

**An analysis of the income tax treatment of realised gains
and losses from the use of short positions in South African
hedge fund portfolio fundamental paired trades**

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Submitted to the University of Cape Town

in part fulfilment of a Master of Commerce specialising in Taxation in the
field of South African Tax

Date of submission: 6 March 2017

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Abstract

This dissertation analyses the nature (capital or revenue) of the proceeds arising from the use of short positions in South African hedge fund fundamental paired trades.

Hedge funds, which typically avail themselves of an array of alternative investment strategies such as short selling in addition to the traditional asset classes, were recently brought into the South African investment regulatory net. This was achieved by classifying regulated hedge funds as a separate category of collective investment scheme in terms of the CISA. This categorisation brought regulated hedge funds into the ambit of section 25BA of the Income Tax Act which carries an important distinction between amounts of a capital nature and amounts of a revenue nature. Given that hedge funds may use short positions for both profit-seeking and risk-mitigation purposes, the resulting proceeds from short sales could be capital or revenue in nature from a tax perspective based on the surrounding facts of the trade.

The onus of discharging the proof that the proceeds resulting from a short sale are capital in nature is significant. The South African case law emphasises the importance of applying the various principles to the specific facts of the case.

The importance of the dominant intention of the trade is highlighted, given the potentially competing purposes of profit-seeking and risk-mitigation present.

Factors that should be analysed in such a scenario include the overall portfolio positioning, the size of the long and short positions relative to each other, the degree of specificity of the risk that the short position purports to hedge against, the manner of re-investment of the short sale proceeds, the level of trading activity in the hedge fund, the level of short positions in the hedge fund, the absolute sizes of the long and short positions in the context of the overall portfolio, the exposure of the hedge fund to the long position after the close out of the short position, the manner of close out of the short position and the holding period of the short position.

While the analysis reveals factors that may be indicative of capital treatment, the classification of short sale proceeds as capital or revenue in nature remains a challenging task to undertake due to the potentially wide variety of facts and circumstances and the potential for undesirable consequences should an incorrect

classification be made. Consequently, improved clarity through the provision of *de jure* guidance as to the nature of short sale proceeds would be welcome.

Abbreviations

AUM	assets under management
the Cisca	the Collective Investment Schemes Control Act (No 45 of 2002)
the FAIS	the Financial Advisory and Intermediary Services Act (No 37 of 2002)
the ITA	the Income Tax Act (No 58 of 1962)
NT	National Treasury
SARS	the South African Revenue Service
the TLAB	the Taxation Laws Amendment Bill, 2013

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1. Introduction

Hedge funds are a form of collective investment vehicle that are distinct from typical collective investment schemes in securities as they use a wider range of investment strategies such as short selling in an attempt to earn superior risk-adjusted investment returns (National Treasury [“NT”] (a), 2014: 5). A well-managed hedge fund could be used effectively to mitigate risk in a diversified investment portfolio as hedge funds are designed to outperform non-hedged portfolios in a downward-trending market (Amin & Kat, 2003: 251). As was succinctly noted by National Treasury (NT (a), 2014: 5): “Hedge funds are therefore designed not to outperform all market conditions, but are designed to protect portfolios on the downside and preserve capital and tend to perform *relatively* better than the market during “bear” markets, largely because of their hedging strategies” (original text emphasis).

The recent first-time regulation of hedge funds in South Africa was effected by declaring hedge funds as a separate category of collective investment scheme under the Collective Investment Schemes Control Act (No 45 of 2002) (‘the Cisca’). With this inclusion under the Cisca, the income tax treatment of hedge funds is the same as that applicable to other collective investment schemes: in terms of section 25BA of the Income Tax Act (No 58 of 1962) (‘the ITA’), amounts received by or accrued to a regulated hedge fund that are not capital in nature need to be distributed to investors within 12 months otherwise the amount is taxable in the fund. If the distribution of the revenue amount occurs within the prescribed 12 months then the hedge fund investor is taxed on this amount, not the fund itself. The correct classification of such amounts as capital or revenue is therefore of vital importance, not merely from an effective tax rate perspective (capital gains are taxed at lower rates than revenue gains) but also an ultimate tax liability-bearer perspective.

In the hedge fund context, where the use of short positions is commonplace (Du Preez, 2016: 17), this raises the question of whether gains and losses realised from the use of short positions are capital or revenue in nature. While the South African share-dealing jurisprudence may be well defined, the relevant facts and circumstances vary considerably and therefore correct classification of such amounts is an arduous, risky task for hedge fund trustees and administrators to undertake.

1.1 Research question

This dissertation explores the capital/revenue debate around the realised gains and losses from the use of short positions in fundamental paired trades, specifically in the context of South African equity long/short hedge fund portfolios.

Equity long/short hedge fund portfolios typically buy shares (“go long”) and take short positions (“short sale”) on equities for both risk mitigation and profit-making purposes, with the fund generally having a long bias (Nelken, 2006: 114). Equity long/short is the most common hedge fund strategy in South Africa (Novare Investments, 2016: 12).

Short selling involves borrowing shares and immediately selling these shares in the market with the anticipation that the value of the share will decline, resulting in a gain when the share is later purchased to return to the lender (Bouzoubaa, 2014: 8).

One of the applications of short selling is in the context of a paired trade. As explained by Gatev, Goetzmann and Rouwenhorst (2006: 797), a paired trade is a popular, relatively simple investment strategy that involves the identification of two financial instruments with a historically high degree of correlation. These are typically stocks in the same industry (fundamental paired trades). At times when the relative price spread between the two stocks widens, the investment strategy entails buying the stock that has underperformed relatively and taking a short position on the stock that has over performed relatively. Should the price spread normalise, as expected, the strategy will yield profits.

It is submitted that SARS, armed with the South African jurisprudence relating to share-dealing, would argue that the gains from short sales in fundamental paired trades are revenue in nature owing to the fund’s intention to profit from the decline in the value of the underlying security. However, given the emphasis of hedge funds as potential risk-mitigation investment vehicles, this dissertation explores (in the context of the existing South African jurisprudence) whether there are facts and circumstances that could indicate that such gains are capital in nature.

The research question that this dissertation seeks to address is therefore:

What factors indicate that realised gains/losses from the use of short positions in South African hedge fund portfolio fundamental paired trades are revenue in nature and what factors, if any, indicate that such gains/losses are capital in nature?

1.2 Outline of dissertation

After a brief introduction of the issue (chapter one), this dissertation dedicates chapter two to setting out the background to South African hedge funds. Given the highly specialised nature of the topic, this chapter explores the concept of a hedge fund, and the concept and role of short positions with a focus on fundamental paired trades in equity long/short portfolios so that sufficient background is provided to understand the technical aspects relevant to the research question.

Chapter three discusses the South African regulatory classification of hedge funds as collective investment schemes and highlights the resulting impact that section 25BA of the ITA has on the taxation of hedge funds. This chapter touches on the various tax proposals discussed between National Treasury and industry; these proposals preceded the current situation of reliance on the South African share-dealing jurisprudence to classify such gains as capital or revenue in nature. As there is no *de jure* guidance in the ITA regarding the classification of realised gains from hedge fund short positions as capital or revenue in nature, the principles laid down in South African case law would be applied to the facts of each case. This chapter also briefly sets out a few practical issues that may arise as a result of the current situation of reliance on the jurisprudence.

Chapter four sets out and discusses the relevant statutory provisions and the applicable jurisprudence.

In chapter five, the hedge fund fundamental paired trade short position context is linked to the existing jurisprudence. This chapter analyses factors that are indicative of gains from short positions in fundamental paired trades being revenue in nature and factors that could be indicative of such gains being capital in nature in an attempt to present a solution to the issue.

The final chapter presents the conclusions derived from the analysis in the preceding chapters.

2. Background to South African hedge funds

2.1 Introduction

From the perspective of the lay investor, hedge funds globally have been perceived in a negative light and have often been misunderstood as to their actual objective in various market conditions. This misconception, together with the few incidences of hedge funds incurring significant investment losses (Du Preez, 2016: 19), have made for a challenging environment for hedge funds to operate in (HedgeNews Africa, 2015: 4). The misunderstanding of the objective of a hedge fund adds uncertainty to the capital/revenue debate for tax purposes given the principles laid down in the applicable South African case law.

The welcome advent of regulated hedge funds in South Africa comes at a time with the South African hedge fund industry still in its infancy (Novare Investments, 2015: 2). Given the challenges faced by global counterparts, as well as the opportunity for growth in the local hedge fund industry, the importance of clarity regarding the taxation of hedge fund investments in South Africa is heightened to attempt to prevent further uncertainty in the industry. This dissertation seeks to explore the capital/revenue tax treatment debate in the South African hedge fund context in an attempt to reduce uncertainty. This chapter sets out a background to hedge funds, particularly focusing on the concepts of an equity long/short hedge fund and a short sale in a fundamental paired trade so as to provide the reader with sufficient knowledge to understand the technical aspects of this dissertation.

2.2 What is a hedge fund?

Part of the reason for the misconception around the actual objective of a hedge fund in various market conditions is that they are not easily defined. Indeed, many commentators agree that no single all-encompassing definition of a hedge fund exists (Lhabitant, 2006). This is echoed by the HedgeNews Africa definition of a hedge fund (HedgeNews Africa, 2015: 64), which is set out as:

There is no standard international/legal definition though they may have all or some of the following characteristics: May use some form of short asset exposure; may use derivatives and/or more diverse risks or complex underlying products; may use some form of leverage, measured by gross exposure of underlying assets exceeding the

amount of capital in the fund; funds charge a fee based on performance relative to an absolute-return benchmark as well as a management fee; often, the manager is a significant investor alongside other fund investors.

Section 63 of the CISCA formally defines a hedge fund as:

an arrangement in pursuance of which members of the public are invited or permitted to invest money or other assets, which uses any strategy or any takes any position which could result in the arrangement incurring losses greater than its aggregate market value at any point in time and which strategies or positions include but are not limited to – (a) leverage; or (b) net short positions.

The clear message from these definitions is that a hedge fund, in contrast to a typical collective investment vehicle, uses a wider range of investment strategies to achieve its objectives.

As the term ‘hedge’ suggests, the aim of a well-managed hedge fund is primarily to protect invested capital during market downturns. Generally, hedge funds use the variety of investment strategies at their disposal to reduce investment risk in falling investment markets (‘bear’ markets), but this in turn means that the fund does not fully experience upturns in investment markets (so called ‘bull’ markets) (Amin & Kat, 2003: 251). Therefore, one would expect a hedge fund to outperform the market during a bear market, but to underperform the market during a bull market.

As a result, investors seek exposure to hedge funds to enhance diversification in their investment portfolios and reduce volatility and preserve their investment capital more effectively (Nelken, 2006: 64).

According to research by McKinsey & Company (McKinsey & Company, 2014: 6-9), despite the aforementioned challenging operating environment for hedge funds globally, alternative funds (defined to include hedge funds, private equity, real estate, fund of funds, commodities and infrastructure) are predicted to experience strong net inflows in the coming years due to the emergence of certain investor trends. These include investors searching for reduced volatility in their investment portfolios after the negative impact of the global financial crisis and a move towards more specific, absolute-return type benchmarks (for example, inflation plus an increment) as opposed to relative-return/market-linked benchmarks. Their research indicates that

over the period 2005-2013, global assets under management (AUM) for the alternative asset category grew at an annualised 10.7%, with global hedge fund AUM specifically growing at an annualised 11.4% over this period. In contrast, traditional asset AUM grew by an annualised 5.4% over the same period. Although the search for superior investment returns is clearly a very important consideration in the minds of investors, the McKinsey & Company research indicates that more and more investors are not solely focused on this objective and therefore they predict the popularity of alternative assets, and by association hedge funds, to grow in the coming years.

It cannot necessarily be assumed that such findings regarding the global hedge fund industry would apply to the South African hedge fund industry but they do point to the potential for growth in the South African hedge fund industry.

2.3 The concept and purpose of a short position

Taking short positions, or 'short selling', is one of several investment strategies used by hedge fund managers to achieve their objectives. Typically, a hedge fund will invest in the traditional asset classes of cash, equity and fixed income, but will also take short positions, which traditional collective investment schemes in securities are not permitted to do in terms of Financial Services Board Notice 90 of 2014 to the CISC. Short selling is one of the most important alternative investment techniques employed by hedge fund managers (Lhabitant, 2006).

In a short sale of shares, the hedge fund manager, anticipating a decline in value of the share, would borrow shares from the owner of the shares and immediately sell the shares, realising cash proceeds (which could in turn be invested in another position subject to collateral conditions stipulated by the lender). The hedge fund would be obliged to return the shares to the owner at a future date. Once the share price has fallen, the hedge fund would purchase the shares in the market, realising a gain, and return the same number of shares originally borrowed to the lender (Nelken, 2006: 96). This gain is the realised gain referred to in the research question of this dissertation¹.

¹ Refer to page 8 for an illustration of the corresponding realised loss scenario.

To illustrate further by way of an example, assume that a hedge fund has R100 directly invested in various equities ('long' positions). These shares are owned by the hedge fund. The hedge fund manager identifies a certain share that he believes will decline in value ('Company A'). The hedge fund then borrows a certain number of shares in Company A from the owner of those shares and immediately sells them in the market (short position) for proceeds of R60. It is agreed that the hedge fund will return the same number of shares of Company A to the lender on or before a date in the future. After some time, the price of Company A shares do decline and the hedge fund purchases the shares in the market for R40. It then returns the shares to the owner. As a result of these transactions, the hedge fund initially received proceeds of R60 and later incurred R40 to purchase the same number of shares, therefore realising a gain of R20 from the short sale.

Assuming that the market value of the other various long positions increased by R10 over this period, the hedge fund would have realised a total gain of R30 on invested capital of R100. In contrast, a long-only fund with the same long equities that is not permitted to take short positions would have only realised a R10 gain on the R100 invested capital. This concept of using borrowed capital to increase exposure to the market and potentially earn greater returns is known as leverage (Ang, Gorovyy, van Inwegen, 2011: 103).

In this example, the short sale achieved its intended purpose. However, market movements may result in losses being incurred on the short position that could exceed the entire market value of the hedge fund. An equity held long can, at a maximum, lose 100% of its value if it falls to zero. In contrast, the share price of an equity held short could rise in value and result in a potentially uncapped loss for the hedge fund as the hedge fund is obliged to purchase the same number of shares to return to the lender, regardless of the current share price, should the lender recall the stock (cancel the loan) or should the hedge fund manager wish to close the short position. This loss could be exacerbated should the long equities in which the proceeds from the short sale are invested decrease in value.

Many hedge fund investors are insulated from such uncapped losses due to the legal structure of the hedge fund. A popular legal structure for hedge funds is the *en commandite* partnership, also referred to as a limited liability partnership (Van

Dorsten, 1993). In such a partnership, an incorporated entity (usually the hedge fund manager or some other non-trading company in the hedge fund context) would serve as the disclosed partner. All other investors would serve as undisclosed (*en commandite*) partners. Under South African common law, only the disclosed partner would be liable for partnership losses. The liability of the undisclosed partners (investors) is limited to their contribution to the partnership, namely their invested capital. Should the hedge fund realise a substantial loss due to an unfavourable short position, the undisclosed partners would not suffer any losses in excess of their invested capital in the hedge fund. The disclosed partner would be liable for the remainder of the losses, which could result in its liquidation.

Despite the risks associated with hedge funds, a well-managed hedge fund can utilise short positions to mitigate investment risk (Amin & Kat, 2003: 251). In a downward-trending market, short positions could be used to protect invested capital. A hedge fund could combine long and short positions on strongly correlated equities to neutralise exposure to market risk as such a portfolio should not experience significant gains or losses, regardless of market movements (Nelken, 2006: 115).

In addition to allowing for capital protection in certain circumstances, short portions also enable the hedge fund to earn short-term gains by profiting from the decline in a security's value. These competing purposes have resulted in uncertain income tax treatment of realised gains and losses in hedge fund portfolios: short-term, speculative gains are more likely to be revenue in nature, but gains arising out of a capital protection strategy are potentially capital in nature given certain facts and circumstances. This dissertation explores precisely that debate.

2.4 Variety of short positions

There are various means to gain short exposure to a particular financial instrument (i.e. benefit from a downturn in that instrument's price). These can broadly be classified into physical short selling, naked short selling and derivatives that create short positions.

Naked short selling involves entering into a short sale without the hedge fund being in possession of or having borrowed the security it wishes to short (Boulton & Braga-Alves, 2010: 400). In contrast, physical short selling first involves the borrowing of

the security before it is sold. Naked short selling is not permitted under the South African hedge fund regulations due to the increased inherent risk (Financial Services Board Notice 52 of 2015, Regulation to the Cisca, 2015: 24). United States market regulators banned naked short selling on certain stocks in 2008 to mitigate against “a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets” (Boulton & Braga-Alves, 2010: 398).

Market participants may also utilise derivatives to create short positions. A derivative instrument is defined in the Financial Markets Act (No 19 of 2012) as:

Any –

(a) financial instrument; or

(b) contract,

that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, on a measure of economic value or on a default event;

Popular examples of derivatives that create short positions include a long put, a short call and single stock futures.

A bought (long) put ‘gives the holder the right to sell an asset by a certain date for a certain price’ (Hull, 1995: 172). Therefore, if the hedge fund manager was bearish on a particular stock, the fund could purchase a put option on that stock which would yield gains should the price of the underlying stock decline as the hedge fund would be able to purchase the stock in the market at the lower price and thereafter sell the same stock at the higher price as agreed in the put option contract.

Similarly, a sold (short) call ‘gives the holder the right to buy an asset by a certain date for a certain price’ (Hull, 1995: 172). Therefore, the party that issued the call option would have an obligation to sell the underlying stock at the agreed price if the option was exercised. If the stock’s price declined and the option was exercised the issuer of the call would realise a gain as it would purchase the stock in the market at the lower price and sell the same stock to the holder of the call option at the higher, agreed price.

Single stock futures are listed, tradable derivative instruments that enable investors to gain exposure to the underlying share on which it is based with less capital than a direct investment in that share would require (Ang & Cheng, 2004: 1). By way of example, an investor may desire exposure to R100 of a certain share. With a single stock future, the investor would be required to deposit funds, known as the initial margin, amounting to a percentage of the exposure. After placing this initial margin, amounting to, say, R15, the investor has exposure to R100 of the underlying share and has therefore leveraged his exposure. The resultant gains and losses are on the full R100 exposure but with only a fraction of the capital invested. Gains and losses on single stock futures are realised daily ("marked-to-market"). Single stock futures can be used to leverage exposure on both long and short positions, should the exposure (R100 in example) exceed the capital (R15 in example, assuming no other capital in the fund).

Short selling is specifically used in the context of a relatively simple equity convergence trading strategy known as paired trades (Do & Faff, 2010: 92). A paired trade involves the identification of two financial instruments with a historically high degree of correlation i.e. instruments that move very closely together (Gatev, Goetzmann & Rouwenhorst, 2006: 797). Typically these are stocks in the same industry (fundamental paired trades) as they are subject to similar industry-specific factors such as regulation, competition etc. At times when the relative price spread between the two stocks widens, the investment strategy entails buying the stock that has underperformed relatively and taking a short position on the stock that has overperformed relatively. Should the price spread normalise, as expected, the strategy yields profits. Studies have found paired trading to be a profitable investment strategy over a long period (Gatev, Goetzmann & Rouwenhorst, 2006: 797), however, recent studies discovered a trend of diminishing profitability from such a strategy over time (Do & Faff, 2010: 83).

2.5 Short sale limitations

D'Avolio (2002: 271-306) investigated the practical considerations concerning equity short sales in the US market. His paper focused on the issues of loan supply (shortability), loan fees and loan recalls (lender cancels loan and requests return of stock).

As corroborated through discussion with a local hedge fund manager², loan supply i.e. the stock of shares that can be shorted is lower for less liquid shares. Intuitively, as demand for short positions increases, the loan supply decreases as the prospective short seller needs to be able to first borrow the share³ and the holder of the share may also become bearish on the share and wish to rather sell the share than lend it. As D'Avolio (2002: 271-306) notes, if the short seller is successful in borrowing the shares in question, it may then be difficult to sell such shares in the market as negative market sentiment surrounding the share could make potential buyers less willing to hold the share.

These dynamics also impact on the cost of executing a short sale. The costs of borrowing an in demand short position, in the form of loan fees, are higher⁴. A short seller does not enjoy the dividend attaching to an equity sold short. Rather, the dividend is paid to the holder of the share, increasing the cost to the short seller (Lake, 1999: 118).

D'Avolio (2002: 271) found that loan recalls are rare on average, but increase during periods of high market volatility. This experience was confirmed by the local hedge fund manager. Equity short sales do not have implied terms but are rather subject to recall by the lender. This is a risk to the profitability of the short sale trade as the lender could recall the stock at any time and the hedge fund would be forced to close the position. The absence of set time period limits in stock loan arrangements does not generally imply that short sellers hold their short positions for prolonged periods of time given the inherent risk in the strategy. It would not be prudent to have a large short exposure for a prolonged period of time.

2.6 The South African hedge fund context

The South African hedge fund industry is small in comparison to the global hedge fund industry. Global hedge fund AUM is in excess of US\$3 trillion (Novare Investments, 2015: 2), whereas South African hedge fund AUM was R68.6 billion at

² Per discussion with Michael Lawrenson, a portfolio manager at Tantalum Capital (Pty) Ltd, a local hedge fund manager.

³ Refer to section 2.4 on page 9 for the distinction between impermissible naked short selling and physical short selling.

⁴ Per discussion with Michael Lawrenson, a portfolio manager at Tantalum Capital (Pty) Ltd, a local hedge fund manager.

30 June 2016 (Novare Investments, 2016: 8). In South Africa, hedge fund AUM is dwarfed by the collective investment scheme industry which has AUM of R2 trillion (Novare Investments, 2016: 3). This is owing to a historical bias towards allocating investments towards traditional asset classes and stagnant growth in the local hedge fund industry as investors waited for the recently promulgated hedge fund regulations to come into force (HedgeNews Africa, 2015: 4, 8).

South African hedge funds are generally more conservative than their global counterparts and invest in less exotic instruments (Du Preez, 2016: 20).

Given that hedge funds utilise a variety of investment techniques to achieve their objectives, an array of hedge fund strategies have emerged. According to the Novare Investments South Africa Hedge Fund Survey 2016 (Novare Investments, 2016: 12), the most common hedge fund strategies in South Africa are:

- Equity long/short: These hedge funds typically purchase shares that are expected to appreciate in value and take short positions on equities that are expected to depreciate in value, for both risk mitigation and profit-making purposes, with the fund generally having a long bias (Nelken, 2006: 114).
- Market neutral: The fund combines long and short positions on related shares with perceived price inefficiencies to target a net equity exposure of close to zero, thereby reducing market risk and targeting steady returns (Nelken, 2006: 95).
- Fixed income hedge: These funds employ a variety of fixed income specific strategies (arbitrage, relative-value yield curve trades) using fixed income instruments (bonds, cash, interest rate derivatives) (Nelken, 2006: 100).
- Multi-strategy: These funds use a combination of various traditional hedge fund strategies in response to prevailing market conditions (Nelken, 2006: 101).

Equity long/short is comfortably the most favoured strategy in the South African hedge fund industry, with 61.6% of total hedge fund AUM allocated to equity long/short as at 30 June 2016 (Novare, 2016: 12).

The majority of South African equity long/short strategies had an average net equity exposure of between 50% and 100% at 30 June 2016, supporting the long bias assertion (Novare, 2016: 24). Revisiting the earlier illustrative example involving Company A shares⁵, assume that the hedge fund invested R50 of the R60 proceeds from the short sale into equities (long positions), with the remainder invested in cash. At this point, the hedge fund would have long equity exposure of R150 (R100 plus R50) and short equity exposure of R60. This equates to a gross equity exposure of R210 (or 210%, being R210 gross equity exposure divided by fund net asset value of R100) i.e. the absolute sum of the long and short equity exposures, and a net long equity exposure of R90 (90%), being the difference between the long and short equity exposures.

This dissertation focuses on equity long/short hedge fund portfolios, owing to their prevalence in the South African market. Equity long/short portfolios hold short positions both to profit and for risk-mitigation. These differing motives present the opportunity to address the research question as the capital/revenue debate is more clearly isolated. Similarly, fundamental paired trades are specifically focused on given the opportunity this specific trade strategy provides to address the research question. Furthermore, this dissertation only considers physical short selling.

⁵ Refer to section 2.3 on page 8.

3. The South African hedge fund regulatory environment and consequential tax implications

3.1 Introduction

This chapter briefly sets out the South African hedge fund regulatory environment and explores how this has impacted on the current tax treatment applicable to hedge fund investors. With the background to hedge funds in the previous chapter, a further understanding of the South African hedge fund regulatory environment is important owing to the direct link between the regulatory classification of hedge funds and their income tax treatment. Although the hedge fund regulation itself does not prescribe the tax treatment of hedge fund gains and losses, the regulatory classification of hedge funds as collective investment schemes brings such gains and losses in the ambit of section 25BA of the ITA.

3.2 The path to regulation

Hedge fund managers have long been regulated in South Africa through the Financial Advisory and Intermediary Services Act (No 37 of 2002) (“the FAIS”). Compliance with the FAIS required *inter alia* registration as a hedge fund manager with the regulatory authorities (the Financial Services Board) to obtain a licence before management of hedge fund portfolios could commence, and regular regulatory reporting requirements (NT (a), 2014: 3). The regulation applied to the hedge fund manager, not the hedge fund itself.

Over a decade ago discussions between various stakeholders in the South African hedge fund industry commenced to regulate hedge funds at fund level (HedgeNews Africa, 2015: 8). The urgency of this project was heightened after the 2008 global financial crisis. The crisis focused attention on the need for increased regulation in the financial markets to enhance investor protection (Novare Investments, 2015: 2). The G-20, a forum comprising of 20 of the world’s largest economies, took on the role of co-ordinating the move to increased financial market regulation among its members. As a member of the G-20, South Africa committed to this process. Proposed hedge fund regulation was released in South Africa in September 2012 for public comment (NT (a), 2014: 4). After a period of negotiation between hedge fund industry stakeholders, hedge fund regulation at fund level was promulgated in South

Africa as from 1 April 2015 (Government Notice 141 of 2015. Regulation to the Cisca, 2015: 3).

Broadly, the regulations distinguish between two categories of hedge funds – retail investor hedge funds (“RIHF”) and qualified investor hedge funds (“QIHF”). QIHF’s are designed for investors with a minimum invested capital of R1 million and who are presumed to have a high degree of financial literacy to understand the unique risks associated with hedge funds. RIHF’s are tailored for the lay investor and have stricter regulatory requirements compared to QIHF’s to offer increased protection to investors (for example, the gross equity exposure of RIHF’s is limited to 200% at any time, whereas QIHF’s can set their own leverage limits, subject to meeting various requirements) (Financial Services Board Notice 52 of 2015, Regulation to the Cisca, 2015). Central to the regulation of both categories of funds is increased risk management and extensive regulatory reporting requirements (Financial Services Board Notice 52 of 2015, Regulation to the Cisca, 2015: 24).

3.3 Interaction between the regulations and the Income Tax Act

The hedge fund regulations were effected by declaring hedge funds as a separate category of collective investment scheme under the Cisca. As a result, the income tax treatment of hedge funds is the same as that applicable to other collective investment schemes regulated under the Cisca: in terms of section 25BA of the ITA, amounts received by or accrued to a regulated hedge fund that are not capital in nature must be distributed to investors within 12 months otherwise the amount is taxable in the fund⁶. If the distribution of the revenue amount occurs within the prescribed 12 months then the hedge fund investor is taxable on this amount, not the fund itself. Key to the taxation of hedge funds is therefore whether the gains realised by the fund from the use of short positions are capital or revenue in nature.

A further consequence of the declaration of hedge funds as collective investment schemes under the Cisca is the requirement, in terms of section 68 of the Cisca, to appoint independent trustees and/or an independent fund administrator to perform a fiduciary oversight role regarding the hedge fund’s activities. The hedge fund administrators and, ultimately, the trustees would be responsible for the classification

⁶ Refer to section 4.2 on page 23 for a discussion of the manner in which the hedge fund itself would be taxed.

of amounts received by a hedge fund as either capital or revenue in nature. While the South African share-dealing jurisprudence may be well defined, the relevant facts and circumstances vary considerably and therefore correct classification of gains and losses from the use of short positions is a potentially challenging, risky task to undertake due to the potential for undesirable consequences⁷ should an incorrect classification be made.

3.4 History of hedge fund tax proposals

South African hedge funds have historically been structured as either *en commandite* partnerships, debenture-structured private companies or trust arrangements (Novare Investments, 2015: 12). The legal structure of the hedge fund, in addition to the nature of the investment return and the nature of the hedge fund investor, has impacted on the manner in which hedge funds have historically been taxed (McCready, 2005: 109). For example, a hedge fund structured as an *en commandite* partnership would not be taxed itself as South African tax law does not recognise a partnership as a separately taxable entity. Rather, the individual partners would be taxed on their share of the partnership's income and capital gains, in terms of section 24H of the ITA and paragraph 36 of the Eighth Schedule of the ITA respectively. In terms of the new hedge fund regulations, a hedge fund may only be structured as a trust arrangement or *en commandite* partnership (Financial Services Board Notice 52 of 2015, Regulation to the Cisca, 2015: 18). Section 25BA of the ITA deems the legal structure of the hedge fund irrelevant for income tax purposes as the section applies to all hedge fund collective investment schemes regardless of legal structure.

As the regulation of hedge funds in South Africa came under focus with the release of draft regulation in September 2012, the 2013 Budget Review touched on the tax treatment of hedge funds. It was proposed that, while the tax regime applicable to other collective investments would also apply to regulated hedge funds (i.e. the ITA section 25BA conduit principle⁸ applicable to distributed income; exemption from capital gains tax on investment disposals in the fund), the gain made by an investor on realisation of their hedge fund units would be taxed as ordinary revenue in their

⁷ Refer to section 3.5 on page 19 for a discussion of the practical issues that could arise due to application of the law.

⁸ Refer to section 4.2 on page 22 for an explanation of the conduit principle.

hands, regardless of the investor's investment holding period of those units (NT (b), 2013: 56). In terms of section 9C of the ITA, the proceeds from the disposal of collective investment scheme units are deemed to be capital in nature if the units were held for a period exceeding three years. The 2013 Budget Review emphasised that this tax treatment "should generate the intended tax result without interfering with daily operations" (NT (b), 2013: 56). The reference "without interfering with daily operations" indicates that National Treasury acknowledged the difficulties that could arise should fund trustees be required to classify portfolio realised gains as capital or revenue in nature.

The draft Taxation Laws Amendment Bill (TLAB) of 2013⁹ refined this approach, with an improved outcome for RIHF investors. Acknowledging that treating certain gains as revenue in nature for tax purposes at fund level would be "highly disruptive", it was proposed that the fund be wholly exempt from tax, irrespective of the nature of the amounts received (revenue or capital in nature). Investors would be taxed on the disposal of their units in the fund. However, a distinction was drawn between RIHF's and QIHF's. RIHF investors would be subject to capital gains tax on the disposal of their units should they have been held for a minimum three year period, in line with section 9C of the ITA. For unit disposals occurring before the completion of the three year period, the nature of the proceeds is determined by the application of the common law. In the case of QIHF investors, proceeds on the disposal of units would always be deemed to be revenue in nature, regardless of the length of the investment holding period (NT (c), 2013: 58). This was in response to the notion that QIHF's by nature would likely have a large degree of derivative trading gains, which would likely be revenue in nature. National Treasury did not want fund gains that are largely revenue in nature to be converted into capital gains at investor level (NT (c), 2013: 58).

The hedge fund industry sought to obtain parity in tax treatment between RIHF's and QIHF's on the basis that the actual investment mandates and investment decision-making in both vehicles could be similar. Capital gains are taxed at lower rates than revenue gains. They posited that there should not be different tax treatments in such instances and tax should not be a factor that drives the investment choice. It was

⁹ Subsequently enacted as the Taxation Laws Amendment Act (No 31 of 2013).

proposed by the hedge fund industry that both categories of regulated hedge fund be afforded the same tax treatment as collective investment schemes in securities (Standing Committee on Finance (SCOF), 2013: 16).

This proposal was accepted by National Treasury (Standing Committee on Finance (SCOF), 2013: 16). In terms of the enacted Taxation Laws Amendment Act (No 31 of 2013), the tax treatment applicable to collective investment schemes in securities was extended to regulated hedge funds, with no disparity between QIHF's and RIHF's. However, the previously proposed exemption from tax in the fund was removed. Consequently, the section 25BA (of the ITA) requirement to distribute all revenue amounts received by the fund within 12 months or risk a tax liability in the fund became the official tax position. The requirement to classify realised fund gains as either capital or revenue in nature was therefore brought into focus. With the capital/revenue debate in a South African context subject to the common law when section 9C of the ITA does not apply, hedge fund trustees seeking to classify hedge fund realised gains as capital or revenue in nature currently find themselves having to apply the common law when making this classification.

3.5 Practical issues with the application of the common law

The necessary requirement to apply the common law when classifying gains and losses that are outside the scope of section 9C of the ITA potentially exposes hedge fund administrators and trustees to increased risk of incorrectly classifying portfolio gains as such a classification is potentially not an easy task to undertake. The consequences of an incorrect decision are concerning. Should a revenue realised gain be incorrectly classified as capital in nature, there is the risk of an unaccrued tax liability arising in the fund in the future upon assessment by SARS. This could occur at a time when the underlying investors in the fund have changed, therefore potentially subjecting investors that were not unit holders at the time the gain was realised to diminished investment returns due to the fund's tax liability (NT (c), 2013: 56). It is uncertain how such a scenario would be treated in practice as it could be challenging to recover the tax from the now redeemed previous investors. The hedge fund itself would be the taxed entity in this scenario, not the previous investors. As a result, the tax liability would fall on the hedge fund and the investors at date of assessment would suffer an impaired investment return as the fund's net asset value

would reduce by the extent of the tax liability. This in turn could lead to these investors redeeming their units in the hedge fund, to the detriment of the fund.

In particular, large institutional tax exempt investors such as retirement funds would be wary of investing in a product that possesses increased risk of fund-level tax liabilities as the imposition of the tax at fund level (currently 45% on assessed realised gains incorrectly classified as capital in nature) rather than investor level (zero for a tax exempt entity) would result in a tax trap in the fund and such an investor would suffer diminished returns due to the consequent reduction in the fund's net asset value.

These issues highlight the importance of providing further clarity regarding the taxation of hedge funds.

4. Review of the South African share-dealing jurisprudence

4.1 Introduction

In accordance with section 9C of the ITA, where qualifying shares are disposed of after an investment holding period exceeding three years, the resultant proceeds are deemed to be capital in nature. This does not automatically imply revenue classification for share disposals after an investment holding period of less than three years. Rather, the capital/revenue debate in such a context is subject to the South African share-dealing common law as there are no rules in the ITA, other than section 9C, to distinguish between capital and revenue nature amounts. The classification of realised gains from the use of short positions in hedge fund portfolios as capital or revenue in nature would similarly rely on this common law due to the absence of any specific *de jure* guidance in this regard.

4.2 Relevant legislation

Section 1 of the ITA defines a “portfolio of a hedge fund collective investment scheme” as ‘any portfolio held by any hedge fund business that qualifies as a declared collective investment scheme in terms of section 63 of the Collective Investment Schemes Control Act’. This definition came into effect when the South African Minister of Finance declared the business of a hedge fund to be a collective investment scheme as from 1 April 2015 (Government Notice 141 of 2015. Regulation to the Cisca, 2015: 3). This meant that, as from that date, a Cisca-regulated hedge fund was classified as a collective investment scheme and the income tax treatment applicable to collective investment schemes also became applicable to regulated hedge funds.

In terms of section 25BA of the ITA:

- (1) Any amount, **other than an amount of a capital nature**, received by or accrued to any portfolio of a collective investment scheme, other than a portfolio of a collective investment scheme in property, must-
 - (a) to the **extent that the amount is distributed** by that portfolio-
 - (i) to any person who is entitled to the distribution by virtue of the person being a holder of a participatory interest in that portfolio; and

- (ii) **not later than 12 months** after its accrual to or, in the case of interest, its receipt by that portfolio

be **deemed to have directly accrued to the person** on the date of the distribution; and

- (b) to the extent that the amount is **not distributed as contemplated** in paragraph (a) within 12 months after its accrual to, or in the case of interest, its receipt by that portfolio-

- (i) be **deemed to have accrued to that portfolio** on the last day of the period of 12 months commencing on the date of its accrual to or receipt by that portfolio; and
- (ii) to the extent that the amount is attributable to a dividend received by or accrued to that portfolio, be deemed to be income of that portfolio.

(emphasis added)

Collective investment schemes in South Africa are therefore taxed on a flow-through basis (the conduit principle) and act as a conduit through which revenue nature amounts pass, retain their nature and are taxed in the hands of the collective investment scheme unit holder, subject to certain requirements being met (de Koker & Williams, 2016: ss 6.13A).

As noted in *Secretary for Inland Revenue v Rosen* 1971 (1) SA 172(A) at 265:

In effect the legislature in those provisions has adopted a principle that can be conveniently termed the conduit principle: the registered shareholder is regarded as a mere conduit-pipe for passing the dividends on to the deemed shareholder, the true recipient of them, in whose hands they consequently retain their identity and character as dividends. The function of the principle is mostly apposite to trust cases, the mere interposition of the trustee between the dividend-paying companies and the beneficiary not being regarded as sufficient to change the character of the dividends as they pass to the latter.

Revenue nature amounts (typically dividends, interest) received by or accrued to a collective investment scheme that are distributed to unit holders within 12 months of accrual to the fund, are deemed to have accrued directly to the unit holders on distribution date for income tax purposes. Such amounts are taxed in the hands of

the unit holders, subject to any permissible exemptions. The collective investment scheme itself is not taxed on these amounts.

Where such an amount of a non-capital nature is not distributed to unit holders within 12 months of accrual to the fund, then this amount is deemed to have accrued to the fund on the last day of the affected 12 month period for income tax purposes. The fund would therefore be taxed on this amount at a current rate of 45%. This would result in the accrual of an income tax liability in the fund, in addition to possible interest and penalties, and a consequent reduction in the fund's net asset value. As collective investment scheme unit holders share in the fund's net asset value, the return of each investor would be reduced.

Should the fund then subsequently distribute this amount to unit holders, section 10(1)(iB) of the ITA prevents double taxation as the section exempts the unit holders from tax on such a distribution.

Inherent in section 25BA of the ITA is a vitally important distinction between revenue and capital nature amounts. Section 25BA only applies to non-capital amounts. If the amount received by the collective investment scheme is capital in nature, there is no requirement for the fund to distribute such an amount to unit holders in order to avoid a tax liability in the fund. Such an amount would be retained in the fund and be re-invested by the fund manager in accordance with the fund mandate.

In terms of paragraph 61 of the Eighth Schedule to the ITA, capital gains and losses realised in the fund that arise from the underlying portfolio activity must be disregarded for tax purposes. Therefore, a collective investment scheme is not liable for capital gains tax on its portfolio activity. Rather, unit holders are assessed for tax upon the disposal of their collective investment scheme units. Capital gains tax would usually apply on the disposal of collective investment schemes units, unless the disposal occurred in a scheme of profit-making, rendering the proceeds revenue in nature in line with the relevant common law principles.

The deemed accrual rule in section 25BA of the ITA therefore renders correct classification of amounts received by collective investment schemes as capital or revenue in nature crucial for both effective tax rate purposes and for purposes of determining the ultimate tax liability bearer.

Classification is relatively simple in the case of traditional income streams such as dividends and interest. However, the distinction is not as clear in the case of realised gains from fund portfolio investment activity. Classification of realised gains from the use of short positions in the equity long/short hedge fund context is particularly difficult given the dual motives of profit-making and capital protection inherent in such portfolios¹⁰.

4.3 Share-dealing jurisprudence

Over time the South African courts have formulated various tests to determine whether the proceeds arising from the disposal of shares are capital or revenue in nature. The capital/revenue debate, particularly in the context of share sales, however, remains a contentious issue due to the wide array of possible facts and circumstances to which such criteria must be applied (West & West, 2011: 2). The general principle is clear – if the disposal occurred in the course of a trade or scheme of profit-making, then the proceeds are revenue in nature; if the disposal was a mere realisation of an investment, then such proceeds are capital in nature.

As laid down in *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* 1992 54 SATC 271 (A) at 279, there is 'no single infallible test' to answer the capital/revenue debate. Rather, the various criteria developed by South African case law is applied to the facts specific to each case. A summary of the relevant tests formulated by the South African courts follows under various sub-headings below.

It is noteworthy that in terms of section 102(1) of the Tax Administration Act (No 28 of 2001), the onus of proving that an amount is capital in nature rests with the taxpayer.

West and West (2011: 5), in an analysis of the South African share-dealing jurisprudence, submitted that the enquiry as to the nature of the proceeds from share sales should cover three aspects – firstly, the taxpayer's intention; secondly, the true nature of the proceeds; and thirdly, factors specific to dealing in shares.

¹⁰ Refer to section 2.6 on page 14 for further context.

4.3.1 Intention

As was noted in *Income Tax Case 1185* 1972 35 SATC 122 (N) at 123, the intention of the taxpayer in respect of the disposed asset is 'perhaps the most important test'. This was echoed in *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste* 1978(1) SA 101 (A), 39 SATC 163 at 181 where the court noted that 'the intention of the taxpayer ... is of great, and sometimes decisive importance'. Essentially, the question to answer is: did the taxpayer have the intention of holding the asset as a long-term investment to derive an ongoing return, which has now merely been realised, or was the asset acquired with the intention of disposing of it at a profit in an operation of business ('scheme of profit-making')?

The origin of the intention of the taxpayer as a test dates back to the early case of *COT v Booyens Estates Ltd* 1918 AD 576, 32 SATC 10. One of the principles from this case is that an objective test of the surrounding facts and circumstances must be performed, with the intention of the taxpayer one of the factors to consider. What the taxpayer claims to be its intention (*ipse dixit*) is taken into account by the courts, but should not be overly relied upon (*ITC 1185 supra*) as naturally the taxpayer's *ipse dixit* could be influenced by self-interest (de Koker & Williams, 2016: ss 5.2.1). Rather, the intention of the taxpayer would need to be supported by an objective review of the relevant facts of the case.

Commissioner for Inland Revenue v Stott 1928 3 SATC 253 (AD) at 262 touched on the concept of a taxpayer changing its intention. Here it was laid down that the intention of the taxpayer at acquisition of the asset is conclusive unless other factors intervene to suggest a change in intention.

A taxpayer could change its intention in respect of an asset and such intention at the time of disposal would be the relevant test. However, the fact that a capital asset is sold by a taxpayer at a profit does not necessarily mean that such asset has been disposed of in a scheme of profit-making and therefore such proceeds should be taxed on revenue account. The courts have established the principle that a taxpayer holding a capital asset is entitled to realise that asset to best advantage (*Stott supra* at 261). However, the manner and extent of activities to enable realisation of such asset could indicate that the taxpayer has changed its intention and effectively

converted such asset to trading stock in their hands, to be disposed of in a scheme of profit-making.

In *John Bell & Co (Pty) Ltd v Secretary for Inland Revenue* 1976(4) SA 415 (A), 38 SATC 87 at 103, it was held that:

a mere change of intention to dispose of an asset hitherto held as capital does not per se render profit resulting from the subsequent disposal of the assets liable to tax; something more is required in order to metamorphose the character of the asset and so render its proceeds gross income.

The facts of the case would determine the presence of this 'something more'.

Clearly, a taxpayer may contemplate or hope for a profit on realisation of a capital asset and to do so would be expected, however, this does not necessarily mean that the taxpayer's intention for income tax purposes is now revenue in nature.

A distinction was drawn between 'contemplation' and 'intention' in *Pick 'n Pay Employee Share Purchase Trust supra* at 9. As explained by Smalberger JA in his judgment, income tax law is concerned with a taxpayer's intention, not with what was merely contemplated.

As noted in *SIR v The Trust Bank of Africa Ltd* 1975(3) SA 652 (A) at 106:

In an enquiry as to the intention with which a transaction was entered into for the purpose of the law relating to income tax, a court of law is not concerned with that kind of subjective state of mind required for the purposes of the criminal law, but rather with the purpose for which the transaction was entered into.

In criminal law cases, under the common law, one is regarded as having 'intended' what could reasonably have been foreseen. For example, if one drives recklessly and causes property damage you are considered to have had the necessary criminal 'intent' even though you may not have 'intended' to cause damage. In income tax law, the focus is on the purpose of the transaction. If entered into for the purpose of realising a profit in a scheme of profit-making, as supported by the facts of the case, the taxpayer's intention points to revenue tax treatment.

A taxpayer's intentions may be mixed, particularly at acquisition. A taxpayer may envisage both holding an asset to derive an ongoing return (indicator of capital

treatment) and disposing of the asset at a profit if the market for the asset so dictates (indicator of revenue treatment) (de Koker & Williams, 2016: ss 5.2.3). In such instances, the courts have attempted to establish the taxpayer's dominant intention. As noted in *The Trust Bank of Africa Ltd supra* at 102 'when there are mixed purposes the question as to whether one of them can be regarded as being the dominant one is essentially a matter of degree'.

In summary, it is important to determine the intention of the taxpayer; however, that intention needs to be assessed in the context of the relevant facts and circumstances of the case.

4.3.2 True nature of proceeds

Although the intention of the taxpayer is an important factor to consider and may be decisive (*Elandsheuwel Farming supra*), in many instances it is not the only factor to consider. As noted by Schreiner JA in his dissenting judgment in *Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd* 1956 (1) SA 602(A) at 365 'there is no legislative provision that makes the intention of the taxpayer decisive of whether the receipt or accrual was of a capital nature or not'. As submitted by West and West (2011: 7), a proper analysis of the nature of the proceeds also requires a consideration of its true nature.

4.3.2.1 The 'tree and fruit' analogy

Commissioner for Inland Revenue v Visser 1978 8 SATC 271 (TPD) at 276 used the 'tree and fruit' analogy to characterise capital amounts as the tree (the income-producing asset) and revenue amounts as the fruits (income) of that tree. For instance, a rent-producing fixed property would be the 'tree' and the rental income derived from this property the 'fruit'. However, the court noted the difficulty in applying this principle due to the wide variety of different circumstances to which it would need to be applied:

'Income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal or tree in the hands of one man may be interest or fruit in the hands of

another. Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset.

4.3.2.2 Manner of realisation

As noted in the *Pick 'n Pay Employee Share Purchase Trust* case *supra*, if the taxpayer disposes of an asset in a scheme of profit-making, the resultant proceeds are revenue in nature. This case further noted that if the proceeds are fortuitous and not worked for, they are more likely capital in nature.

As previously alluded to, the *Stott* case *supra* at 261 laid down that:

Every person who invested his surplus funds in land or stock or any other asset was entitled to realise such asset to the best advantage and to accommodate the asset to the exigencies of the market in which he was selling. The fact that he did so could not alter what was an investment of capital into a trade or business for earning profits.

However, this realisation could be performed in such a manner to indicate that the disposal occurred in a scheme of profit-making.

In the landmark *Natal Estates v Secretary for Inland Revenue* 1974(4) SA 177 (A), 37 SATC 193 case, the taxpayer owned large pieces of land on which sugar cane plantations were situated. The taxpayer had been engaged in sugar production for many years and had held the land as a capital asset. After considerable time, substantial pieces of land were disposed of by the taxpayer at a significant profit. The issue in question was whether the land had been disposed of in a scheme of profit-making and accordingly should be taxed on revenue account. The court acknowledged the principle that the mere decision to sell an asset is not sufficient to render the proceeds revenue in nature. The court held that, after assessing 'the totality of the facts', the test for whether the taxpayer had 'crossed the Rubicon' and gone over to the business of land development is a matter of degree. In this case, the taxpayer's activities, including the vast scale of its operations, intensive planning and national scale marketing, indicated that the taxpayer had 'crossed the Rubicon' and disposed of the land in a scheme of profit-making.

In *Commissioner for Inland Revenue v Wyner* 2003(4) SA 541 (SCA), 66 SATC 1, the taxpayer knowingly acquired a property at a discounted price to its true market value and shortly thereafter disposed of the property at a substantial profit. In this

case the court emphasised the principle from *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 2 SATC 71 (AD) at 75 that ‘a gain made by an operation of business in carrying out a scheme for profit making’ is revenue in nature. The profit realised in the *Wyner* case *supra* was not fortuitous and was designedly sought and worked for, and was therefore held to be revenue in nature.

Echoing this principle, van der Merwe AJA, in his judgment in the recent *CSARS v Capstone 556 (Pty) Ltd* (20844/2014) [2016] ZASCA 2 (9 February 2016) case at 24, noted that:

Whilst recognising that it is not universally valid, our courts have in circumstances such as the present consistently applied the test that a gain made by an operation of a business in carrying out a scheme of profit-making is income and vice versa.

In analysing the meaning of a scheme of profit-making, the judge, referencing Hefer AP’s judgment in *Samril Investments (Pty) Ltd v Commissioner, South African Revenue Service* [2003] SASCA 118; 2003 (1) SA 658 (SCA) para 2 stated at 26:

He pointed out that profit-making is also an element of capital accumulation. He said that: ‘Every receipt or accrual arising from the sale of a capital asset and designedly sought for with a view to the making of a profit can therefore not be regarded as revenue. Each case must be decided on its own facts...’

Thus the mere intention to profit is not conclusive. There must be ‘an operation of business in carrying out a scheme of profit-making’ for a receipt to be income.

Therefore, as mentioned earlier, a taxpayer can hope for a profit from the disposal of a capital asset, but ‘something more is required’ for the asset in question to have been disposed of in a scheme of profit-making and the resultant proceeds to be revenue in nature. As noted in *Capstone supra* at 26, ‘an operation of business in carrying out a scheme of profit-making ... refers to the use of the taxpayer’s resources and skills to generate profits, usually, but not always, of an on-going nature’. The manner and extent of realisation is therefore vital in determining whether the taxpayer has embarked on a scheme of profit-making.

In *Income Tax Case 1283* 1978 41 SATC 36 (SW) the taxpayer carried on a trade as an Angolan coffee bean exporter. The economic situation in Angola worsened and the taxpayer converted as much of his wealth into coffee beans as he could and

exported the coffee beans in an attempt to salvage his capital. The court ruled, based on the facts of the case, that the resulting profits on sale of the coffee beans abroad were capital in nature as although the coffee beans had been acquired with the intention of re-selling them, they had not been disposed of in a scheme of profit-making. Rather, the purpose was to salvage the taxpayer's wealth. This illustrates the importance that the disposal must occur as part of a scheme of profit-making to be considered revenue in nature.

4.3.2.3 Holding period

In *Bloch v Secretary for Inland Revenue* 1980(2) SA 401 (C), 42 SATC 7, the taxpayer held shares in a private company that was formed to acquire land with the intention of developing a residential township thereon. The original intention of the taxpayer was to then sell these units and the resultant profits to accrue to shareholders by way of dividends. The property development occurred but before any units were sold, the taxpayer sold its shares in the private company for a substantial profit after property prices in the area experienced a tremendous upsurge. The issue in question was whether the resultant proceeds were capital or revenue in nature. The court held at 14 that the taxpayer:

had to show that the shares in issue were an item of fixed capital in his hands; that this entailed his establishing on a balance of probabilities that his dominant intention or purpose in acquiring and holding shares was to hold them more or less permanently so as to produce income.

In this case, the court sided with the taxpayer and held that the proceeds were capital in nature as the project has been entered into for the purpose of investing their capital to acquire shares from which an income stream (dividends) would be generated, and the shares were sold as a mere realisation of this investment.

In his judgment in this case, Vos J noted that not all capital assets produce an income, citing the examples of a house and artwork. He sought to refine the principle that a capital asset is that intended to be held long term so as to derive an income return to:

capital is that which is held with an element of permanency and with the object that it should produce an economic utility for the holder

SARS notes in its *Comprehensive Guide to Capital Gains Tax* that the actual length of the holding period is 'generally an unreliable indicator of whether the proceeds from its disposal will be capital or revenue nature' (SARS: 2015, 17). A longer holding period may be indicative of capital, however, the issues of intention and manner of realisation would be more important to consider. Although such guidance provided by SARS is not law, it does provide valuable insight into the manner such cases may be argued in a court of law.

In the *Natal Estates* case *supra* the taxpayer held the land for over 40 years before disposing thereof and the court ruled that the resultant proceeds were revenue in nature as the land was disposed of in a scheme of profit-making. The importance of assessing the facts of each case is emphasised. Nonetheless, a short holding period generally leads the courts to conclude that the taxpayer possessed a profit motive (West & West, 2011: 15).

As noted in the *Bloch* case *supra*, the actual holding period is far less important than the original intention to hold the asset on a long term basis. Indeed, the courts have ruled that realisation of an asset relatively soon after its acquisition does not necessarily render the nature of the proceeds revenue if the realisation was the result of a new intervening factor ('nova causa interveniens'). In *ITC 1185 supra*, the expansion of an industrial company into an industrial area, causing an increase in property prices, was ruled to be such a new intervening factor. As a result, properties purchased by the taxpayer the year before for letting purposes (capital intention) and disposed of to the industrial company at a significant profit soon after the commencement of the expansion were held to still be on capital account. As was noted in the judgment at 128:

The fact that a property is sold for a substantial profit very soon after it has been acquired is, in most cases, an important one in considering whether an inference adverse to the taxpayer should be drawn, but it loses a great deal of its importance when there has been a *nova causa interveniens*.

In the *Capstone* case *supra*, the taxpayer acquired shares for the purpose of effecting a business rescue operation. At the time of acquisition, it was envisaged that the turnaround would take between three and five years to complete (if successful at all) and the intention at acquisition was of a long-term, capital nature.

The shares were sold only five months after acquisition and SARS attempted to tax the proceeds on revenue account. The court focused on the all surrounding facts of the case rather than the short holding period and noted that there had been various intervening factors which explained the short holding period; specifically, by the date of disposal, the world economy had improved significantly and was now booming and the turnaround had been enormously successful and took far shorter than initially anticipated. The real purpose of the scheme always remained a rescue operation and was not a profit-making scheme.

The courts have noted that a taxpayer is likely to be more successful in proving an intention to hold an asset on a long term basis if the taxpayer is able to show that he had the financial resources to meet the related investment holding costs. If the taxpayer claims insufficient funds as a reason for realisation of a purported capital asset, there would be doubts as to the cogency of the capital intention as such long term intention would be incapable of being carried out (PricewaterhouseCoopers, 2003: 1131). In such cases, the courts are more likely to rule that the asset was in fact acquired for the purpose of profitable resale (*Commissioner for Inland Revenue v Lydenburg Platinum Ltd* 1929 AD 137).

Advancing on the concept of holding period, the courts have ruled that realising a capital asset to best advantage may require 'the hand of time' (*John Bell supra* at 103). Therefore, where a taxpayer delays realisation in anticipation of an increase in asset prices, the delay alone does not render the resulting proceeds revenue in nature (West & West, 2011: 9).

4.3.2.4 No halfway house

The principle that an amount is either capital or revenue (must be one or the other) was laid down in *Pyott v Commissioner for Inland Revenue* 1945 13 SATC 121 (AD) at 126 where it was stated:

I do not understand how this £9,000 could be, to cite from counsel's Heads of Argument, 'non-capital', and yet 'not income'. This is a half-way house to which I have no knowledge.

However, where a single amount contains 'two or more separate elements, one or more of which would characterise it as capital', an apportionment between capital

and revenue has been permitted (*Tuck v Commissioner for Inland Revenue* 1988(3) SA 819 (A), 50 SATC 98).

4.3.2.5 Compensation receipts

The enquiry as to whether an amount received as compensation is capital or revenue in nature centres on the reason for the compensation. Should it be to 'fill a hole' in the taxpayer's profits or compensate for a loss of floating capital (trading stock), the receipt is revenue in nature (*Burmah Steamship Co Ltd v IRC* 1921 SC at 160). Conversely, if compensating for a loss in the taxpayer's income-earning structure, the amount is capital in nature.

4.3.2.6 Low yielding assets

Low yielding assets are more likely revenue in nature as there is more likely an intention to resell the asset in a scheme of profit-making. In *Yates Investments (Pty) Ltd v Commissioner for Inland Revenue* 1956(3) SA 124 (A), 20 SATC 368 the taxpayer purchased land containing a garage near the Johannesburg Stock Exchange and let the garage for a period of three years for a very low rental. At acquisition the taxpayer claimed that its intention was to erect an office building on the land, however, this was not done. The land was sold at a substantial profit and the court at 371 ruled that the proceeds were revenue in nature, noting that 'in view of the meagre returns from the stands...it is difficult to understand why no attempt was made by the company to erect a revenue-producing building, if such was in fact its intention'. Accordingly, it was ruled that the intention was always to resell the land at a profit.

Cases involving zero yield investments such as Kruger Rands predominantly focus on the intention of the taxpayer (West & West, 2011: 11). If held as a store of wealth, as supported by the surrounding facts, rather than for profitable resale, the proceeds are more likely to be capital in nature.

4.3.3 Factors specific to share sales

Where the enquiry as to the nature of proceeds relates to share sales, the courts have developed certain principles specific to share transactions.

4.3.3.1 'For keeps' test

It was held in *Barnato Holdings Ltd v Secretary for Inland Revenue* 1978(A) SA 440 (A), 40 SATC 75 at 91 that shares held as capital assets are:

acquired for better or for worse, or, relatively speaking, for 'keeps' (i.e. only to be disposed of if some unusual, unexpected, or special circumstance, warranting or inducing disposal, supervened), which is the usual badge of a fixed, capital investment.

However, recently the 'for keeps' test has been rejected by the courts as a factor indicating capital intention. In *Income Tax Case 1867 75 SATC 273 (WC)*, the court noted that the concept of holding shares 'for keeps' and only disposing thereof under special circumstances comes from 'an old, static economic order that no longer exists'. Given the modern equity market and rapid technological advances in the modern age, it cannot be expected that companies invested in will be 'successful for overly lengthy periods'. As a result, holding shares 'for keeps' does not necessarily make good sense. Therefore, an investor cannot reasonably be expected to hold a share 'for keeps' and not doing so should not taint the resultant proceeds as revenue in nature.

4.3.3.2 Transaction-by-transaction approach

As noted by West & West (2011: 25), the courts tend to analyse share-dealing cases at a transactional level rather than on a portfolio basis. Accordingly, whether the share transactions occurred 'in the management of a portfolio or in respect of single holdings' does not appear to have influenced the court's decision (West & West, 2011: 14).

However, as held in *Commissioner for Inland Revenue v Middelman* 1991(1) SA 200 (C), 52 SATC 323, occasional profitable share sales does not of itself deem the seller a dealer in shares.

Conversely, and not specific to share-dealing cases, the courts have recognised that while isolated disposals do not generally constitute the carrying on of a trade as there is usually an element of continuity inherent in carrying on a business (*Stott supra*), a once-off venture can constitute a trade (*Stephan v Commissioner for Inland Revenue* 1919 32 SATC 54 (WLD)). As noted in *ITC 1849* (2010) 73 SATC 176 (P),

the taxpayer should be able to more successfully discharge the onus of proving that share sale proceeds are capital in nature in respect of isolated share sales if the taxpayer holds other shares as capital assets (de Koker & Williams, 2016: ss 3.4.7).

4.3.3.3 Purpose

As ruled in the *Middelman* case *supra* at 328, 'shares bought for the dominant, main and overriding purpose of securing the highest dividend income possible will be of a capital nature when the profit motive is incidental'. Of importance is that the profit motive must be merely incidental. In contrast, the courts have ruled that where the taxpayer has a main but secondary or subsidiary profit motive, the proceeds from such share sales are revenue in nature (*Commissioner for Inland Revenue v Nussbaum* 1996 58 SATC 283 (A)).

As noted in *African Life Investment Corporation (Pty) Ltd v Secretary for Inland Revenue* 1969(4) SA 259 (A), 31 SATC 163 at 175 the determination of whether such secondary purpose exists or is merely incidental to the dominant dividend yield motive 'is a matter of degree depending on the circumstances of the case'.

The court ruled against the taxpayer on this issue in *Commissioner for Inland Revenue v Tod* 1983(2) SA 364 (N) 45 SATC 1. In this case, the taxpayer acquired shares *cum dividend* (ripe with dividends) with the clear purpose of enhancing his portfolio's dividend yield. The subsequent sale of these shares was held to be on revenue account as the facts of the case indicated that the taxpayer had a secondary purpose to profit from the sale of the shares.

4.3.3.4 Scope and frequency

The *Nussbaum* case *supra* involved an individual that inherited a share portfolio and built it up over many years with the express motive of earning a strong dividend yield rather than holding the shares for the purpose of profitable resale. He also desired to protect the invested capital from erosion by inflation. The taxpayer maintained that any share sales were motivated by the search for better dividend yield rather than the resulting profits. After some time the attention of SARS was raised and the taxpayer was assessed on revenue account in respect of his share sales. The court had to determine whether the taxpayer had a secondary profit-making purpose or

whether such profit motive was merely incidental to the dominant motive of enhancing his dividend yield.

Analysing the facts of the case, the court found that the share sales were conducted on a large scale and very frequently and there were instances where previously disposed of shares were re-acquired shortly after disposal. A substantial number of shares had been held for a period of less than five years. The share sales were almost always profitable. The taxpayer admitted that he kept a 'constant watch on the portfolio'. As noted in the *African Life Investment Corporation (Pty) Ltd* case *supra* at 174 'assets which are continually being watched with a view to fixing the most favourable moment for sale, are assets held for trading and can be equated to stock-in-trade'. These factors led the court in the *Nussbaum* case *supra* to rule that the taxpayer was 'farming' the investment portfolio and that the taxpayer had failed to discharge the onus of proving that the profits in question were capital in nature. The court noted that while the scope and frequency of share transactions is not a conclusive factor, they are important to consider.

4.3.4 Jurisprudence pertaining to short positions

As noted by West & West (2011: 23), there is no South African jurisprudence specifically relating to the taxation of gains arising from short positions.

Income Tax Case 1756 1997 65 SATC 375 (C) involved a trust that held a portfolio of 'blue chip' shares. After the world stock market crash of late 1987, and given the trustees' intention to build up a long-term share portfolio over time, it was decided to acquire 'All Share Futures' contracts¹¹ to protect against possible rises in the price of the type of shares the trust wished to invest in. As these shares were not readily available to invest in at the time in the desired quantities, and given the belief that share prices would rise after the market crash, the trust sought to use the futures contracts to effectively 'lock in' lower acquisition prices going forward than it would be expected to pay in the market (i.e. hedge against a market upturn).

These futures contracts were disposed of after a period of one year which resulted in a gain of R537 085. One of the issues in question in this case was whether such a

¹¹ Refer to section 2.4 on page 11 for a brief description of single stock futures. All Share Futures are similarly tradable listed derivative instruments with underlying exposure to the broader JSE All Share Index, rather than a specific stock.

gain was capital or revenue in nature. Unfortunately, due to the novelty of the issue before the court and the need to ‘consider the precise nature and operation of the ‘futures market’’, the court held at 377 that it:

had not been adequately placed in a position to decide whether or not the gains on the sale of the All Shares Futures contracts had resulted from a scheme of profit making and had the court been required to answer the question on its merits the court would have had no option but to find that appellant had failed to discharge the *onus* which rests upon it

Consequently, the gain was held to be revenue in nature. It is important to note that this case did not deal with gains that would arise from the use of short positions (hedge against downside risk) and the judgment did not rule that gains arising from hedging strategies are necessarily revenue in nature. Rather, the court noted that the taxpayer had failed to discharge the onus of proving that the gain was capital in nature (West & West, 2011: 18).

4.4 Conclusion

Of vital importance to the operation of section 25BA of the ITA, which prescribes the tax treatment of amounts received by regulated hedge funds, is the distinction between amounts of a capital nature and amounts of a revenue nature. As the ITA contains no provisions specifying whether gains arising from the disposal of assets are capital or revenue in nature (apart from shares held for at least three years), the South African common law must be consulted in such instances.

Given that this chapter set out the South African share-dealing jurisprudence, the following chapter will attempt to apply this jurisprudence to the hedge fund fundamental paired trade short position context in an attempt to answer the research question of this dissertation.

5. Application of the jurisprudence to fundamental paired trades

5.1 Introduction

The previous chapter set out the common law principles relevant to the capital/revenue debate in the context of South African share-dealing cases. This chapter now applies the jurisprudence to the hedge fund fundamental paired trade context to address the research question of this dissertation. This is achieved by applying the jurisprudence to four distinct fundamental paired trades, each specifically chosen to illustrate the application of the law to common differential facts in the context of short positions. The four trades are based on actual investment views that were taken and acted upon; however, certain facts have been altered and certain assumptions made in an attempt to provide an opportunity to demonstrate the principles.

It should be emphasised that the objective of the dissertation is to analyse the nature of the realised gain/loss arising from the *short* position. The realised gain/loss on the corresponding long position may be relevant in applying the law to the facts of the case in question, however, no conclusion as to the nature of the long position gain/loss is sought or derived.

5.2 Rationale for focus at a trade level

As noted previously¹², share-dealing cases are generally analysed at a transactional level rather than at a portfolio level. As a result, the approach of this chapter is to focus on specific paired trades and to apply the law to the facts of those trades (in line with the approach our courts would likely take given the existing jurisprudence)

That said, holistic or portfolio considerations may be relevant to the analysis of the specific trades in question. For example, in isolation a certain trade may bear the imprint of capital; however, when analysed in the context of the overall investment portfolio a revenue intention may be indicated due to an overall high degree of trading activity in the portfolio (*Nussbaum supra*). Importantly, the specific facts of the trade as well as the surrounding circumstances ought to be analysed.

¹² Refer to section 4.3.3.2 on page 34 for further context.

Indeed, there may be an argument that the hedge fund short position tax treatment debate should be approached from a holistic perspective. Given the overarching objective of a hedge fund to provide capital protection to investors during market downturns¹³, it could be argued that the tax treatment should mirror this capital preservation objective and that the underlying portfolio's realised gains and losses should be classified as capital in nature for tax purposes, regardless of manner of trade execution¹⁴.

Despite the assertion above that hedge funds primarily aim to avoid loss of investor capital, the characteristics of a hedge fund (and short sales in particular), as discussed in chapter two, *prima facie* present the taxpayer with an onerous task of discharging the onus of proof that realised gains from short positions are capital in nature. Given the unique risks involved in hedge fund management, a highly skilled investment manager is required (Nelken, 2006: 97). As noted in the *Capstone* case *supra* at 31, 'the nature of the business activities of the taxpayer must be scrutinised' in analysing the nature of the proceeds. A hedge fund manager regularly engaging in short sales and keeping a 'constant watch on the portfolio' (*Nussbaum supra*) is approaching its task in a business-like manner and will find it more difficult to discharge the onus of proof compared to an investor that rarely gains exposure to short positions. Hedge fund gains by nature are unlikely to be fortuitous as they are worked for through diligent investment management (*Pick 'n Pay Employee Share Purchase Trust case supra*), rendering the gains less likely to be capital in nature.

Further hedge fund characteristics (such as the potentially high degree of trading activity in a hedge fund, the brief temporality of short positions particularly in comparison to the average long position, and the zero income yield nature of short positions) increase the burden of proving that realised gains from short sales are capital in nature.

5.3 Applicability of findings to realised gains and losses

The findings of this dissertation are equally applicable to realised gains and realised losses from fundamental paired trade short positions given the manner in which the realised gain/loss is calculated from a tax perspective.

¹³ Refer to section 2.2 on page 6 for further context.

¹⁴ This argument is flagged as an area for future research in chapter 6.

For simplicity's sake this dissertation has consistently referred to realised gains and losses i.e. the resulting profit or loss from the short sale in question. This gain/loss is computed as the proceeds from the sale of the borrowed asset less the cost of acquiring the asset sold short to return to the lender.

In a short sale, the sale of the borrowed asset occurs before the close-out acquisition¹⁵. Therefore, when performing a hypothetical tax computation for a hedge fund, the first point of reference in the ITA is the opening paragraph of the gross income definition, contained in section 1 of the ITA. 'Gross income' excludes amounts of a capital nature (unless specifically included in a specific paragraph to the definition). Therefore, if the facts of the trade indicate that the resulting proceeds are revenue in nature, the proceeds would be fully included in gross income.

The taxable income calculation later calls for the deduction of allowable expenditure. As the proceeds in this instance have been ruled to be revenue in nature, the hedge fund would have been engaged in a scheme of profit-making in executing the short sale in question. Therefore, the hedge fund would have carried on a trade and would be able to deduct the cost of acquiring the borrowed asset in terms of the general deduction formula. Note that no reference has been made to the respective quanta of the proceeds and cost of acquisition in the short sale. If the short sale was successful from the perspective of the hedge fund, the proceeds would exceed the cost and a realised gain would result. Conversely, the cost of acquisition could exceed the proceeds, realising a loss from the trade. There is no provision in the ITA that would prevent this loss from being utilised to reduce taxable income.

Similarly, if the short sale proceeds are capital in nature (and therefore the proceeds not included in gross income and the cost of acquisition not deductible in terms of the general deduction formula), the manner of calculation of the resulting capital gain/loss in terms of the Eighth Schedule of the ITA, namely proceeds less base cost, would not discriminate based on whether the result is a gain or loss. In the

¹⁵ For a short sale taxed on revenue account there is the possibility of a timing mismatch for tax purposes as the proceeds from the short sale may arise in the tax year in question, however, the related acquisition of the borrowed stock on close-out may only occur in the following tax year. SARS notes in Binding Private Ruling 060 that on the date that the stock is borrowed, an 'unconditional obligation' to return the stock exists and therefore, in line with the relevant common law, this obligation (valued at market value) would be allowed as a deduction in terms of the general deduction formula in the same year as the proceeds were received, subject to adjustment when the cost of acquisition is actually quantified.

context of a regulated hedge fund collective investment scheme whether the result is a capital gain or capital loss is irrelevant due to the operation of paragraph 61 of the Eighth Schedule of the ITA which disregards such capital gains/losses at fund level.

The key question is therefore whether the proceeds from the short sale are capital or revenue in nature, not whether the net result of the short sale is a gain or loss, as the findings apply equally to the gain and loss scenarios.

For clarity purposes, the realised gain or loss referred to in this dissertation is gross of any related security borrowing fees.

5.4 Analysis of fundamental paired trade examples

5.4.1 Trade A: Long Barloworld Limited, short Imperial Holdings Limited

5.4.1.1 Facts of the trade

This fundamental paired trade centres on perceived relative mispricing between two similar businesses in the South African diversified industrial sector - Barloworld Limited (BAW) and Imperial Holdings Limited (IPL). Given the similarity of the businesses and the high degree of correlation that movements in their share prices have historically exhibited, on an occasion when the relative price spread between the two widened, a paired trade was implemented. The key driver of the mispricing in this case was a strong local currency, with the market overestimating how long the rand strength would continue.

BAW and IPL both have interests in motor retailing, car rental and logistics. However, the businesses had one key area of differentiation: IPL owned a business unit that imported Korean motor vehicles for sale in South Africa; BAW owned a business unit that sold equipment and related services to the mining industry in US dollars. At a point in time when the South African rand was strong, IPL was able to import the Korean vehicles relatively inexpensively and had currency hedges in place to protect their import cost advantage for up to nine months. Conversely, BAW's rand revenue is negatively impacted by a strong rand as its mining equipment business unit earned in US dollars. The market placed a premium on IPL and BAW underperformed relatively. Taking the view that the rand would weaken and the price of the stocks would converge as a result, a long position on BAW and a lesser short

position on IPL were taken (IPL short exposure 50% lower than BAW long exposure). Individually, these exposures were relatively large positions in the context of the investment portfolio. The short sale proceeds were re-invested in line with the portfolio's asset allocation at the time.

The overall investment portfolio was bearish towards South African industrials during the trade due to concerns over an overvalued rand, rising interest rates, weak economic growth and high levels of unemployment, and it was underweight South African industrials compared to the market and the portfolio's historical sector allocation. The portfolio exhibited a higher than average gross equity exposure during the life of the trade¹⁶, with a large degree of short positions on South African industrial stocks and a higher than average long local equity asset allocation.

Over a period of a year, BAW strengthened and IPL weakened, yielding gains on both the long and short legs. The short position was voluntarily closed out by the hedge fund manager. The hedge fund remained invested in BAW subsequent to the close out of the IPL short position.

This trade has been selected for analysis as it provides the opportunity to apply the law to a vanilla (simple) fundamental paired trade focused on two similar businesses that have an identified reason for the relative mispricing. The investment portfolio positioning at the time of the trade also presents an interesting opportunity for analysis. The fact that the trade was effective and yielded gains on both the long and the short position is further reason for its selection.

5.4.1.2 Application of jurisprudence to the trade

Our courts have consistently stressed the importance of the intention test in assessing the nature of proceeds arising from asset disposals¹⁷. In tax law cases, this has been ruled to mean 'the purpose for which the transaction was entered into' (*The Trust Bank of Africa Ltd supra*). It is therefore important to ascertain the purpose of this particular trade. This must be assessed from the perspective of the hedge fund manager, rather than the underlying hedge fund investor. The hedge

¹⁶ Refer to section 2.6 on page 14 for an explanation of the concept of gross equity exposure.

¹⁷ Refer to section 4.3.1 on page 25 for further context.

fund, through the activities of the appointed hedge fund manager, is in control of its investing activities, not the investor. *Richmond Estates supra* at 361 noted that:

A company is an artificial person 'with no body to kick and no soul to damn' and the only way of ascertaining its intention is to find out what its directors acting as such intended.

This reasoning similarly applies in the context of a hedge fund.

An analysis of this trade reveals two clear purposes for the trade at its inception. In such cases, the dominant purpose needs to be determined, based on the particular facts of the case (*The Trust Bank of Africa Ltd supra* at 102).

The first objective of the trade is a profit-seeking objective predicated on the view that the observed price disparity between IPL and BAW will narrow going forward as the rand weakens. Should this occur, profits would result on both the IPL short leg and the BAW long leg.

The second objective is a hedge against a downward trend in the South African industrial cycle, which would manifest itself in declining share prices of South African industrial stocks. Should this occur, it would be expected that the share price of both IPL and BAW would decrease; however, the presence of the short position on IPL would serve to offset the loss on the BAW long position, thereby preserving invested capital during the market downturn.

Should the first objective be dominant, the proceeds would be revenue in nature as the hedge fund would primarily have had the intention of closing out the trade in a scheme of profit-making in an operation of business (*Capstone supra*).

Should the second objective be dominant, and the profit motive merely incidental (*Middelman supra*), the proceeds would more likely be capital in nature. The real purpose of the trade in such an instance would be capital preservation, rather than profit-making.

The facts of this trade do suggest a genuine concern regarding the possibility of a downturn in South African industrials. The overall investment portfolio was structured with this risk in mind. The portfolio's weighting to South African industrial stocks was lower than what it typically had been historically. Furthermore, this weighting was

lower than the market index's weighting to industrials. The fact that the short sale proceeds were re-invested in line with the portfolio's existing asset allocation affirms this reasoning. If the portfolio was overweight South African industrial stocks or the short sale proceeds were used to gain increased long exposure to such stocks, there could be doubts as to the cogency of a capital preservation purpose in this specific trade given the seemingly contradictory over-exposure of the overall portfolio to South African industrials.

The high degree of short positions on South African industrials could similarly be congruent with an intention of protecting against a downturn in the South African industrial cycle. This could lead to the conclusion that the IPL short was also for the purpose of capital preservation. *ITC1846 supra* found that a sale of shares is more likely capital in nature if the taxpayer holds other shares as capital assets.

The portfolio had a lower than usual long exposure to industrial stocks which could in fact be seen to mitigate the need to protect against the risk of an industrial cycle downturn (as the portfolio was already under-exposed to the risk). Had the fund held a large long exposure to industrial stocks, the presence of the large short exposure would be more congruent with a capital preservation intention. In this case, the industrial exposure was lower than average, making the presence of the large short exposure potentially more congruent with a profit-making intent. It could be argued that the portfolio's higher than average long exposure to general local equity, was to be hedged by the short exposure in the portfolio. The presence of low industrial equity exposure and doubts as to the strength of the correlation between general domestic equity and the industrial cycle would weaken this argument. It becomes more difficult to argue that the purpose of a short position is to preserve capital, as opposed to seek profit, if the exposure the short position purports to hedge is not present or is insignificant (i.e. that the offsetting and matching long position is not held).

It could be argued that despite relatively low long exposure to South African industrial stocks, the fund held a large BAW long position on which it was very bullish, but nevertheless that it was considered prudent to hedge this specific concentrated exposure. This argument would gain weight if the fund was a long-term holder of BAW, evidenced by an analysis of its holdings both pre- and post the IPL

short trade. In this case the fund continued to hold the BAW long position after the short position close out.

However, it must be noted that there are two possible responses to an anticipated decline of this nature: seek short exposure to protect one's existing exposure to the risk or seek short exposure to profit from the decline. A closer examination of the portfolio's exposure absent the short exposure needs to be performed to determine whether the main purpose of this relatively large portfolio short exposure was to preserve the portfolio's capital or to profit from the anticipated decline in the industrial sector. The fact that the portfolio held a large long position in BAW (a diversified industrial business that the hedge fund manager felt was undervalued by the market and had good prospects) indicates that a significant long position existed that stood to be protected by the IPL short from a general downturn in the South African industrial cycle. The BAW position was double the size of the IPL short position, which adds weight to this view.

The fact that the trade realised gains on both the long and short leg and was voluntarily closed out by the hedge fund after a year would likely make the discharge of the onus of proving that the proceeds are capital in nature more onerous. The trade was profitable on both legs and could be seen as being actively worked for given the final result, especially given that it was voluntarily closed out rather than the result of a recall of the borrowed stock by the lender.

The brief temporality of the trade could further point to a profit-seeking intention. The *Capstone* case *supra* at 32 noted that 'the period for which the asset is held and the period for which it was anticipated it would be held at the time of acquisition will be relevant'. In isolation holding period may not be as important as the test of intention¹⁸, however, it is relevant in so far as it could shed light on the intention of the trade. In this trade, given the large size of the BAW and IPL holdings and the positioning of the portfolio against the risk of a downturn in the industrial cycle, it could be argued that the trade was executed with a high degree of conviction. In other words, that the rand would soon weaken and/or that the industrial cycle would soon experience a downturn. Therefore, the trade could play out imminently and over a brief period of time. This would make it more likely that the proceeds are

¹⁸ Refer to section 4.3.2.3 on page 31 for further context.

revenue in nature. The seemingly brief one year actual holding period could support this. However, it should be noted that in general short positions are not held for prolonged periods of time due to the inherent risks involved¹⁹. The brief temporality of short positions is an innate characteristic of short positions.

If it were found that the trade was executed for the purpose of capital preservation, it could be difficult to discharge the onus of proof that a secondary, profit-seeking motive did not exist simultaneously. As noted in the *African Life Investment Corporation (Pty) Ltd* case *supra* at 178:

There was more than a mere hope or expectation that the shares might rise in value. This is not, therefore, a case of 'fortuitous and unforeseen enhancement' in the values of its investments (cf. *Overseas Trust Corporation, Ltd. v Commissioner for Inland Revenue*, *supra*, at 453). Profits were anticipated and fully expected and, in making them, the appellant had in mind a definite purpose, distinguishable from, although not unconnected with, the purpose directed at dividends. In pursuit of what might be described as a composite purpose, it used its powers of realization to secure better dividends and also to make profits on sales. In my opinion we do not here have a dominant purpose into which the regular dealing in shares is absorbed as a merely incidental activity.

It seems implausible on the facts that there was nothing more than a mere hope of realising profits from the trade. The trade involved the careful identification of two highly correlated stocks that exhibited a price disparity due to differing market perceptions around ongoing rand strength. Steps were taken to position the portfolio to benefit from an expected normalisation in relative pricing. Although the capital preservation purpose may be dominant, an element of profit-seeking does exist. As noted in *Capstone supra* at 26:

the mere intention to profit is not conclusive. There must be 'an operation of business in carrying out a scheme for profit-making' for a receipt to be income.

Given the context of a hedge fund utilising investment analytical skills on an ongoing basis and the element of profit-seeking inherent in the trade, it seems difficult to argue that 'an operation of business in carrying out a scheme for profit-making' did not exist.

¹⁹ Refer to section 2.3 on page 8 and section 2.5 on page 11 for further context.

In the final analysis, the short leg of a paired trade of this nature appears more likely than not to be classified as revenue.

5.4.2 Trade B: Long Mondi plc, short Mondi Limited

5.4.2.1 Facts of the trade

This fundamental paired trade centres on an identified arbitrage opportunity arising due to significant mispricing between dual-listed shares of the same business.

Anglo American plc (Anglo), in a bid to focus on its core mining portfolio, distributed its shareholding in Mondi, a paper and pulp producer, via an unbundling transaction during July 2007. At the time, Anglo had a large offshore shareholder base and to alleviate exchange control and foreign asset allowance issues for Anglo's foreign shareholders, Mondi was dual-listed: Mondi Limited (MND) was listed on the Johannesburg Stock Exchange (JSE) and Mondi plc (MNP) gained a primary listing on the London Stock Exchange and a secondary listing on the JSE. Despite the separate corporate entities, shareholders in both MND and MNP are exposed to the same underlying business.

At the time of the unbundling, the South African Reserve Bank (SARB) declared that South African investors wishing to hold MNP would be required to utilise their offshore investment allowance²⁰ as such shares were to be classified as foreign assets in their hands. This onerous regulatory ruling led to a sustained period of selling pressure on MNP by large institutional holders of the share and a strong propensity to hold the economically equivalent MND as MND remained classified as a domestic asset. This led to a significant relative mispricing between MNP and MND, despite the exposure of both shares to the same business. Taking the view that this disparity would not persist, a long position on the under-valued MNP and an equivalent short position on MND was taken. Individually, these exposures were relatively large positions in the context of the investment portfolio. The short sale proceeds were re-invested in line with the portfolio's asset allocation at the time. The

²⁰ Regulation 28 to the Pension Funds Act (No 24 of 1956), which stipulates the extent to which retirement funds may invest in particular asset classes, limited offshore investments by retirement funds to 15% of the aggregate fund value at the time of this trade.

Individual South African investors are required to obtain approval from the SARB to invest amounts offshore in excess of regulatory limits (currently investments exceeding R11 million per calendar year).

portfolio exhibited an average gross equity exposure and a high level of portfolio turnover (trading activity) at the time.

The trade was in place over the subsequent two years and initially yielded a combined unrealised loss as the price spread widened. On 22 July 2009, the SARB declared that MNP has been classified as a domestic asset and therefore South African investors no longer needed to use their offshore investment allowance when acquiring MNP (SENS, 2009). With this announcement, the price disparity between MND and MNP closed within a single trading day, and the short position was voluntarily closed out at the same time. The entire MNP long position was disposed of soon after. Overall, the paired trade yielded a gain on both the long and the short leg.

This trade has been selected for analysis due to its unique price disparity issue and *prima facie* speculative intention.

5.4.2.2 Application of jurisprudence to the trade

The dominant purpose of this trade must be determined, based on an objective review of the surrounding facts and circumstances. In the context of hedge fund short positions, which do not yield an income stream, the real purpose of the short position gains even greater importance. As noted in section 4.3.2.6 above, cases involving zero yield investments predominantly focus on the purpose of the transaction. In the short position context, if held for the purpose of capital preservation, the proceeds are more likely capital in nature. If held for the purpose of profitable close out, the proceeds are more likely revenue in nature.

Two distinct purposes emerge from this trade. Firstly, there is a speculative intention of profiting as the abnormal stark price disparity between MNP and MND normalises. Secondly, the MND short provides protection for the MNP long exposure should the stock market experience a general decline or should the Mondi business underperform, leading to a decrease in the share price of both MND and MNP. The test of which purpose is dominant is a 'matter of degree' (*The Trust Bank of Africa Ltd supra*).

It appears unlikely that the dominant purpose is to hedge against poor performance of the Mondi business (which would manifest itself in a decline in the share price of

MND and MNP, however, the gain realised on the MND short position would offset the loss on the MNP long position to a certain extent). The intention to profit appears to be more likely. Large positions on MNP and MND were held, which does not accord with a view that there is a significant risk in the Mondi business. It would be simpler and, perhaps, more effective, rather not to take on this specific paired trade at all if the business risks of Mondi were seen as significant.

Although ultimately profitable, the fact that the trade marked to market at a loss during the two year holding period is further evidence that it was not executed to hedge against Mondi business risk but it was rather held to profit from the eventual regulation amendment. If the primary concern was Mondi business risk, it is less likely that the trade would have been held for the two year period as it was generating losses in the interim. It appears that the interim unrealised losses were accepted as a necessary cost of the trade in order to eventually profit from it.

Similarly, the assertion that the MND short primarily served to protect the MNP long exposure from a general decline in the stock market seems unlikely. In such an instance the risk is of a general stock market decline, rather than a more specific macroeconomic risk (e.g. the South African industrial cycle in trade A above, the rand gold price in trade C below, the rand oil price in trade D below). The fact that the purported hedge is to a more general risk suggests that it was not the dominant purpose of the trade, and was rather a remote objective.

The facts of the trade point to a dominant speculative intention. In the *Wyner* case *supra*, the taxpayer knowingly structured her affairs to profit from a discrepancy between the municipal valuation of her property and the true market value thereof. Similarly in this trade the hedge fund has specifically positioned itself to profit from the arbitrage opportunity arising from the valuation discrepancy between dual-listed stocks of the same business. The profits that arose were not fortuitous, but were rather designedly sought and worked for.

The fact that the positions were large relative to the aggregate portfolio adds weight to this argument. This was not a mere hopeful investment view that carried a minor weight in the portfolio. The large weight indicates a higher degree of conviction in the trade. As noted in the *Capstone* case *supra* at 32:

When dealing with an investment, the nature of the risk undertaken has a bearing on whether the exercise is one directed at building up the value of the taxpayer's capital or directed at generating revenue and profit.

The large weight of this trade in the portfolio exposed the hedge fund to greater risk (not less) if the regulation was not amended to correct for the pricing anomaly, pointing to a revenue intention.

The high degree of trading activity in the portfolio supports the view that the trade was executed in the course of a scheme of profit-making. The *Nussbaum* case *supra* noted that a large scope and high frequency of surrounding transactions increases the likelihood that the trade in question was executed with a revenue intention.

The positions were held for a period of two years. This may seem to be a relatively long period of time, especially given the brief temporality usually associated with a short position. However, the real reason for the two year holding period is that the regulation only changed after two years. Had it changed sooner, the trade would have been closed out sooner. The intention to profit when the regulation was amended always remained the dominant purpose of the trade. In the *Yates* case *supra* the taxpayer let out a property for a meagre rental for a three year period before it was sold for a profit. The court held that the taxpayer's intention regarding the property was and always had been revenue in nature, despite the three year holding period and the fact that it was let out at a low rental made it clear that it never seriously considered the property to be capital in nature, but was rather always held with a view towards profitable resale.

The change in the regulation in this paired trade was not a *nova causa interveniens* (as was evident in *ITC1185 supra* and *Capstone supra*) that explains the reason for a profitable realisation of the MND short position while still classifying the resulting proceeds as capital. The change in regulation was always anticipated and part of the strategy of the trade - it merely took two years to occur.

The fact that the short position was entirely closed out voluntarily on the same day that the price disparity normalised, and that the long position was entirely disposed of soon after suggests that the dominant purpose throughout was to profit from the

price convergence. Once the convergence occurred, there was no further purpose for the trade and it was consequently closed out.

In the final analysis, the short leg of a paired trade of this nature appears more likely than not to be classified as revenue.

5.4.3 Trade C: Long AngloGold Ashanti Limited, short gold metal

5.4.3.1 Facts of the trade

This fundamental paired trade was implemented at a time when the price of gold metal was high and, seemingly contradictorily, gold miner shares were undervalued.

Gold miners were struggling with significant wage inflation and increased unit costs as mining activity was increasingly occurring at deeper levels. This negative news had led to a decline in the share price of gold miners. The price of gold metal was high due to low global interest rates, making gold, a zero yield asset, a popular store of wealth in the absence of sufficient high-yielding investment alternatives. The low global interest rate environment was not expected to be a short-term trend given the fears of a global recession. Intuitively, a high gold price is beneficial for gold miners as it would lead to increased revenue. However, gold miner shares remained at depressed levels.

Given this background, a long position on AngloGold Ashanti Limited (ANG) shares was taken with a short position on a gold exchange traded fund (ETF). ANG was selected as it was viewed as the most attractive South African gold miner. The investment portfolio had no other exposure to gold miners. The gold ETF is a traded debenture instrument that provides investors with direct exposure to the rand gold price without having to physically hold gold. The short exposure amounted to 75% of the long exposure. ANG sells gold in US dollars and is therefore exposed to rand/dollar currency fluctuations in addition to movements in the gold price. As the gold ETF in question is priced in rand, a lower short exposure was taken to adjust for the effects of currency fluctuation on ANG. The exposures individually represented moderate sized positions in the context of the aggregate investment portfolio. The short sale proceeds remained invested in cash during the trade.

The hedge fund manager recognised the disparity between the gold price and gold mining shares which ought to normalise over time and yield overall profits given the structure of the paired trade. However, of particular concern was the negative impact that a sudden large decline in the gold price could have on the price of gold miners' shares. While the then high gold price had not apparently been properly factored into the price of ANG shares, a decline in the gold price was expected to have a significant negative impact on the ANG shares as, *ceteris paribus*, it would lead to a decline in ANG revenue and therefore profits.

Over the following months the rand gold price continued to increase due to rand weakness and gold metal strength. Contemporaneously, ANG shares remained flat. The positions were then voluntarily closed out, yielding a realised loss on the short leg.

This trade has been selected as it presents an opportunity to analyse a position that carries an emphasis on protecting the portfolio's gold exposure (gold hedge against inflation in a low interest rate environment via ANG shares) while a price convergence objective was simultaneously evident (i.e. potentially strong dual purposes to the trade).

5.4.3.2 Application of jurisprudence to the trade

In line with the applicable case law, the dominant purpose of the trade must be determined i.e. gold hedge (more likely capital in nature) or profit from the price convergence (revenue intention). *ITC1283 supra*²¹ involved a differentiation between a revenue intention and capital intention by focusing on the real purpose of the transaction. The real purpose in that case was to salvage the taxpayer's wealth and the resulting proceeds were ruled to be capital in nature.

The hedge fund manager had a cogent reason for holding a long position in ANG, due to the perceived undervaluation of gold mining shares by the market. This long position may have been held on capital or revenue account (this dissertation focuses on the nature of the short sale proceeds), but what is clear is that a long position existed which stood to be hedged. Apart from an outright disposal of a long position

²¹ Refer to section 4.3.2.2 on page 29 for a brief discussion of the facts of this case.

(so as not to fall foul of the ‘for keeps’²² test laid down in the *Barnato Holdings* case *supra*), a taxpayer wishing to hold a long position but also hedge against the real risk of capital loss has no alternative but to take a related short position (West & West, 2011: 23). It must be noted however, that the recent *ITC1867* case *supra* played down the importance of the ‘for keeps’ test in the modern equity market.

It appears from the facts of the case that there was greater conviction in the undervalued gold miners appreciating over time, as opposed to the high gold price falling, as evidenced by the view that global interest rates would remain low for the medium term (and therefore gold should remain popular). Given the expected strong relationship between ANG shares and the gold price, the disparity does present the potential to profit from this particular paired trade. However, the facts of the trade appear to suggest that investing in ANG was at the forefront of the hedge fund manager’s mind (it was the only gold miner in which there was any investment) and as a secondary thought it was considered how this exposure could be protected in case of a decline in the gold price (hence the gold ETF short position).

This may appear to be a slight distinction but it is important. Trade A above was predicated on both the stock held long appreciating in value and the stock held short declining on a relative basis to normalise at a point close to the long-term relationship between IPL and BAW. In contrast, this trade was focused on gaining long exposure to ANG which was then hedged against a possible decline in the gold price. Although this is a fundamental paired trade that was expected to yield overall profits as the current anomalous relationship between ANG and gold metal normalised, it appears that the more significant objective of the short position was to hedge the ANG position and the key driver behind any profits from the paired trade would predominantly arise from the appreciating long position.

ANG was the only gold miner in the portfolio and the size of the position was moderate in the context of the broader portfolio, indicating that while bullish on ANG, the fund was not overly bullish on gold miners. This implies that the need to provide a gold hedge was viewed as important. If the fund was overweight long gold positions, the cogency of the argument that the main purpose of the short gold ETF was capital preservation would be diminished. The fact that the short position

²² Refer to section 4.3.3.1 on page 34 for an explanation of the ‘for keeps’ test.

amounted to 75% of the long position so as to hedge the rand gold exposure in ANG as completely as possible indicates that there was clear thought and reasoning underpinning the gold hedge i.e. it was not merely an incidental purpose but was more likely an important consideration. The high probability of a significant negative impact on the ANG share price in the event of a decline in the gold price strengthens the indications for the gold hedge.

The fact that the share sale proceeds were invested in cash, rather than a higher risk asset class illustrates that the purpose of the short sale was more likely capital preservation.

The short position was held for a relatively short period of time, which could infer a profit motive. However, the brief holding period must be assessed in the context of the short position generating a loss. It is understandable that the hedge fund would want to close out a loss-making short position. Whether the short position realised a loss or a gain does not influence the real purpose of the trade (and therefore its tax classification); however, the loss does make the brief holding period more understandable. The fact that the ANG long position was simultaneously disposed of provides further evidence that the main objective of the short position was to provide a hedge. Without the short position (closed out as it was loss-making) the ANG exposure no longer had a hedge against a decline in the gold price (and hence was exposed to the risk of capital loss) and therefore the ANG exposure was simultaneously closed out.

If it were found that the trade was executed for the purpose of capital preservation, it remains a difficult task to refute the argument that a secondary, profit-seeking motive did not exist simultaneously, which would taint the proceeds as revenue in nature. However, the facts of this case strongly support the view that the dominant purpose of the short position was to protect the ANG exposure; hence, classification of the short position as capital seems indicated.

5.4.4 Trade D: Long Sasol Limited, short oil commodity

5.4.4.1 Facts of the trade

This fundamental paired trade centres on an investment view of the rand oil price and its relationship to the Sasol share price. Sasol, although not actually engaged in

the sale of oil, produces petroleum products that have a close correlation with oil. Therefore, as the oil price declines, so should the revenue of Sasol. There is a high degree of correlation between the rand price of oil and the Sasol share price.

At the time that this trade was executed, the rand oil price was low. The market price of Sasol shares was contemporaneously pricing in an even lower rand oil price going forward. The hedge fund manager was bullish on Sasol at the time due to a strong management team and value-adding capital projects on which the company was embarking. This bullish view, coupled with the low rand oil price and its reflection in the price of Sasol shares led to the implementation of a long position on Sasol shares and a short position on an oil exchange traded note (ETN). The oil ETN served to provide investors with direct exposure to the oil price without having to physically hold the commodity; stated differently, the value of the ETN is linked directly to the oil price. The short position exposure amounted to 75% of the Sasol long exposure given that Sasol also produces chemicals and is therefore not entirely an oil business. The oil ETN is generally difficult to borrow due to low liquidity.

The long and short exposures individually represented moderate sized positions in the context of the aggregate investment portfolio. The short sale proceeds were held in cash to serve as collateral for the borrowed ETN.

The oil price declined further after the positions were implemented; however, the decline in Sasol shares was not as great as the decline in the oil ETN, given that the market had already priced a lower oil price into the price of Sasol shares. As this unfolded, the lender of the oil ETN called on the loaned ETN, and the oil ETN short exposure was closed out by the hedge fund to return the ETN to the lender, six weeks after it had been borrowed. The hedge fund continued to hold the Sasol long position, and purchased further shares in Sasol at the relatively low share price. The trade therefore yielded a realised gain on the short position, and a lower unrealised loss (in absolute terms) on the Sasol shares over the same time period.

This trade has been selected for analysis due the brief holding period resulting from the lender's recall of the ETN. The presence of a hedge against a decrease in a commodity price, similar to trade C above, also presents an interesting opportunity for comparison between the two trades.

5.4.4.2 Application of jurisprudence to the trade

Similarly to the previous trades analysed, the dominant purpose of the trade must be determined i.e. oil hedge (more likely capital in nature) or profit from the price convergence (revenue intention).

In the *Bloch* case *supra*, Vos J sought to refine the principle that a capital asset is that intended to be held long term so as to derive an income return to:

capital is that which is held with an element of permanency and with the object that it should produce an economic utility for the holder.

The objective of protecting an investment from an identified risk factor through the use of a hedge would fall under Vos J's concept of 'economic utility for the holder'. The desire to protect invested capital is an important consideration and taking steps to serve such a primary purpose should be viewed as capital. West and West (2011: 26) note that the South African case law 'does not appear to have considered the risk-based motives for the sale of shares, particularly in the context of a diversified portfolio'.

The hedge fund had cogent reasons for holding Sasol shares. It needs to be determined whether the purpose of the oil short position was primarily to protect this long position or to profit from the expected convergence of the oil price and the Sasol share price. This trade can be distinguished from trade C. In trade C, similarly to this trade, there was an observation of a pricing disparity between a commodity and an equity that should bear a strong relationship to that commodity. However, in trade C there appears to have been a greater concern of the impact a decline in the gold metal price would have on ANG shares. In this trade, while the negative impact that a decline in the oil price would have on Sasol equity would have been considered, the Sasol share price already factored in a lower future oil price. Therefore, if the oil price declined, Sasol shares would likely also decline but not to the same extent. In contrast, the reason behind the depressed ANG share price in trade C was not an expectation of a lower future gold price, but rather escalating cost factors. There appeared more to lose in trade C (compared to this trade) from a decline in the related commodity price. The dominant purpose in trade C was therefore more likely capital preservation compared to this trade.

Of greater importance in this trade appears to have been the price convergence expectation (i.e. the expectation that the price of oil would increase to normal levels).

While the short sale proceeds were invested in cash during the trade, this was a requirement stipulated by the lender of the oil ETN. In contrast, the resulting proceeds in trade C were voluntarily and deliberately invested in cash, a low risk asset class, indicating that trade C bore a greater imprint of capital preservation.

The fact that an illiquid short position was implemented suggests that the dominant purpose was more likely profit-seeking. As noted in the *Capstone* case *supra* at 32, the 'nature of risk' undertaken is an indicator of whether the transaction was focused on capital accumulation or profit-seeking. It is riskier to borrow an illiquid instrument as it may be difficult to purchase the instrument to return to the lender on close out. However, it must be noted that the oil ETN was possibly the only appropriate position that could hedge Sasol's rand oil price exposure, necessitating the exposure to such illiquid instrument.

The fact that the short exposure amounted to 75% of the long position so as to provide for a one-for-one relationship between the rand oil exposure in Sasol and the related short position indicates that if the purpose was to hedge, it was effectively structured, thereby adding support to a potential capital preservation argument. The moderate size of the positions during the life of the paired trade also supports the notion that the purpose of the trade was less likely profit-seeking. However, these factors need to be considered in the broader context of the facts surrounding the trade.

The lender recall of the short position contrasts to trades A, B and C where the short position was voluntarily closed out. It may be argued that such an act was out of the control of the hedge fund and therefore the resulting gain should be considered fortuitous and of a capital nature. However, the hedge fund would have known that the instrument was highly illiquid and subject to greater risk of recall. The chance of a recall is present in any short sale. It cannot be viewed as a new intervening factor of such an unexpected nature that renders any resulting proceeds fortuitous.

The short position had to be closed out a mere six weeks after it was taken out due to the recall. This brief temporality in isolation points to greater likelihood of a profit

motive. However, the hedge fund's hand was forced and it had to exit the trade as soon as it did. A consideration as to whether the hedge fund would have continued to hold the short if it had not been recalled by the lender may be of interest. However, it would be difficult for the court to speculate as to what the hedge fund might have done but for the lender recall. Such a consideration would need to be supported by the facts of the trade.

The observed price disparity between Sasol shares and the oil ETN did narrow over the six week holding period, which would render the paired trade less attractive from a profit-seeking perspective and more likely that the trade would have been closed out in any event. The hedge fund continued to hold the Sasol shares post close out and added further long exposure to Sasol shares. This could indicate that the purpose of the short exposure was never primarily to hedge against a decline in the rand oil price. If this were the main purpose and the fund could no longer hold the short position, as in this case, it is more likely that the long Sasol exposure would have been reduced. The opposite happened, leading to a stronger inference of a profit motive.

5.5 Conclusion

The characteristics of a hedge fund and short sales in particular present the taxpayer with an onerous task of discharging the onus of proof that realised gains from short positions are capital in nature.

Of importance is the determination of the dominant purpose of the short position: investment capital preservation (with resulting proceeds more likely capital in nature) or profitable close out as part of a scheme of profit-making (revenue in nature). This is likely to be a challenging task in the context of an equity long/short hedge fund engaging in fundamental paired trades where short positions are held both to profit and for risk-mitigation in varying circumstances. An analysis of the facts and circumstances of the trade in question, together with a consideration of the broader investment portfolio and what it reveals as to the nature of the trade in question, is required.

The analysis in this chapter reveals various factors that should be considered in determining whether the short sale proceeds are capital or revenue in nature. These include the following:

- An analysis of the overall portfolio positioning may reveal whether the hedge objective is dominant or whether the profit motive is dominant. A portfolio over-exposed to the particular risk that the short position purports to protect against indicates that the short sale is not an effective hedge and is more likely rather aimed at profit-seeking. Similarly, a portfolio under-exposed to the risk also raises doubts as to the effectiveness of the hedge as insignificant exposure to actually hedge exists. In such an instance, it would seem more likely that the short position is directed at profit-seeking. The portfolio asset allocation would need to be analysed.
- An appropriate match between the long and short positions in a paired trade considering position sizes and nature so as to produce an effective hedge is more likely focused on capital preservation. The size of the positions relative to each other and whether adjustment has been made to tailor the short exposure to more accurately hedge the long exposure (e.g. the specific choice of short position nominal amounting to 75% of long position in trade C to adjust for the impact of exchange rates on ANG shares) would be important considerations.
- The more specific the risk the short position seeks to protect against, the more likely the purpose of the short position is to preserve invested capital. A more remote risk (e.g. general decline in stock market compared to a decline in a specific commodity's price) more likely infers a profit-seeking motive.
- Re-investment of the resulting short sales proceeds in a low risk asset class during the trade is an indicator that the short position is directed at capital preservation.
- A high level of trading activity in the hedge fund and a high level of short positions are indicators of a revenue intention. However, the level of short

positions must be considered in the context of the level of long positions and the nature of the risks the short positions purport to hedge against.

- A greater absolute size of the short and long positions relative to the size of the portfolio more likely infers a profit-seeking motive.
- Whether the portfolio held the long position before the short position and/or whether the long position remains held by the portfolio after the short sale close out may be an important factor to consider. If held post the short sale close out it could indicate that the short sale was not primarily focused on capital preservation as the fund continues to hold the long position despite the absence of the short position. This could, however, be explained if the risk was no longer viewed as significant. The facts of the trade in question would be important to assess.
- The manner of the short sale close out, specifically voluntarily or owing to a lender recall, is a factor to consider.
- The temporality of the short position should be considered, with a briefer holding period more likely inferring a profit-seeking intention. However, it should be noted that short positions are generally held for brief periods of time given their nature and related risks.
- The apparent conviction of the hedge fund manager in the instrument held short declining in value may be an important consideration, with a greater conviction more likely indicating a revenue intention. An instrument held short that carries an expectation of a greater decline than another instrument held short is more likely focused on profit-seeking.

6. Conclusion

This dissertation sought to determine what factors indicate that the realised gains and losses arising from the use of short positions in hedge fund fundamental paired trades are revenue in nature and what factors indicate that such gains and losses are capital in nature.

Hedge funds, which typically avail themselves of an array of alternative investment strategies such as short selling in addition to the traditional asset classes, were recently brought into the South African investment regulatory net. This was achieved by classifying regulated hedge funds as a separate category of collective investment scheme in terms of the Cisca. This categorisation brought regulated hedge funds into the ambit of section 25BA of the ITA which carries an important distinction between amounts of a capital nature and amounts of a revenue nature. Given that equity long/short hedge funds utilise short positions for both profit-seeking and risk-mitigation purposes, the resulting proceeds from short sales could be capital or revenue in nature from a tax perspective based on the surrounding facts of the trade.

The onus of discharging the proof that the proceeds resulting from a short sale are capital in nature is significant due to the characteristics of a hedge fund and the apparent focus of a short sale on profit-making due to the generally brief nature of short positions. The South African case law relevant to the capital/revenue debate is laid out in chapter four of this dissertation. The jurisprudence emphasises the importance of applying the various principles to the specific facts of the case.

Chapter five of this dissertation applies the law to four fundamental paired trade examples, a specific hedge fund trading strategy, in an attempt to identify factors that indicate capital or revenue tax treatment.

The importance of the dominant intention (read purpose) of the trade is highlighted, given the potentially competing purposes of profit-seeking and risk-mitigation present in a hedge fund.

Factors that should be analysed in such a scenario include the overall portfolio positioning, the size of the long and short positions relative to each other, the degree of specificity of the risk that the short position purports to hedge against, the manner of re-investment of the short sale proceeds, the level of trading activity in the hedge

fund, the level of short positions in the hedge fund, the absolute sizes of the long and short positions in the context of the overall portfolio, the exposure of the hedge fund to the long position after the close out of the short position, the manner of close out of the short position and the holding period of the short position.

While the analysis revealed factors that may be indicative of capital treatment, the classification of short sale proceeds as capital or revenue in nature remains a challenging task to undertake due to the potentially wide variety of facts and circumstances and the potential for undesirable consequences should an incorrect classification be made. Consequently, improved clarity through the provision of *de jure* guidance as to the nature of short sale proceeds would be welcome.

This dissertation applies the law to the facts of the trade, bearing the surrounding circumstances of the overall portfolio in mind. A further area of research could focus on addressing this issue from a more holistic perspective. By arguing that the overall objective of a hedge fund is to protect investment capital in falling markets, it could be argued that the tax treatment should mirror this objective and that the gains and losses should all be capital in nature, regardless of the individual facts of each underlying trade.

Another area for future research is the application of the research question to a different short position context rather than the fundamental paired trade context.

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