THE TAX TREATMENT

OF A

FINANCIAL INSTRUMENT

PURCHASED

BY A TRUST

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1996

Chapter 1

Introduction

Interest has always been considered as the charge for money borrowed and akin to rental in its treatment for tax purposes. As a result it has been considered to be a revenue expense which, provided has been actually incurred, in the production of income, for the purpose of the trade, is fully deductible.

The main area of concern has been the timing of the incurral or accrual of the interest which has opened a plethora of opportunities for tax practitioners in specialising in mismatching these fundamental aspects creating a time lag between the incurral and the accrual for the benefit of the taxpayer.

As a result of this Section 24J of the Income Tax Act has been introduced with the design to remove this apparent mismatching and confirm the view held in some judgements that interest does accrue *de die in diem.*

In this paper I propose to look at a further aspect which has been highlighted by the introduction of Section 24J, the nature of interest as a revenue expense and the taxability of the interest where S24J applies. This will be done by means of an example, in which a trust (discretionary or vesting) purchases Eskom Stock, at a discount, for the benefit of the beneficiaries. Two fundamental questions arise, can the discount received be classed as interest in terms of section 24J and if so will it be taxable, and secondly, if the answer to the first is yes, who should be taxed. First it is necessary to look back at the previous treatment of interest and the effect the introduction of S 24J has had on this.

Chapter 2

Historical treatment of interest

The timing of incurrals and accruals

Previously interest was taxed or allowed to be deducted according to when the amount accrued or was incurred. This aspect has been the discussion of much case law and for the purposes of this paper only a superficial review will be carried out.

The main area of investigation, and that which S24J has been introduced to clarify has been the timing of the accrual or incurral of interest. Perhaps one of the most controversial cases surrounding this concept is that of ITC 1485.[1] This case, which centred on the deductibility of interest in respect of Negotiable Certificates of Deposit (NCD), looked at the time of incurral in respect of the interest expense. The taxpayer, a bank sought to deduct the total interest up front, as shown on the NCD's, even though payment was deferred.

In finding against the bank, **Melamet J** held *"Interest is an expense to compensate a lender for the time period during which the money is lent to a second party. It cannot be incurred prior to the time during which the money is used. It is incurred and accrues day to day."*[2]

This judgement, which put forward a very controversial view for the treatment of interest has been upheld in form by the introduction of section 24J. However the judgement varies from the precedent held in earlier cases which follows the general principle of Section 11(a), that the interest is incurred immediately there is an unconditional liability to pay, irrespective of the date of actual payment.

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1 52 SATC 337

2 ITC 1485 52 SATC 337

In the case of ITC 1587[3] which looked at the deductibility of the discount in respect of a promissory note, **Van Dijkhorst J** in referring to the earlier judgement in ITC 1485 stated,

"The proposition that interest cannot be incurred prior to the time during which the money is used but is incurred and accrued from day to day is in my respectful view too widely stated. Nothing prevents parties to agree that interest on a loan for a fixed period will be payable in advance.... Nothing prevents parties to calculate the interest, which is compensation for money lent, not on a daily basis but on a weekly or monthly basis or just in a lump sum."[4]

It is clear therefore that the judgement in ITC 1485 was viewed as incorrect and that prior to the introduction of section 24J, interest accrues or is incurred, in terms of the general principles, that is when an unconditional entitlement or liability occurs.

The introduction of section 24J is designed to remove this controversy and dictate when the incurral and accrual of interest will take place.

Interest - capital or revenue

A further matter which has been discussed in the courts is the concept of interest as a revenue expense. Historically, interest has without doubt been classed as of a revenue nature, *"the fruit of a capital sum invested"*[5]. However, in many more recent cases this principle has been attacked and in some circumstances interest has been held to be of a capital nature.

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3 57 SATC 97

4 ITC 1587 57 SATC 97

5 Notes on SA Income Tax 1996 Keith Huxham, Philip Haupt

What is the situation therefore, where money is borrowed or lent at a premium or discount? The difference between the face value and the actual cost or amount received has historically represented a capital amount. The difference being treated as a capital receipt on sale of the instrument.

For instance, where Eskom stock is purchased prior to the accrual date of the interest, the purchaser is without doubt purchasing interest as part of the cost, this is reflected in the purchase price which would constitute the capital cost of the stock. Likewise for the seller, the moneys received would constitute a capital return on the stock sold irrespective of the fact the amount contained an element of interest.

The question then arises as to whether this treatment was in fact correct. The introduction of section 24J has indicated that this interpretation could have been incorrect and as will be seen later in this report has opened many questions relating to the revenue nature of interest.

Chapter 3

The effect of Section 24J

Section 24J has been introduced, not as a taxing section but merely to clarify the confusion which has evidently arisen over the treatment of interest. The section identifies when interest accrues or is incurred, containing separate rules for interest accruing and interest being incurred by persons other than a company.

The formulation of section 24J relies heavily on the introduction of the accruals basis of taxation for financial instruments recently introduced into Australian tax law. The Australian consultative document relating to the accruals basis stressed the need to move away from the legal form for taxing instruments to one which more closely related to the economic substance of the transaction, again addressing the mismatching of accruals and incurrals of interest.

Section 24J is aimed at financial arrangements which attract interest over a period in excess of 12 months, or where a premium or discount is reflected in addition to the face value of the capital sum. In the case of the party incurring the interest, the interest is deemed to be incurred on a day to day basis over the period of the arrangement and in the case of the recipient of the interest, he is deemed to receive this on a day to day basis over the period of the arrangement irrespective of when the interest is actually paid.

Because of the potential confusion which can arise from section 24J it is perhaps best reviewed by looking first at the recipients liability and secondly at the payers liability.

Interest accrued

The section applies where there is an "income instrument" as defined. An instrument is defined as "*any form of interest bearing arrangement, whether in writing or not, including-*

a) any stock, bond, debenture, bill, promissory note, certificate or similar arrangement;

b) any deposit with a bank or other financial institution;

c) any secured or unsecured loan, advance or debt;

d) any acquisition or disposal or any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest bearing arrangement;

e) any repurchase agreement or resale agreement;

which was issued or deemed to have been issued after 15 March 1995, or issued on or before 15 March 1995 and transferred on or after the date of promulgation of the Income Tax Act 1995[6]*, but excluding-*

i) any lease agreement; and

ii) any agreement qualifying for an allowance contemplated in section 24(2) to the extent that such section is applicable to the holder of such agreement."[7]

In addition, "income instrument" is further defined as:-

a "in the case of a person other than a company,

(i) the terms of which will, or is reasonably likely to, exceed one year; and

(ii) which is issued or acquired at a discount or premium or bears deferred interest.

b in the case of a company, any instrument;"[8]

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6 Note the changes in the 1996 Income Tax Act.

7 Section 24J Income Tax Act 1962 as amended.

8 Section 24J Income Tax Act 1962 as amended.

It is clear from the definitions covered in section 24J, outlined above that the potential scope of the section is very wide. Accruals of interest were only subject to the timing provisions of section 24J where in respect of an income instrument as defined above. The 1996 Amendment Act extended this to include accruals of interest in respect of companies from "instruments" as defined, so extending the scope of section 24J in relation to interest accruing to companies.

Although I do not propose to get involved in the mechanics of section 24J save to highlight it's relevance in determining the treatment of interest, the accrual and incurral of the interest in terms of the section is calculated by reference to a yield to maturity basis, which is covered in brief below.

Interest incurred

For the purposes of determining the treatment of interest paid, the payer will fall into the terms of the section where interest is paid or incurred in relation to an "instrument" therefore applying the section to a much wider interpretation than where interest accrues (except in the case of companies as discussed earlier.)

Because the section refers to an *"issuer of an instrument during a year of assessment"*[9] and an "issuer" is further defined as *"a person who has incurred any interest.... or..... would be liable to pay such interest"*[10] interpretation of the section means that the normal rules for establishing an unconditional liability must apply and that there must be an actual liability and not merely a contingent liability to pay the interest.

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9 Section 24J Income Tax Act 1962 as amended.

10 Section 24J Income Tax Act 1962 as amended.

The amount of interest to be taken into account when determining the application of section 24J on the day by day basis, is arrived at by using a yield to maturity calculation. This involves calculating the cash flow of moneys in and out over the period of the instrument, and from this establishing an internal rate if return (IRR) for the investment. Once arrived at the IRR is applied on a day by day basis for calculating the interest liability for tax.

Example

I purchase Eskom stock valued at R1m on the 1 Jan in year 1. The anticipated return after having held the stock for 3 years is R 300 000. What is my taxable interest for year 1 assuming the interest is calculated on an annual basis and my year end is February?

Cash Flow

Year 1	(1 000 000)
Year 2	0
Year 3	1 300 000

Internal rate of return = 14.01754%

The interest which will accrue to me in year 1 amounts to:

$$1\ 000\ 000 \times 0.1401754 \times 60/365 = R\ 23\ 043$$

I would be taxable on this amount although I will not receive the interest until the end of year 3.

Although providing a framework in which to calculate interest on a day to day basis, section 24J, in particular the definition of the section, raises a whole host of questions relating to normal income tax principles. This is one of this aspect that I propose to look at further in the following chapters.

Chapter 4

Purchase of an Income Instrument by a trust

As mentioned in the introduction, the main purpose of this paper is to analyse a particular circumstance which could occur and the impact of previous legislation and current legislation on this.

If a trust, discretionary or vesting, purchases Eskom stock at a discount for the benefit of the trust beneficiaries, what are the tax implications for both the trust and the beneficiaries?

In order to analyse this scenario, it is necessary to look at several aspects:

a The nature of the discount and whether this is capital or revenue, discussed in this chapter; and

b In light of the introduction of section 24J, who should be taxed on the discount received, discussed in chapter 5.

Interest, revenue or capital ?

The concept that interest can be of a capital nature has in many recent cases caused the courts to look at the purpose to which the money is put, in determining whether the interest is considered to be of a revenue or capital nature.

In ITC 736[11] the taxpayer raised a loan to build a property from which rental income was to be derived. Because the taxpayer did not commence immediately and hence only received a small rental he incurred a loss in respect of the interest paid which he sought to deduct. The Commissioner disallowed the loss incurred.

[11] ITC 736 18 SATC 207

The court held that the interest would have been incurred irrespective of whether any rental income was derived and that the loan had been used to purchase an income producing asset and as such the interest was held to be capital in nature.

In the case of CIR v Drakensburg Garden Hotel (Pty) Ltd [12] the taxpayer who leased a hotel from a company (Stiebel) and ran a separate business as a trading store, borrowed funds to purchase the shares in Stiebel in order to ensure absolute control over the property. The interest on the loan was claimed as a deduction for tax purposes. In disallowing the deduction, the Commissioner argued on two counts; (a) the expense was in the production of exempt income from dividends and not income as defined; and (b) there was not a sufficiently close enough connection between the purchase of the shares and the income earned and hence the interest was of a capital nature.

In finding in favour of the taxpayer on both counts **Shreiner JA** stated that the case warranted *"an enquiry into the distinction between expenditure disbursed merely to protect or preserve a capital asset and expenditure aimed at improving such an asset and making it more productive. This distinction is no doubt a fine one, since the purpose of preserving a capital profit bearing asset may, and generally will, be to earn income from it which it could not yield if not preserved".*[13]

In quoting from the case Sub Nigel (supra) he acknowledged that interest incurred in relation to a capital asset could be considered capital in nature, however stated that *"precisely when expenditure upon a capital asset is itself of a capital nature cannot easily be stated".* [14]

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12 1960 (2) SA 475 (A), 23 SATC 251

13 CIR v Drakensburg Garden Hotel (Pty) Ltd 1960 (2) SA 475 (A), 23 SATC 251

14 CIR v Drakensburg Garden Hotel (Pty) Ltd 1960 (2) SA 475 (A), 23 SATC 251

In Burgess v CIR [15] the taxpayer borrowed money in order to purchase shares on a short term basis for the purpose of making a substantial profit. In order to reduce the risk inherent in such a venture, the taxpayer covered the risk with a single premium endowment policy. In addition, the transactions were not entered into by individuals but by an *en commandite* partnership of which the taxpayer was a member.

Due to an unexpected crash on the stock exchange the partnership made a considerable loss and the taxpayer chose to withdraw from the investment. The taxpayer claimed his portion of the loss incurred.

The Commissioner disallowed the loss stating that the interest expense had not been incurred for the purpose of a trade but a tax scheme and the cost of purchasing the endowment policy was of a capital nature and not deductible.

In finding in favour of the taxpayer, **EM Grosskopf JA** stated that the scheme was a short term speculative venture and *"does not in its nature differ from the speculative purchase of land or shares with the intention of re-selling at a profit. An asset so held is not a capital asset and a profit made on its realisation does not constitute a capital gain."* [16]

As can be seen from the cases covered above, although it has always been considered that interest by it's nature is revenue, the *"the fruit of a capital sum invested"*[17] depending on the use the capital has been put to, the interest can be considered capital in nature.

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15 1993(4) SA 161(A), 55 SATC 185

16 Burgess v CIR 1993(4) SA 161(A), 55 SATC 185

17 Notes on SA Income Tax 1996 Keith Huxham, Philip Haupt

Is the discount capital or revenue?

In the situation where a capital asset such as Eskom stock is purchased at a discount, does the difference between the price paid for the stock and the face value represent a capital gain to be realised on the eventual sale of the stock? Or does it represent deferred interest?

Meyerowitz[18] maintains that where money is borrowed at a discount, in the case of Eskom stock, they are repayable at their face value and not at the discounted value, and the difference between the amount repayable and the purchase price is a capital profit.

However in ITC 244 it was held that the premium paid on a loan can be regarded as income. Howevern in ITC 968[19] a taxpayer received payment from his capital account following his retirement from a partnership over a period of five years in the form of promissory notes. He discounted these, with a finance house in order to raise finance and claimed the loss on the value, ie the discount applied, on the grounds the discount equated to interest charged by the finance house on the loan against which the promissory notes were secured.

The court held that this was not in fact the true transaction and what had actually happened was that the taxpayer had sold a capital asset, ie the promissory notes, and the loss realised therefore was of a capital nature.

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18 Meyerowitz on Income Tax 1995-96 The Taxpayer

19 ITC 968 24 SATC 726

In referring to the case of Moser v Meiring [20], the court held that *"the position when the payee of a promissory note sells the note at a price below the face value of the note..... in the absence of any agreement between the third party and the payee, as to the latter repaying the sum received by him, the transaction is not a loan of money".*[21] In the case where there is no loan, then the transaction must be one of a sale. The inference being that for an element of interest to exist there must be a loan and not a sale.

In Tucker v Ginsberg[22] the issue of whether a sale or loan had occurred was also discussed.

"The object of both discounting a bill and lending money on the strength of it is the same, namely, to provide the one party with ready money, but the nature of the two transactions is fundamentally different ..... in the former transaction, the object is achieved by the party selling the bill before its due date for an amount in cash that is less than the amount of the bill (the difference being known as the 'discount' or 'discount charges'), and on negotiation of the bill to the discounter, he becomes the owner of all the rights given by it against the various signatories thereto ... The seller does not undertake to re-pay the amount of the bill on due date.... In the latter transaction, the object is achieved by the party borrowing the money from the lender and undertaking to re-pay an equal amount on due date, the bill being negotiated or delivered to the lender merely as security for the re-payment of the loan."[23]

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20 1931 OPD 74

21 ITC 968 24 SATC 726

22 1962 (2) SA 58 (W)

23 1962 (2) SA 58 (W)

This concept was further discussed in ITC 1587[24] where promissory notes were offered on the money market for sale at a discounted price. The taxpayer sought to deduct the loss realised on the sale against his taxable income. The Commissioner disallowed the loss on the grounds that it related to the sale of a capital asset and was therefore of a capital nature.

In finding in favour of the taxpayer, **Van Dijkhorst J** held that the discount was an expense in the form of interest and the transaction entered into was a loan and not a sale. *"Where a party offers his own promissory note, the discounting house gets merely a promise in writing the strength of which depends upon the worth of the party signing the note. Such a transaction can hardly be called a 'sale'".*[25] He went on to say that *"even if the difference between the discounted value and the face value of the notes were to be regarded as a loss, it would in the circumstances of this case not be of a capital nature."*[26]

The above cases hinge on the matter of whether the transaction is classed as a loan or a sale. In the case of a loan, the borrower agrees to repay the amount of the loan or bill, and for the use of the money is charged interest albeit in the form of a discount on the face value of the loan. In the case of a sale the purchaser takes on all rights in relation to the bill and the seller does not undertake to repay the bill on the due date. This fundamental distinction determined whether there is an element of interest, which could be taxable as a revenue receipt or whether there is a profit on sale not taxable as a capital receipt.

Secondly, if there is found to be an element of interest, it is necessary to determine whether the interest represents interest of a revenue nature or interest of a capital nature. In order to ascertain this it is necessary to look at the purpose the capital is put to, for example to raise working capital by issuing a bill at discount, or to hold as an investment.

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24 57 SATC 97

25 ITC 1587 57 SATC 97

26 Ibid.

In the example in point, the trust had purchased the Eskom stock at a discount and legal ownership of the stock had changed hands, therefore one could argue that there had been a sale. The stock could then either be held to maturity or sold at a later stage with the view of realising a higher price than that paid. In this instance it can be argued that the discount received is capital in nature representing a profit on the sale of the stock.

In ITC 1578 an insurer realised a profit on the sale of treasury bills and bankers acceptances and claimed that the profit realised was not taxable in the 1983,1984 and 1985 years of assessment. Inland Revenue, using the authority from a practice note issued at the time disagreed and included the profits in taxable income.

It was held that until the 1982 year there had been practice to tax profits and that from the 1983 year this practice had changed to one of non-taxation. However it was held that the profits were taxable as they had *"the character of interest"*[27].

It is argued that this case can be distinguished from the facts of the present situation in that the business of the appellant was that of purchasing and selling instruments and these were all held for a relatively short time. In addition, the motive for the original purchase of the instruments was to sell at a profit, whereas in the present situation the motive is one of investment for the earning of interest.

[27] ITC 1578 57 SATC 97

The effect of section 24J

Section 24J was primarily introduced to resolve the exploitation of mismatching accruals and incurrals of interest through tax planning. This was clearly emphasised in the Budget Review in 1995 in which the Minister stated *"In order to reflect the economic reality of financial instruments and to remove any uncertainty with regard to the timing of deductions and accruals for tax purposes, appropriate amendments will have to be made to the Income Tax Act to introduce an accrual basis which will recognise the spreading of interest (including discounts and premiums) on a day-to-day (yield to maturity) basis for tax purposes".* [28]By also introducing the definition of "income instrument", the section brings into taxable income what has almost always been considered capital.

Is the intention of the section to undermine previously accepted tax principles and change what has been consistently treated as a capital profit as interest and taxable? If this is the case then examples such as the one in point are faced with considerable difficulty in providing for tax on income which has not been received.

Under Australian law, the recent introduction of the accruals basis of taxation in relation to financial instruments, specifically deems gains and losses on the disposal of the instrument to be for revenue account this would also by it's intention, deem discounts received to be for revenue account.

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[28] Extract from Budget Review 1995 (The Taxpayer March 1995)

In the consultative document put forward by the South African Tax Advisory Committee in July 1994 it states that the committee does not agree with this proposal but is in favour of applying normal tax principles and that *"it is not recommended that the proposed accrual system should, other than regulating the timing of deductions and accruals, interfere with general tax principles"*[29].

The question which then needs to be raised is whether Section 24J is intended to deem income previously treated as capital as revenue and subject to the yield to maturity basis, or whether the section is purely intended to define exactly how interest is to be taxed once it has been determined as revenue in nature in terms of general tax principles.

It can be argued that the section was not introduced as a taxing section but more to assist in the clarification of the timing of accruals and incurrals, and that the intention of the section was also never to undermine the accepted principles relating to taxation, including those laid down for determining capital and revenue. If reference is made to the Explanatory Memorandum (1995) this is reinforced where it is stated that;

"It must be emphasised however that the proposed legislation will not interfere with general tax principles such as the source principle or the capital or revenue nature of interest accrued or incurred in respect of such arrangements, but will only deal with the timing of the incurral and accrual of interest in respect of such arrangements."[30]

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29 Consultative document on the tax treatment of financial arrangements (Tax Advisory Committee) July 1994

30 Extract from The Explanatory Memorandum to 1995 Income Tax Bill (The Taxpayer June 1995)

Despite the above comment, the wording of the section does indicate that in the example of the trust there may be a problem in relation to the discount received and the definition of "income instrument" contained in the section. In addition, how is the trust expected to deal with the tax charge on the discount received which must be calculated on a day by day basis on a yield to maturity basis disregarding the fact that the actual receipt will not take place until the stock is sold.

How will section 24J impact on the discount?

In my opinion section 24J never intended to change generally accepted tax principles and override the normal capital v revenue rules. The section was introduced to eliminate the mismatching of accruals and incurrals seen in the previous treatment of interest.

The definitions contained in the section are there to add clarity to the nature of the arrangements entered into, they are not there to impose a tax on income which would under normal rules be considered capital. The fact that the section deems a discount received to be interest does not change the character of that interest and if the interest is capital in nature it remains so.

In the case of the example in point, it would be necessary to look at the facts surrounding the purchase of the stock. If the intention of the trustees was to purchase the stock as a long term investment, for the benefit of the beneficiaries of the trust, I believe it can be argued that the discount received is capital in nature and not subject to tax under section 24J. Taking the same reasoning as the finding in ITC 968 the realisation of the discount could not take place until the stock is sold in which case a profit would be realised and this profit must be of a capital nature.

In ITC 1587[31] the loss was considered revenue in nature because the transaction was seen as a loan and not a sale and therefore the discount was interest of a revenue nature. If the promissory note had taken the form of a different type of instrument which had been sold rather than guaranteed payment, the discount would have taken on a different character. In this instance the discount would have represented a loss between the discounted and face value and could have been argued to be of a capital nature. This argument was put forward in the alternative by Inland Revenue.

"It was further contended in the alternative that the transaction (being the sale of the promissory notes) *constituted a the sale of an asset worth R 35 million for only R 33 778 356,16, that the loss incurred was of a capital nature and that it was therefore not deductible from gross income".*

In ITC 1578[32] it was inferred that the reason the discount was taxable was due primarily to the existence of a practice note permitting the taxation of discounts at that time. In addition, the appellant was a insurer in the business of buying and selling instruments for the purpose of making a profit in the same way as a money lender makes a profit by lending money. There can be little doubt therefore that the resulting gains would have been taxable even in the absence of the practice note.

In the event therefore, that the trust trades in the purchase and sale of stock then the situation would also be very different. The intention of the trust must then be to buy and sell regularly with the sole intention of realising the discount as a profit in the same manner as the appellant in ITC 1578[33], and therefore the discount, representing the future profit would be taxable in terms of section 24J.

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31 57 SATC 97
32 56 SATC 254
33 56 SATC 254

This interpretation has been followed in case law in both Australia and the UK. In the recently reported case of FCT v ERA [31] the taxpayer issued a series of 90 day promissory notes in US dollars at a discount to raise capital for expansion. The taxpayer claimed a deduction for the loss incurred on the promissory notes which was upheld in the Federal Court.

Although the Commissioner did not contest this point on appeal, bringing the case to appeal on the calculation of the discount, it was held that the discount was of a revenue nature because it was *'a necessary outgoing made in the normal course of the continuance and maintenance of the business as an enterprise conducted for the purpose of profit".*[32]

In the judgement, **Dawson, Toohey, Gaudron, McHugh and Kirby** stated *"Where a taxpayer incurs a loss or expense in raising funds by issuing promissory notes at a discount to their face value, its entitlement to a deduction for that loss or expense depends on the use to which the funds are to be put. If the funds are to be used as working capital, the cost of the discount will be deductible as a revenue expense. If the funds are to be used to strengthen 'the business entity, structure, or organisation set up or established for the earning of profit', the cost of the discounts will generally not be deductible because they will be a capital and not a revenue expense".*[33]

This therefore suggests that the Australian view point is in fact to determine the underlying purpose for the capital in order to ascertain the taxability of any discount which may apply, indicating that even with specific law relating to the treatment of financial instruments, normal tax principles still apply in determining the nature of the discount.

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31 94 ATC 4923 (1996)

32 FCT v ERA 94 ATC 4923 (1996)

33 FCT v ERA 94 ATC 4923 (1996)

In the UK case Lomax (HMIT) v Peter Dixon & Son Ltd[34] the taxpayer issued loans at a discount and redeemed loans at a premium. The issue brought before the court was whether discount was assessable as income. In finding that the discount was capital in nature, **Lord Greene** stated that the discount could only be of a capital nature where there was a relatively low risk in terms of the investment.

"I venture to think that no business man would regard the discount or premium as anything but capital. In each case the result is the same - the subscriber is paying for a more or less hazardous investment less than the figure at which it is to be redeemed and in exchange has to be content with a lower rate of interest".[35]

This judgement indicates that in addition to the purpose for which an instrument is purchased, the risk taken by the investor can be a deciding factor in determining whether the discount received should be capital or revenue. A short term speculative purchaser, prepared to take higher risks for a more profitable return is akin to operating a "profit making scheme" and should be taxed accordingly. A trust however, purchasing an asset to create interest income with a relatively low risk would on the other hand, be purchasing a long term investment which would clearly be a capital asset and any gain made on realisation capital in nature.

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34 1 KB 671 (1943)

35 Lomax v Peter Dixon & Son Ltd (1943) 1 KB 671

Chapter 5

Liability for taxation

Although it can be argued in the current example, the discount received is of a capital nature and hence not taxable in terms of section 24J, assuming the trust is either trading in the buying and selling of stock, or changes it's intention to one of a profit making scheme, case law has indicated that in this event the discount received would be revenue in nature and therefore subject to tax in terms of section 24J.

In this instance, the question arises as to how the tax payable on the discount needs to be ascertained and on who the liability will fall.

Where there has been a donation, settlement or other disposition

Section 7 of the Act deems income arising in a trust where there has been a "donation, settlement or other disposition" to be taxable in the hands of the donor.

Such a situation could arise where the donor donates the capital to the trust to purchase the Eskom stock in which case a donation would have occurred, or where the donor provides an interest free loan to the trust to purchase the stock, in which case it could be argued an "other disposition" as defined has occurred.

The question which arises is whether notional income, in the form of the discount can be deemed to be taxable in the hands of the donor in terms of section 7.

In terms of section 7(5) the income arising in the trust is deemed to be taxable in the hands of the donor where there is a stipulation or condition denying the income to the beneficiaries until the happening of an event. Therefore, could a discount received by the trust be deemed income in the hands of the donor in terms of section 7 assuming all other conditions are met?

In Hulett v CIR[36] it was held that where the income received by the trust is notional it could not be received either by the trustee or the beneficiary, therefore it could not be deemed to be received by the donor.

In his judgement **Selke J** confirmed that Section 7(5) could not apply in terms of notional income received by a trust; *"The only income which could be effective for these purposes is such income as the trustees actually receive in hard cash or it's equivalent, that is to say, such tangible physical assets as should come into their possession or control by way of income from the trust, and be thus available to them from time to time to make immediate, or at least effectual, provision for the maintenance and support of the children. It seems clear to me that 'deemed' income,...falls outside that category. It is notional merely, and has no physical counterpart;.....Seeing that the facts of the present case concern solely 'deemed' income in my opinion subsection 9(5)* [now 7(5)] *has no application."*[37]

In the event therefore that section 7 can be invoked and there has been a donation or other disposition as discussed above, in terms of the logic argued in Hewlett's case the notional income represented by the discount is not available to the trustees or the beneficiaries and therefore cannot be deemed to be taxable in the hands of the settlor.

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36 1944 NPD 263, 13 SATC 58

37 Hulett v CIR 1944 NPD 263, 13 SATC 58

In a vesting trust

In the event the right to the income vests in the beneficiaries, can the notional interest arising from the discount received be taxable in the beneficiaries hands in terms of Section 25B?

Section 25B governs the taxation of trusts where the has been no "donation, settlement or other disposition" as defined in the anti avoidance sections contained in Section 7 of the Act. In short, Section 25B denotes when the income should be taxed in the trust and when it falls to be taxed in the hands of the beneficiaries.

It provides that *"any income received by or accrued to a trustee of a trust, shall -*

(a) *to the extent to which it has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to have accrued to the beneficiary;"*[38]

There can be little doubt therefore, that where the trust deed vests the income the discount will immediately accrue to the beneficiaries in terms of Section 25B the trust simply acting as a conduit through which the income flows, and fall to be taxed in their hands in terms of section 24J, even where the income is notional and therefore cannot be claimed by the beneficiary. The fact the income vests means that the beneficiary has an unconditional right to the income even if this right cannot be exercised until some future date.

[38] Extract from Section 25B Income Tax Act 1962 as amended

This was borne out in the case of Armstrong v CIR[39] where the beneficiary had a vested right to income arising in the trust. Part of the income received by the trust comprised dividend income and part comprised interest and rent. The court held that where there is a vesting right the income is in fact received by the beneficiary and the trust merely acts as a conduit. **Stratford CJ** in his judgement made reference to this concept; *"In the simple case I am now examining, namely. that of a trio comprising a company, the intervening trustee, and the beneficiary, it is manifest that in the truest sense the beneficiary derives his income from the company, for that income fluctuates with the fortunes of the company and the trustee can neither increase nor diminish it, he is a mere 'conduit pipe'."*[40]

In a discretionary trust

In the case where there is no vested right to the income, the trust will be taxable on any income arising in the trust. In our example therefore the trust will have to account for tax on the amount of the discount received calculated on a yield to maturity basis.

Provided the trust has other income, the problem is overcome, but what if the Eskom stock is the only asset held by the trust? In this case the trust will have to account for the tax from capital reserves of the trust, this could cause the trust to have to sell the stock acquired in order to raise income to pay the tax charged.

If however the trustees wish to distribute the income two questions arise;

- firstly, is there income to distribute? and;
- secondly, can this be distributed and subsequently taxed in the hands of the beneficiaries.

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39 1938 AD 343, 10 SATC 1

40 Armstrong v CIR 1938 AD 343, 10 SATC 1

Is there income as defined?

Although Section 24J deems the discount received to be interest in terms of the definition "instrument". In terms of fact, no income has actually been received by the trust it is simply "notional interest" and not actual income received by the trust. Can the trustees therefore distribute notional income?

It has been argued previously, following the principle laid down in Hulett v CIR, [41] that the trustees cannot be expected to exercise their discretion in relation to the distribution of notional income which in reality has not been received and that any distribution would have to be held over until such time as the stock is sold and an actual income received.

[41] 1944 NPD 263, 13 SATC 58

In the event however that the trustees are considered able to distribute the notional income, the result will be that the notional interest will fall to be taxable in the hands of the beneficiaries in terms of Section 25B of the Act as discussed below.

Section 25B(2) states:

"Where a beneficiary has acquired a vested right to any income referred to in sub-section (1) in consequence of the exercise by the trustee of a discretion vested in him in terms of the relevant deed of trust, agreement or will of a deceased person, such income shall for the purposes of that sub-section be deemed to have been derived for the benefit of such beneficiary."[42]

If there is no vested right and the trustees have a discretion relating to the distribution of the income, the trustees may exercise their discretion to vest the right to the income to the beneficiaries. However two concerns arise as a result of this in our example, does the term "income" include notional income as inferred in Section 24J? And must the distribution take the form of an actual distribution in order for section 24J to apply?

If we look at the first point relating to the term "income". In terms of the definition in section 1 of the Act, "income" means gross income less exempt income, gross income being;

"the total amount in cash or otherwise, received by or accrued to, or in favour of such person during a period of assessment from a source within or deemed to be within the Republic; excluding receipts of a capital nature."[43]

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42 Section 25B Income Tax Act 1962 as amended.

43 Extract from Section 1 Income Tax Act 1962 as amended.

Again we must revert back to the argument previously put forward as to whether the discount remains capital in terms of the normal tax principles or whether section 24J overrules these principles and deems the discount to be revenue. Although section 24J deems the discount to be interest, interest can still be considered as capital as has already been discussed.

If it can be argued that the discount, although deemed interest in terms of section 24J is capital in nature, even where the deemed interest is distributed from the trust it will retain it's capital nature in the hands of the beneficiaries and therefore will not be taxable.

This fact was borne out in the case Armstrong v CIR[44] in which the beneficiary had a vested right to income arising in the trust which consisted of interest, dividends and rental.

The Commissioner, in this case sought to tax the whole income in the hands of the beneficiary denying the beneficiary the exemption afforded under Section 10(1)(k) on the grounds that the income had changed it's character because of the intervention of a trustee.

In finding in favour of the beneficiary **Stratford CJ** stated that *"the clear intention of the Act can only be effectively and generally carried out by exempting the person ultimately receiving such moneys"*.

Therefore confirming that even where a trustee is interposed, the nature of the income received by the beneficiary is retained and any exemptions available are available to the beneficiary.

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[44] 1938 AD 343, 10 SATC 1

In the event the interest is revenue in nature, the question which arises is whether the "notional interest" or discount is in terms of law available for distribution by the trustees, and if so who is liable to the tax thereon.

Can the income be distributed and taxed in the hands of the beneficiaries

The second main problem surrounding section 25B is whether there must be an actual physical distribution of the income for Section 25B to apply and tax the interest in the hands of the beneficiaries. It is argued that because there cannot be an actual distribution due to the fact the interest is notional, then section 25B cannot apply and the deemed interest remains taxable in the trust. This was borne out in Hewlett's case (discussed above) where it was held notional income received by the trust cannot have really been received by the trustees and therefore cannot be distributed by them.

In summary, it is argued that, if the trust is a discretionary trust, and the trustees exercise their discretion to distribute the income, the discount received can only be taxed in the hands of the trust, if it can be taxed at all, as section 25B(2) cannot be invoked in the event "notional interest" has been received, but only where it is possible to make a physical distribution of actual income received.

Chapter 6

Accounting for the tax in the trust

If the discount is deemed to be interest in terms of section 24J and in addition considered to be revenue in it's nature it is necessary to establish how the tax should be accounted for.

If we take an example recently reported in The Taxpayer[45] it is possible to see how this works.

"If the face value of the stock is R100 payable in five years time and the price paid is R80, R4 will be deemed to accrue each year in addition to the actual interest accruing during the year. The problem raised is that, while the R4 is taxable, who is to bear the tax thereon?"[46]

In a vesting trust the income received in the form of interest and the discount will simply flow through to the beneficiaries and be taxable in their hands. The beneficiaries will be able to account for the tax on the "notional interest", being the discount received out of the actual interest received thereby lowering their net income.

e.g

Assuming the actual interest received in year 1 is R20, the notional income R4 and the tax on the notional income R2, it is necessary to determine how much will be distributed to the beneficiaries and subsequently taxed in their hands.

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45 The Taxpayer May 1996

46 The Taxpayer May 1996

Total income received (R20 interest + R4 discount)	R24.00
Tax thereon (assuming a rate of 40%)	R9.60
Net income attributable to beneficiaries	R14.40
Actual income received by beneficiaries (R20 interest - R9.60 tax)	R10.40

In this case a problem does not arise as the trust simply acts as a conduit for the income to flow through to the beneficiaries. But how will the situation fare if the trust is discretionary?

If the trustees do not exercise their discretion to distribute the income, the total income will be taxed in the trust on the same basis as has been shown above. The problem only arises when the trustees exercise their discretion to distribute the interest income received. It has already been stated that the trust cannot distribute the discount as it is notional in it's nature, therefore this must be taxed in the trust. The trust is free however to distribute any interest received to the extent that sufficient income is retained to meet the tax liability.

As has already been discussed in the previous chapter, it is held that the trustees cannot distribute notional income, therefore the R4 represented by the discount must be taxable in the trust. The result being that the beneficiary will receive a lower amount of income as the trust will have to retain income to account for this tax.

Again, assuming the actual interest received in year 1 is R20, the notional income R4 and the tax on the notional income R2, it is necessary to determine how much will be distributed to the beneficiaries and how much will be taxable in the trust.

The editors of The Taxpayer suggest that the trust must pay tax on the R4 notional income and the R2 being income retained to meet the tax on the R4 resulting in a tax on tax situation, leaving the balance of R18 to be distributed to the beneficiaries.

An alternative method would be for the trust to retain sufficient income from the balance distributable to the beneficiaries to meet the liability for tax on the total income retained in the trust as follows:-

Distribute to beneficiary	=	20(interest) - X (where X = tax charge on total income received)

assuming a tax rate of 40%;

X	=	40% x (20 + 4 - (20 - 2)
	=	40% x (4 + X)
	=	1.6 + 0.4X
	=	2.67

Therefore:

Total income		24 (interest plus discount)
Distributed to beneficiary	interest less tax (20 - 2.67)	17.33
Taxable in trust	20 + 4 - 17.33 =	6.67

This leaves the "notional income" of R 4 plus the tax liability of R 2.67 in the trust, ensuring that the trust is left with sufficient funds to meet the tax liability arising in the trust. The R 17.33 distributed to the beneficiaries would fall to be taxed in their hands in terms of section 25B(2).

In either event it is essential that sufficient funds are retained in the trust to meet the tax liability on the notional income received.

In the above example arbitary tax rates have been used simply to illustrate the potential problems which may arise in the instance where a discretionary trust is required to account for tax on income received and not distributed through to the beneficiaries.

Chapter 7

Conclusion

Interest - capital or revenue

Section 24J was introduced following a review of taxation procedures in Australia as an accrual basis of taxation for financial instruments. Despite the fact the consultative document put forward in Australia aims to tax all gains as revenue, where discounts are received, case law has shown that the normal tax principles will apply.

In South Africa both the consultative document and the explanatory memorandum which accompanied the introduction of the section, stated that the introduction of the section was aimed at clarifying the timing of the incurral and accrual of interest for tax purposes. There was never any intention to override the normal tax principles relating to source and capital v revenue.

Case law has indicated that it is the motive or intention behind the acquisition of the instrument and the purpose to which the capital is put which denotes whether it is for investment purposes or for a scheme of profit making. In the case of investment there can be little doubt that the purpose is to hold the instrument as a capital asset to realise interest income and therefore any profit made on the sale of the asset, be it by virtue of a difference between the price paid and the redemption value, represents a capital profit.

In the example in point, if the trust purchased Eskom stock as an asset to create interest income for the benefit of the beneficiaries, intended as an investment, and not in a scheme of profit making through buying and selling stock to sell at a profit, the discount received, representing the difference between the price paid and the redemption value represents a capital profit, not subject to tax. Section 24J will therefore not apply.

If the trust was acting in a scheme of profit making by regularly buying and selling stock with a view to realising profit, then in terms of normal tax principles and stated case law, there can be little doubt that the profit realised, being the difference between the price paid and the face value, is for revenue account and subject to the timing provisions of section 24J.

The introduction of section 24J serves only to determine when an accrual or incurral of interest should be brought into account, the fact that the section deems a discount to be interest only serves to clarify this. In determining whether that discount, interest as it may be, is capital or revenue, requires reversion back to normal tax principles laid down by case law, which once determined, will decide whether section 24J applies or not.

Accountability of tax

Section 25B permits the "conduit principle" for taxing the beneficiaries of trust income where they have a vested right to that income. This could be where the trust deed vests in the beneficiaries or where the trustees exercise their discretion to vest the income in the beneficiaries.

In the instance where the trust deed vests the income in the beneficiaries, the conduit applies and the income simply passes through to the beneficiaries and is taxable in their hands. Where the trust is discretionary the trustees must first have income to distribute before this can vest in the beneficiaries.

A discount received on the purchase of an asset cannot be income capable of distribution until such time as that discount is realised. Therefore any discount received by a trust on the purchase of a financial instrument cannot be distributed to the beneficiaries and taxed in their hands in terms of section 25B(2).

If a trust is therefore "trading" in the purchase and selling of financial instruments at a discount for the purpose of making a profit, and the trust is discretionary, any discounts received, which fall to be taxed in terms of section 24J can only be taxed in the trust.

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