is not necessary for the liability to have been settled during the tax year, but rather that the expenditure was incurred.[139]

In *Edgars Stores Ltd v CIR* [140]**,**the court found that in order for the appellant to be able to claim a tax deduction in terms of section 11(*a*), the critical requirement is that they have incurred an unconditional obligation they during the current tax year.[141] This reaffirms that for South African tax purposes a contingent liability does not imply actually incurred and therefore any contingent liability will not be deductible.[142]

3.4.3 During the year of assessment

The wording “during the year of assessment” is not specifically required by the provision of section 11(*a*), however, in *Concentra (Pty) Ltd v CIR*[143] the court stated that expenditure is only deductible in the year of assessment in which it is incurred.[144]

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[135] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 117.
[136] *Port Elizabeth Electric Tramway Co Ltd v CIR* [1936] 8 SATC 13
[137] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 117.
[138] *Caltex Oil (SA) Ltd v SIR* (1975) 37 SATC
[139] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 118
[140] *Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A) 50 SATC 81
[141] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 118
[142] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 118.
[143] *Concentra* (*Pty) Ltd v CIR* (1942) 12 SATC 95
[144] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 118.

Therefore, this implies that a taxpayer is unable to carry over expenditure incurred during the current year of assessment to a subsequent year or vice versa.[145]

There is however a proviso in the ITA to the above phrase and this is stated is section 24M. Simply put, the taxpayer is allowed a deduction in the year of assessment an amount becomes quantifiable.[146]

3.4.4 In the production of income

In *Port Elizabeth Electric Tramway Co Ltd v CIR* **[147]**, the court considered what was the actual meaning of the phrase "in the production of income".

> The business of the taxpayer concerned was transportation. The driver of one of its cars was involved in an accident, and unfortunately succumbed to the injuries sustained in the accident. The taxpayer was compelled to pay compensation to the deceased's dependants.

There are two critical questions that have to answered when a taxpayer is considering if the expenditure was incurred in the production of income and they are stated as follows:[148]

1. What gave rise to the expenditure?
   In this regard, the employment of the driver as an employee of the taxpayer and thus fulfilling their duties as a driver of the company gave rise to this expenditure.
2. Was the action closely connected with (inevitable concomitant) the income generating activities from which would have resulted in the expenditure being incurred as part of the trade?
   The transportation of passengers is the income generating activity, the action that gave rise to this was the employment of the driver. By virtue of a vehicle being driven, there is an inherent potential risk of an accident that arises. Therefore, the two elements are closely related with each other.[149]

The word "income" thus encompasses income as defined int terms of section1 of the ITA. In *CSARS v Mobile Telephone Networks Holdings (Pty) Ltd [150](2014 SCA*), the court ruled that the overriding factor when considering the term "expenditure incurred

[145] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 120.
[146] Ibid
[147] *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936) 8 SATC 13
[148] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 120.
[149] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 120.
[150] *CSARS v Mobile Telephone Networks Holdings (Pty) Ltd* (2014) 76 SATC 205

in the production of income" is to determine what was the purpose of the expenditure as well as its effects.[151]

In *CIR v Nemojin Pty (Ltd)* [152] ,the court considered expenditure incurred with dual purposes. The court specifically considered whether expenditure was incurred to produce income as defined by the ITA or exempt income. When considering the phrase "incurred with a dual purpose", the main element the court will attempt to establish is the closeness of the connection between the expenditure incurred and the exempt income received or accrued.[153]

3.4.5 Not of a capital nature

An onerous task is undertaken when determining the nature of expenditure (i.e.: capital or revenue). The process undertaken to distinguishing the nature of the expenditure is done on a case by case basis with specific attention given to the purposes of the expenditure. [154]

The courts have established useful tests to distinguish between capital and revenue expenditure. In *New State Areas v CIR* [155],the following was laid down:

- Floating capital is capital that changes form from money to goods and vice versa, thus making it income in nature[156]
- Fixed capital is capital employed to acquire or improve property, plant, tools etc, thus making this capital in nature[157]
- Expenditure that is incurred for the purpose of the income-generating operations is income in nature[158]
- Expenditure that is incurred for the purpose of improving or adding to the income-generating operations is capital in nature.[159]

The case of *CIR v George Forest Timber Co Ltd*[160] also useful to consider when the question regarding the nature of the expenditure arises. The principle established in

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[151] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 120.
[152] *CIR v Nemojin (Pty) Ltd* (1983 4 SA 935 (A); 45 SATC 241.
[153] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 126.
[154] Ibid
[155] *New State Areas Ltd v CIR* (1946) 14 SATC 155 (at 163)
[156] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis, p. 126
[157] Ibid
[158] Ibid
[159] Ibid
[160] *CIR V George Forest Timber Co Ltd* 1924 AD 516 at 526

this case is that the proceeds which have been used to purchase an asset classified will be classified based on the nature of the asset (i.e.: the expenditure incurred on an income-producing asset will be capital in nature and this will be revenue in nature if incurred on working capital asset). [161]

3.4.6 Nature of expenditure and losses related to derivatives

When determining whether the nature of derivative expenditure (i.e: capital versus revenue), the fundamental criteria is to determine whether money spent was incurred in production of income or not.[162]

In order to verify this, the intention of the taxpayer would be considered as well as whether the outlay resulted improved income producing asset or whether this was to maintain the current operating level of this structure.[163]

The taxpayer will therefore have to consider the reason for incurring the derivative expenditure.[164] The key determinant to this test will be the objective of taxpayers when entering into a derivative transaction.[165]

It thus follows, that if the purpose of the derivative transaction expenditure and or losses were incurred in accordance with a “scheme of profit making” or for speculative purposes, this will imply that the income will be classified as being income in nature. If, however, the purpose of these transaction was to improve or add to the taxpayer’s income generating machine, then these transactions will be classified as capital in nature.[166]

The purpose of hedging transaction is a fundamental determinant with regards to deductibility of derivative expenditure and losses. The nature of the derivative expenditure will follow the same principle which has been established with regards to income. I.e.: if the derivative expenditure is incurred for “scheme of making a profit, it

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[161] *CIR V George Forest Timber Co Ltd* 1924 AD 516 (1 SATC 20) at 25-26
[162] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban, p. W-10
[163] Ibid
[164] Ibid
[165] Ibid
[166] Ibid

will be income in nature and vice versa if it was incurred in order to protect the capital structure.[167]

3.5 The source of derivative income

South Africa follows a resident based taxed system. That means South African residents are taxed on their world-wide receipts and accruals. Due to the scope limitation as stated in this report, the research will consider the implications of source rules only for resident taxpayers.

In *CIR v Lever Brother and Unilever Limited*[168]**,** the court held that the source of the income is the originating course of the receipt.[169] The test that a taxpayer should apply is determining what the sources is, firstly to determine what is the cause of the receipt and thereafter the location of this receipt.[170] The dominant source should be determined in the instance where there is more than one source to the receipt.

A different view was adopted by the court in decision of *Essential Sterolin Products (Proprietary) Limited v CIR*[171] as well as *First National Bank of Southern Africa Ltd v CSARS 64*[172]. The fundamental criteria applied in both these judicial decisions was to establish what is the "dominant cause" of the receipt of income. [173] When this was determined, it resulted in the validation of source of the income.

In *CIR v Black 21 SATC*[174], despite the fact that the taxpayer conducted a separate business of buying and selling shares in London, the London Broker still consulted with the taxpayer. Due to the above facts, it was questionable whether the test to determine the dominant cause and location of receipt could be applied correctly.[175]

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[167] Ibid
[168] *CIR v Lever Bros & Unilever Ltd* 1946 AD 441, 14 SATC 1
[169] Haupt, P., 2020. *Notes on South African Income Tax 2020*. H & H Publications: Roggebaai, p. 39
[170] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban, p. W-10
[171] *Essential Sterolin Products (Pty) Ltd v CIR* 1993 (4) SA 859 (A), 55 SATC 357
[172] *First National Bank of Southern Africa Ltd v SARS* (2002) 64 SATC 245
[173] Haupt, P., 2020. *Notes on South African Income Tax 2020*. H & H Publications: Roggebaai, p. 38
[174] *CIR v Black* 1957 (3) SA 536 (A)
[175] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban, p. W-10

The preferred approach is the one which was followed in the court's decision in *Overseas Trust Corporation Limited v CIR 2 SATC 71.* In this judicial decisions, the taxpayer, bought and sold securities through brokers that were located in Germany pursuant to a scheme of profit making. The court held that, despite the fact that the German brokers executed the sale of the equities, the source of the sale of the equities was in South Africa as the capital used to earn the profit was employed in South Africa.[176]

Hutton [177]concluded on the following:

> *"Income derived by a South African taxpayer from derivative transactions with foreign counterparties will invariably be sourced in South Africa unless the taxpayer conducts its offshore derivatives business through a branch or office outside South Africa."*[178]

One can thus argue, that the source of a hedging transaction is directly be linked to that of hedged item.[179]

With regards to determining the source of derivative transactions, consideration should be given to the overall business operations of the taxpayer and how these derivative transactions can be linked to the operations.[180]

3.6 CONCLUSION

The South African tax regime has established regulations and principles to follow when determining the nature of derivative expenditure and losses. To determine the nature of the losses and expenditure, consideration will be given as to how the derivatives were employed in the business of the taxpayer.

When a taxpayer is engaged in derivative transactions, regard will be given as to what was their intention at the outset of the transaction. If the taxpayer's intention for

[176] Ibid
[177] Hutton, S.J., 1998. The taxation of derivatives in South Africa. *The Taxpayer*, *47*(10), pp.184-190.
[178] Ibid
[179] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban, p. W-10
[180] Ibid

transacting using a derivative contract in the pursuit of making a profit, the nature of the yield, whether it be revenue or expenditure and losses will also be classified as revenue in nature.

The taxpayers' intention for entering into a derivative transaction will drive the classification of the proceeds for ITA purposes. I.e.:if the taxpayer has a speculative motive, then the nature of the return, whether it is revenue or losses, this return would be classified as revenue in nature for Income Tax Act purposes. In the similar manner, if the taxpayers' intention when transacting using a derivative was for the purpose of protecting their fixed capital, then the yield generated will be capital in nature. Derivative transactions have a short tenor by their nature. They can be rolled from one to the next when they are used for hedging purposes. It is therefore critical to establish the intention of the taxpayer . Was it a scheme of making a profit or protecting the profit generating structure? Tree or fruit test.

Therefore, if the taxpayer enters into a hedge using a derivative in order to protect against generating a devaluation as a result of an identified risk, it thus follows, that any proceeds generated from the hedge transaction will be classified as being capital nature.[181] The CGT provision will be applied to these proceeds. Taxable capital gain derived from derivatives are included in the determination of taxable income in terms of section 26A of the ITA.

3.7 Timing of Income and expenditure or losses associated with derivative transactions

3.7.1 Introduction

This part of the research will undertake to obtain understanding of the specific timing provision that related to derivative transactions in terms of the ITA.

The ITA includes a number of provisions that govern the timing of derivative transactions. In the instance where there is no specific provision that exist in that

[181] Brincker, E. 2007.*Taxation principles of interest and other financing transactions*. LexisNexis Butterworths: Durban, p. W-10

regard, the taxpayer has to resort back to the general principle of accrual and receipt.[182]

The specific timing provisions of the ITA can be grouped as follows:

Transaction that are taxed based on "fair value"[183] basis:

- *Foreign currency option contracts and forward exchange contracts - section 24I;*
- *Financial institutions and authorised users -section 24JB and section 11(jA);*
- *Interest rate swaps that are held as trading stock (at the election of the taxpayer) – section 24K; and*
- *Options held as trading stock - section 24L.[184]*

Transaction that are taxed based on "yield to maturity"[185] or realisation basis:

- The net interest on an interest rate swap is spread evenly over the period of the swap – section 24K;
- Options other than currency options and options held as trading stock are taxed on realisation – section 24L; and
- All other derivatives are taxed at realisation.[186]

3.7.2. Section 24I - Gains and losses on foreign exchange transactions

Section 24I provides translation rules for foreign exchange differences and it mostly follows the mark-to-market rules. This provision of the ITA, deals with tax treatment for transactions that are denominated in foreign currency.

Section 24I states the following

> In determining the taxable income of any person contemplated in subsection (2), there shall be included in or deducted from the income, as the case maybe, of that person-
> (a) any exchange difference in respect of an exchange item or in relation to that person, subject to subjection (10A); and
> (b) (i) any premium or like consideration received by, or paid by, such a person in terms of foreign currency option contract entered into by such person; or
> (ii) any consideration paid by such person in respect of a foreign currency option contract acquired by such person.

This section, therefore, results in the inclusion or deduction of any foreign realised or unrealised exchange gains or losses into the taxpayers' taxable income in the year in which they arise.

[182] De Jager, P., Parsons, S. & Roeleveld, J.J. 2012. A commentary on SARS' proposed fair value tax on financial instruments. SA Journal of Accounting Research, 26(1): 165 – 184 Available at: http://www.sajar.co.za/documents/SAJAR-26-8-DeJager-final.pdf [Accessed on 30 April 2020]
[183] Ibid
[184] Ibid
[185] Ibid
[186] Ibid

3.7.3. Section 24J - Incurral and accrual of interest

This provision of the ITA, deals with how interest must be calculated for income tax purposes for both the holder and issuer of a financial instrument. The provisions of section 24J (2) are set out as follows:

> where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to – "
> (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
> (b) an amount determined in accordance with the alternative method in relation to such year of assessment in respect of such instrument,

The provisions of section of section 24J (3) are set out as follows:

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

The purpose of section 24J of the ITA, is to provide guidance as to when and how interest income or expenditure should be determined and included in the taxable income of a taxpayer. The revenue or losses incurred are included in taxable income based on a yield to maturity basis.

3.7.4 Section 24JB – Taxation in respect of financial assets and liabilities of certain persons

This section deals with the inclusion or deduction from income of any covered persons, of all amounts that are recognised in the profit or loss in the statement of comprehensive income, in respect of financial assets and financial liabilities that are recognised at fair value in the profit or loss in terms of IFRS9.

Section 24JB applies to a "covered person". In terms of section 24JB (1), a "covered person" is defined as follows:

> (a) any authorised user as defined in section 1 of the Financial Markets Act that is a company;
> (b) the South African Reserve Bank;
> (c) any -
> (i) bank;
> (ii) branch;
> (iii) branch of a bank; or

(iv) controlling company
as defined in section 1 of the Banks Act;

(d) any company or trust that forms part of a banking group as defined in section 1 of the Banks Act excluding -
(i) a company that is a long-term insurer as defined in section 1 of the Long-term Insurance Act;
(ii) a company that is short-term insurer as defined in section 1 of the Short-term Insurance Act;
(iii) a company of which more than 50 per cent of the shares are directly or indirectly held by a company contemplated in subparagraph (i) or (ii) if that company does not form part of the same group of companies as a bank.

3.7.5 Section 24K – Incurral and accrual of amount in respect of interest rate agreements

This provision of the ITA, deals with how a taxpayer who has entered into interest rate agreement will calculate the income for income tax purposes.

The provisions of section 24K (2) are set out as follows:

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

"An interest rate swap is defined as a contractual agreement between two parties to exchange a series of payments, calculated by reference to a notional principal amount, over a stated period of time."[187]

3.7.6. Section 24L – Incurral and accrual of amounts in respect of option contracts

This section provides guidance on how option contracts will be taxed in terms of the ITA. An option contract is defined as follows:

> an option contract' means an agreement the effect of which is that any person acquires the option (excluding a foreign currency option as defined in section 24I(1)-.
> (a) to buy or to sell t another person a certain quantity of corporeal or incorporeal things before or on a future date at a pre-arranged price; or
> (b) that an amount of money will be paid from another person before or on a future date depending on whether the value or price of an asset, index currency, rate of interest or any other factor is higher or lower before or on that future date than a pre-arranged value or price.

Section 24L(2) states the following:

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

[187] The Tax Advisory Committee, 20 July 1994. South Africa: Consultative document on the tax treatment of financial arrangements, p. 63

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

"Section 24L(2i) does not specifically apply to option contracts which are held by a person as trading stock. When a taxpayer holds option instruments as trading stock, they will have to revert back to the normal timing principles of accrual and receipt. Section 24L(3) states that in the instance when an option contract is exercised, terminated or disposed of before the end of its original term, the portion of the premium or consideration attributable to the period from the date of exercise, termination or disposal until the end of the original term of the contract is deemed to be incurred on that date."[188]

3.8 Challenges posed by the derivatives

As discussed in chapter 3 of this research report, the income as well expenditure and losses that arise from derivative transactions would only be included in gross income and deducted from income in terms of section 11(a) when the taxpayer is unconditional entitled to receive or pay for the transaction. As noted in section 3.8, when the timing of derivative transaction does not address the specific provisions of sections 24I, 24JB, 24K and 24L, the taxpayer has to revert back to the general taxation principles as laid out in the ITA. When it comes to derivative transactions, applying the general timing principles can result in some challenges. These challenges are explained by way of an example [189]

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

The application of the general timing principles which are brought to our attention in the above example, have been adequately dealt with by section 24K. The reason for this is that this is an interest-bearing agreement as defined. The Income Tax Act will thus provide for the taxpayer to deduct the lump sum on a daily basis over the term

[188] Oguttu, A.W. 2012. Challenges in taxing derivative financial instruments: international views and South Africa's approach. *SA Mercantile Law Journal*, *24*(4), pp.385-415. Available at: https://heinonline.org/HOL/LandingPage?handle=hein.journals/safrmerlj24&div=38&id=&page= [Accessed on 7 March 2020
[189] Ibid

of the transaction. The person who receives the interest will also include this amount in their gross income in a similar manner as the payer.

A summary of the challenges which are encountered by the taxpayer in applying the general timing rules to the taxation of derivatives are outlined by the TAC[190] as follows:[191]

> "The general scheme of the tax law brings to account amounts when received or accrued and allows deductions for expenditure and losses when incurred, requiring analysis of each contractual arrangement by which taxpayers earn
> their income. In addition, there are specific provisions for certain financial transactions, largely to eliminate identified tax avoidance or deferral opportunities. The present system is prone to the following problems:
> a) it can give rise to an unacceptable degree of uncertainty because traditional tax accounting rules do not appropriately reflect the substance of the and/or there is little by way of judicial precedent as to the correct tax treatment of the transaction.
> b) Tax planning opportunities arise because of timing mismatches between the deduction of expenditure and losses and the accrual of income, including cases where the tax treatment is different between parties to the
> same financial transaction.
> c) Inequality in the tax treatment of arrangements that are economically the same but different in legal form
> d) The general scheme of law does not comfortably accommodate many new financial products".

Hutton[192], further expands on these identified issues in the following manner: :

> a) The valuation of open positions held by the taxpayer at year end. The appreciation or depreciation in the market value of a derivative instrument will not be taxed or allowed as a deduction until it is actually incurred or
> accrued when the instrument matures, is disposed of or otherwise closed out.
> b) Matching the timing of the recognition of income and losses on a revenue hedging transaction with the correlative income and losses on the underlying hedging transaction. Whereas the hedge and the underlying transaction are treated as a single unit for accounting purposes, they are taxed in isolation and the application of the ordinary timing rules can result in the income or loss resulting from a hedging transaction being taxed or allowed at a different time from the income or loss on the underlying transaction. This can leave the taxpayer matched in economic terms but unmatched for income tax purposes which distort the efficacy of the hedge.

3.9 Conclusion regarding the timing of income and expenditure

The ITA, incorporates specific provisions which provide for the timing of the incurral and accrual for those identified derivative transactions. Notwithstanding the specific provisions, the taxpayer will revert to gross income general taxation principles of received by or accrued to when determining the timing.[193] The application of these

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[190] The Tax Advisory Committee, 20 July 1994. South Africa: Consultative document on the tax treatment of financial arrangements, pp 21-22
[191] Ibid
[192] Hutton, S.J., 1998. The taxation of derivatives in South Africa. *The Taxpayer*, *47*(10), pp.184-190.
[193] *Lategan v CIR* (1926), CPD 203, 2 SATC 16

general taxation principles where discussed in section 3.3 above. A taxpayer will thus include in their gross income amount any income derived from derivative transactions which has no conditionally attached to it. If there are still further conditions to be met in terms of the derivative agreements, then such income will not form part of the taxpayers' gross income amount.

Section 11(*a*) of the ITA, stipulates that amount will be deductible when it is actually incurred by that taxpayers and when the taxpayer has an unconditional obligation to pay.[194] The implications of the general deduction formula specifically looking at derivatives is set out in section 3.5 of this report. It can thus be concluded that, a taxpayer will be allowed to deduction against their income for ITA purposes when they have derived a loss from a derivative contract during a year of assessment and there are not further conditions attached.

[194] *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936) CPD 241, 8 SATC
Caltex Oil (SA) Ltd v SIR (1975) 37 SATC 1

Chapter 4

The Relevance of the existing framework to the taxation of derivative

This chapter examine the adequacy of the existing framework, that is contained in the Income Tax Act and whether they are flexible enough to deal with the innovation brought by derivative instruments. A further analysis will also be made with regards to the history of the some of the unintended consequences as a result of enactment of new tax laws in South Africa. The common law principles of substance over form will also be reviewed with specific discussion of sections 80A to 80L and how these GAAR provision address the taxation of derivatives instruments.

Winston Churchill is quoted as having said, “if you make ten thousand regulations you destroy all respect for the law”.

4.1 Principles of taxation

As stated in the introduction to this research report, a good tax system is benchmarked against the canons of taxation which have been set out in The Wealth of Nations.[195] The TAC indicated that the taxation of derivative instruments should comply with the following principles:

- certainty – the taxpayers know on which basis they will taxed;
- tax neutrality – basis on which the financial instruments which are in substance similar will be treated;
- flexibility – due to the fact that derivatives constantly change, principle of certainty should outweigh the disadvantage of complexity that may be introduced pursuant to the legislation being flexible.

The view of Asprey as documented in The Asprey Report (the Full Report of the Taxation review Committee under the Chairmanship of Mr Justice Asprey) is that, following equity canon, the subsequent fundamental canon is that of simplicity, which is determined with reference to the costs of administration and compliance on the one hand and the costs to the taxpayer on the other. [196]The report further states that:

[195] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke: South African Income Tax 2018*., LexisNexis, Durban’ pp. 5-8

[196] Snyman, SL. 2015. A Critical Analysis of the Taxation of Financial Assets and Financial Liabilities in terms of section 24JB of the South African Income Tax Act, M.Com (Taxation), Dept. of Accounting, Rhodes University

> Both costs will be the less if the assessor and the assessed can each establish with certainty what is due: uncertainty entails the cost of consultation with experts and sometimes the yet greater costs of litigation. Both kinds of costs are increased, and certainty is endangered, when a tax, whether in the interest of equity or of efficiency, requires the drawing of fine distinctions between what is and what is not liable, and when these distinctions involve such uncertain ideas as 'purpose' or 'value to the recipient.[197]

Derivatives can be structured in virtually any economic position at the same time they will take cover under the guise of a different transaction.[198] Derivatives grants their users the exceptional advantage of being able to change characteristics so that they may be classified under a rule that is most fitting for them.[199]

4.1.1 Challenges that may emanate from complex derivative taxation rules

The financial engineering with specific focus on derivatives, is by nature very innovative hence this market has shown tremendous growth over the past few years. Financial engineers are always trying to come up with smart solutions to cater for the need for their clients and hence there are constantly a new wave of derivative instruments launched in the market.

In considering whether there is a need for new legislation to govern the taxation of derivatives, the report will consider the Goodhart's law, the put call parity, the unintended consequences together with the recommendation of the TAC as sated above.

4.1.2 Goodhart law

Derivative contracts are clever schemes constructed by financial engineers tailoring them based on the needs of their clients or their own. As a result, prior to considering the introduction of new laws to tax derivatives, it is recommended that established principles which have been taken shape in the market to be considered. One such adage is that which has been coined as the Goodhart's law which is defined as follows:

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[197] Williams, R.C. 2005. *Income Tax in South Africa cases & Materials. Second Edition*. LexisNexis Butterworths. Durban

[198] Nesvetailova, A., Guter-Sandu, A., Palan, R. and Millo, Y., 2018. Tax Evasion and Avoidance through Financial Engineering:The State of Play in Europe*. Coffers EU Horizon 2020 Project.* Available at: http://coffers.eu/wp-content/uploads/2019/11/D1.7-Working-Paper.pdf [Accessed on 27 April 2020]

[199] Ibid

Goodhart law states that “when a measure becomes a target, it is subsequently no longer a good measure.”[200] “A case in point, in the instance when people anticipate the effect of a new policy, and their actions alter the policy’s outcome, the target was a bad measure.”[201] In other words, as soon as you announce a new policy with new regulations, people will find ways around it.[202] This law is particularly important in relation to the taxation of derivatives. Given that derivatives are composite of the cash market and that they can take many forms, i.e.: they can be structured in combination like a collar swaption, which is a combination of a swap and a put and call option, or a total return swap, these characteristics makes these instruments very easily adaptable to change.

Increasing the complexity of tax laws may be self-defeating, as invariably, taxpayers devise more complex schemes and the cycle caries on.[203] This has the effect of increasing costs for the economy, such as costs for continuous amendments of the legislation, administration costs and increasingly comprehensive and detailed reporting requirements.[204] Invariably, new legislation results in and increases complicate costs on the taxpayers.

4.1.3 Unintended consequences

This section of the report will discuss the South African history in relation some of the unintended consequences as a result of enactment of new tax laws in. The objective of this section is to bring to highlight the recent legislation that had unintended consequences. One such drafting was that of section 24JB.

Maroun[205] refers to the dangers of the unintended consequences which arise when new laws and regulations are introduced and the fact that the effect is seldom in line

[200] Koehrsen, W. Towards Data Science. Unintended Consequences and Goodhart’s Law, Available at https://towardsdatascience.com/unintended-consequences-and-goodharts-law-68d60a94705c [Accessed on 27 April 2020]
[201] Ibid
[202] Ibid
[203] Naude, S.J., 1984. The South African close corporation. *Journal for Juridical Science*,*9*(2), pp.117-131.
[204] Ibid
[205] Maroun, W. 2015. Peculiarities of the fair value taxation regime for financial instruments**.** South African Journal of Accounting Research, 29:2:151-161 Available at https://www.tandfonline.com/doi/abs/10.1080/10291954.2015.1006484 [Accessed on 26 April 2020].

with the policy-maker's expectations. Roots [206]states: "If ever there were a society in which laws operated as anticipated by their makers, it is unknown to history".

Snyman [207]states that, it has never before been necessary to analyse tax principles in the context of IFRS and that section 24JB may have introduced unintended consequences, anomalies, uncertainty and complexity.

The legislator introduced section 24JB as a new concept into tax legislation which required certain taxpayers to apply accounting principles in determining the tax consequences relating to their financial assets and liabilities. Snyman [208], correctly points out that the introduction of section 24JB represents a departure from the normal tax principles of taxing gains and losses on realisation basis. Maroun[209] also raises concerns that the introduction of this new tax provision results in dependency on the International Financial Reporting Standards (IFRS). This is because the principles of IFRS are forward-looking for investors whereas tax principles are not.

4.1.4 Put-call parity

As an extension of section 4.1, this research explores the further consequences of the introduction of a mixed taxation system.

Derivatives can result in smart "transactional form" which has been referred to as the cubbyhole system.[210] This is an inconsistent patchwork of rules that emphasise form over economic substance in the treatment of derivatives[211]. To put this into perspective, we will use an example of a put call parity as explained by Philip de Jager et al.

> An investor may obtain the returns on an instrument without actually holding that instrument. For example, in order to obtain the return on an equity share, an investor may either acquire that share, or purchase a or purchase a risk-free zero-coupon bond together with buying a call option on the share and selling a corresponding put option at the current share price for that same share. The returns on the two baskets of investments should be the same, and can be

[206] De Jager, P., Parsons, S. & Roeleveld, J.J. 2012. A commentary on SARS' proposed fair value tax on financial instruments. SA Journal of Accounting Research, 26(1): 165 – 184 Available at: http://www.sajar.co.za/documents/SAJAR-26-8-DeJager-final.pdf [Accessed on 30 April 2020]

[207] Snyman, SL. 2015. A Critical Analysis of the Taxation of Financial Assets and Financial Liabilities in terms of section 24JB of the South African Income Tax Act, (M.Com (Taxation), Dept. of Accounting, Rhodes University, Grahamstown)

[208] Ibid

[209] Maroun, W. 2015. Peculiarities of the fair value taxation regime for financial instruments**.** South African Journal of Accounting Research, 29:2:151-161 Available at https://www.tandfonline.com/doi/abs/10.1080/10291954.2015.1006484 [Accessed on 26 April 2020

[210] Nesvetailova, A., Guter-Sandu, A., Palan, R. and Millo, Y., 2018. Tax Evasion and Avoidance through Financial Engineering.. Available at http://coffers.eu/wp-content/uploads/2019/11/D1.7-Working-Paper.pdf [Accessed 27 April 2020]

[211] Ibid

expressed in the following equation:

$$R_{share} = R_{debt} + R_{call} + R_{put}$$

The taxation of the two sides of the equation is not the same in a mixed tax system. The return on the left-hand side of the equation would be taxed on realisation only, while the returns on the right-hand side would be taxed on a yield-to-maturity or fair value basis. Put-call parity demonstrates that the returns of any financial instrument can be obtained by some combination of other instruments, and therefore "it is a near-impossible task to create bright lines delineating where one instrument ends and the next begins. There is simply insufficient economic difference between the potential instruments, and there are infinite possible variations on each theme.

Philip de Jager et al[212], further points the significant negative consequences that come about from a mixed tax system.[213] He highlights the fact that the impact will not only result in skewed allocation of resources towards certain financial instruments but will also distort the allocation of resources towards activities of tax compliance, tax planning and tax avoidance.[214] These efforts are economically inefficient:

> The time that lawyers and accountants spend figuring out how a taxpayer should report income from an instrument and the time spent figuring out how to arbitrage inconsistencies in the treatment of economically similar instruments is waste" (Brunson 2008: 10). Furthermore, the opportunities for abuse tarnish the perception of the financial instrument market and hinder its use for legitimate purposes.

4.1.5 Conclusion

Oguttu[215], states that the challenges that emanate from the taxation of derivative transactions is the lack of understanding of derivative trading which has resulted in the growth of the financial industry. She further states that in order for business to prosper there is a need for a legal system that clearly understands derivative contract formulations as an informed (not tax) regulatory framework.

It is submitted that Oguttu is correct regarding the above. At the core of the problem is the understanding of derivatives. The introduction of specific taxation principles poses a taxation risk to these instruments as it could further result in unintended consequences as commentators have highlighted.

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[212] De Jager, P., Parsons, S. & Roeleveld, J.J. 2012. A commentary on SARS' proposed fair value tax on financial instruments. SA Journal of Accounting Research, 26(1): 165 – 184 Available at: http://www.sajar.co.za/documents/SAJAR-26-8-DeJager-final.pdf [Accessed on 30 April 2020]

[213] Ibid

[214] Ibid

[215] Oguttu, A.W. 2012. Challenges in taxing derivative financial instruments: international views and South Africa's approach. *SA Mercantile Law Journal*, *24*(4), pp.385-415. Available at: https://heinonline.org/HOL/LandingPage?handle=hein.journals/safrmerlj24&div=38&id=&page= [Accessed on 7 March 2020

4.2 Partial examination of GAAR

A thorough study of GAAR will not be undertaken in this section. However, it is important to note that these tax provisions as well as judicial decisions will be considered in some detail particularly when examining the adequacy of the taxation of derivatives in South Africa.

The ITA contains specific anti-avoidance provisions (discussed under the timing section 3.8 of this report) as well as general anti-avoidance provisions which are set out in sections 80A to 80L. They provide guidance and remedies to the Commissioner of SARS in identifying 'impermissible tax avoidance'. These statutory regulations will be considered and examined in the context of derivative instruments.
It is thus important to understand the difference between tax avoidance and tax evasion.

> **Avoidance** is described as an attempt to minimise a tax liability using legal terms, to regulate ones' affairs in such a manner that they pay the minimum tax imposed by the Act rather than the maximum. [216]This notion was established in IRC v Duke of Westminster.[217]
>
> **Evasion** is described as the use of illegal means to reduce tax liability, by falsification of book, suppression of income, fraudulent non-disclosure of income, overstatement of deductions.[218]

Therefore, the significance of distinguishing between the two is that tax avoidance is perfectly legal and tax evasion is not.[219] Tax evasion is a criminal offence as it is an action that contravenes the ITA, whereas, tax avoidance does not fall foul of the ITA.

A derivative agreement is considered to be "sham" in substance if it has no real change in each party' economic position. This would apply in an instance where the taxpayers' intention was to recharacterize the nature of their income. If the taxpayer entered into a derivative contract and the intention was to change the character of the income (i.e. to obtain a tax benefit by changing the nature of income from revenue account to capital account, thereby paying tax at a lower rate, or changing the nature of expenditure and losses from capital account to revenue account, thereby obtaining a higher tax deduction), the derivative contract can thus be

[216] Haupt, P., 2020. *Notes on South African Income Tax 2020*. H & H Publications: Roggebaai, p. 637
[217] *IRC v Duke of Westminster (1936) 19 TC 490 at 520*
[218] Haupt, P., 2020. *Notes on South African Income Tax 2020*. H & H Publications: Roggebaai, p. 638
[219] Ibid

challenged by SARS. The taxpayer will then have to provide evidence of what the reason for entering into a derivative transaction was. If the intention was for hedging purposes, they would be requested to provide evidence of the hedged item and hedge documents which are required for IFRS purposes. The hedge effectiveness will be tested to confirm the correlation between the asset and the hedge.

Taxpayers and financial engineers alike need to be cognizant of the new General Anti-Avoidance Rules ("GAAR") which are used to combat the misuse of the Income Tax Act in the structuring of derivatives instruments. This will be considered under section 4.2.2 of this research.

4.2.1 Substance over form

Tax is always based on the substance of the transaction which is described as the true intention or rather "real agreement", rather than the written agreement between two parties.[220]

The judicial precedence of common law dictates that the substance will prevail over the legal form.[221] In *Kilburn v Estate Kilburn*[222], the learned judge Wessels ACJ held that:

> it is a well-known principle of our law will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance".[223]

In *Zandberg v Van Zyl (1910 AD 320)*[224], the court held the following:

> Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes what they are meant it should have. Not infrequently however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose) the parties to a contract endeavour to conceal its real character. They call it by name, or give it a shape, intended not to express but to disguise its true nature. And when the court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The maxim then applies plus valet qou agitur quam qoud simulate concipitur. But the words of the rule indicate its limitations. The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstance that the same object might have been attained in another way will not necessarily make the arrangement other than what it purports to be.

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[220] Ibid
[221] Kanamugire J, *A Critical Analysis of Tax Avoidance in the Income Tax Act 58 of 1962, as amended* (2008).
[222] *Kilburn v Estate Kilburn* 1931 AD 501
[223] Ibid
[224] Emslie, T., 2009. Substance and form: a distinction with a difference.

This substance over form common law doctrine was applied in *ERF 3183/1 Ladysmith (Pty) Ltd v CIR*[225], wherein the question was whether the taxpayer had obtained a right whose value would have been taxable in terms of par (*h*) of the definition of gross income.

The facts to the case were as follows:

> The lessor wanted to erect a factory in a tax efficient manner. The taxpayer then concluded a series of agreements including leasing vacant land to a tax-exempt entity. The terms of the lease stated the tax-exempt entity was would not be obligated to erect a building on the land. The lessee being the tax-exempt entity, further sub leased this land which placed an obligation on the sub-lessee to pay lease premium which would enable the lessee to erect a factory building.[226]

The court held that the lease agreements contained a simulation which was used to disguise the true intention of the parties, which was that the lessor will have a right to improvements made on the land. The lessor was thus liable for the tax on the value of the improvements.[227]

It can thus follow that If parties to a derivative transaction enter into an agreement where the true intention of the transaction is different to its legal form, this may be tantamount to tax evasion. SARS will in any event apply the anti-avoidance rules to the transaction and thus tax the transaction based on the parties' true intention.[228]

In *CSARS v NWK Ltd*[229]**,** the court stated that a taxpayer is free to arrange his affairs so as to minimise tax liability and that there is nothing wrong with arrangements that are tax-effective. The court also noted the following qualification to its judgement:[230]

> But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not.[231]

The *learned Judge Lewis JA further stated:*

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[225] *ERF 3183/1 Ladysmith (Pty) Ltd v CIR* 1996 (3) SA 942 (A), 58 SATC 229
[226] Haupt, P., 2020.*Notes on South African Income Tax 2020*. H & H Publications: Roggebaai, p.639
[227] Ibid
[228] Ibid
[229] *CSARS v NWK Ltd* (2011) 73 SATC 55
[230] Stiglingh, M., Koekemoer, A., Van Heerden, L., Wilcocks, J.S., De Swardt, R.D. and Van der Zwan, P., 2017.*Silke, South African Income Tax 2018*. LexisNexis,
[231] Ibid

> In my view the test to determine simulation cannot simply be whether there is intention to give effect to contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their situation.[232]

The courts make it clear that if transactions are entered into with the sole intention of achieving tax evasion it will be regarded as simulation of which is a criminal offence. What is important to consider is that regardless of the statutory tax rules, the substance over form rule is first assessed for an agreement or transaction, or indeed, a derivative agreement. The substance over form rule, provides that the form of an agreement will not be given effect to if it does not reflect the true intention of the parties. It can thus be said that these relatively complex transactions mentioned above fell by the wayside, when the court considered the "true intention" of the parties.

4.2.2 GAAR as per section 80A to 80L of the ITA

The purpose of GAAR provisions is to prevent the taxpayer from entering into transactions or arrangements that do not make economic sense other than to obtain a tax advantage.

As noted, the Commissioner has common law remedy for dishonest arrangements (*in fraudem legis*) and whereby the courts are willing to apply the concept of 'substance over form' to schemes. In fact, an agreement may accurately reflect the true intention of the parties', but if the result is categorised as impermissible tax avoidance the Commissioner may set it aside.

In terms of section 80A, an impermissible avoidance arrangement describes the term impermissible as containing the following elements:

- Sole or main purpose is to obtain a tax benefit,
- An arrangement that is abnormal, lacks commercial substance in a business context, or creates non-arm's length rights or obligations. There must thus be a misuse of the Act.

[232] Ibid

A transaction is said to be ‘abnormal’ or ‘tainted’, if any part of the transaction or series of transactions that were not ‘carried out by a means or in a manner which would not normally be employed for *bona fide* purpose, other than obtaining a tax benefit’. In a business context, the test is against a ‘*bona fide* business purpose’. As stated by Professor Michael Graetz (Yale), “if a deal done by very smart people that, absent tax consideration, would be very stupid”.

Section 80C explains what is meant by the phrase “lack of commercial substance as follows:

it is an arrangement that ‘would result in a significant tax benefit for a party but does not have a significant effect upon either the business risks or net cash flows of that party.’.

Lack of commercial substance is further indicated by:

1. The presence of ‘round-trip financing’; or
2. Elements of a transactions that have the effect of offsetting or cancelling each other; or
3. Legal form that is significantly different to the substance being the “true intention” of the agreement; or
4. Tax indifferent of accommodating parties

The ITA expands further from section 80D to section 80F on these non-commercial indicators excluding the substance over form indicator.

The GAAR provisions can thus be applied to derivative transactions in the following manner:

- the ‘sole or main purpose” can be disproved if the derivative agreement changes the character of the income or expenditure and losses,
- the “abnormal” test can be rebutted, if after considering the primary uses of derivatives as described in section 2 of this report, and disregarding the tax element in the transaction, one still comes to the conclusion “that the transaction was very stupid”.

After considering the above factors, SARS may thus state that there has been misuse of the ACT.

Chapter 5

Conclusion

This study sets out a basic understanding of derivative transactions. This took the form of defining these instruments, understanding how they are traded and then defining the primary uses of the instruments. The research confirmed that the three primary uses of derivatives. Derivatives are useful innovation in the market as they assist in transferring risk (when used as a hedge), or they can be used for the purpose of speculation when a taxpayer has an intention of generating income without acquiring the underlying. An example was made of the mechanics of the two types of derivative instruments to demonstrate how profit or expenditure or losses would be generated from a derivative agreement. As noted, derivatives can take the form of forward based contracts or options-based contracts. Derivatives can be traded as a stand-alone, in combination or form part of a structured instrument.[233]

The research, then undertook to apply the general taxation of derivatives in South Africa in terms of the ITA. The report concluded that in determining the nature of the derivative income or expenditure or losses, consideration will be given to the taxpayers' intention. This will include the examination of facts and whether a scheme of profit making was undertaken or not. The nature of the expenditure or loss incurred as a result of a derivative transactions can either be classified as capital or revenue in nature from an Income Tax Act perspective. The notion of tree and fruit plays an important factor when determine this. In determining the nature of the expenditure and losses, consideration will be given as to how the derivatives were employed in the business of the taxpayer. The timing of inclusion of derivative contracts will is based on the specific provision as set out in sections 24I, 24J, 24JB, 24K and 24L of the ITA. If none of the specific provisions apply to a derivative contract, the taxpayer will then have to revert back to the general principles of timing principles as laid out in gross income definition.

[233] National Treasury. n.d. An examination of the South African OTC derivatives markets to recommend measures for strengthening their regulatory oversight. Available at http://www.treasury.gov.za/legislation/bills/2012/FMB/Annexure%20C%20An%20examination%20of%20the%20OTC%20derivatives%20market%20(Skerrit).pdf [Accessed on 30 April 2020],

The research further considered if there was a need for an enhancement of the ITA specifically on derivative contracts. The introduction of specific taxation principles poses a challenge to taxation due to the nature of these instruments.

Derivatives are composite of the underlying transaction and thus can take any shape or form. The introduction of new tax regulations specifically for derivatives will be fruitless for the taxpayer and SARS. The derivative engineers will be able to modify their terms as soon as new legislation is enacted. There are also further unintended consequences as written by a few commentators regarding the recent introduction of section 24JB. Tax abuse itself is a relatively fluid concept. The South African Income Tax Act contains a good balance of general and specific provision to tax derivative transactions. The current provisions are in line with TAC recommendation where the principle of certainty supersedes the need for complex legislation. The Commissioner has further powers that are built into the GAAR provisions which give him power to reconstruct and ignore certain legs of a transaction in determining what is taxable and how should the transaction be taxed. Further to this, the courts have established the doctrine of substance over form and thus this can be used to override questionable transactions.

As Oguttu has stated, the problem is the understanding of derivatives. The introduction of specific taxation principles poses a risk to taxation risk to these instruments as it could further result in unintended consequences as commentators have highlighted.

More resources should be focused on understanding the derivatives. The other alternative could be to remove the incentive to the nature of income and have one effect for all transactions. Unfortunately, this may not be well received by the taxpayers.

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