

THE INCOME TAX NATURE OF DERIVATIVES HEDGES –

*A critical analysis of the classification of gains made hedging a capital share investment
with a Single Stock Futures contract*

By

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SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

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in partial fulfilment of the requirements for the degree M.Com (Taxation)

Faculty of Commerce

UNIVERSITY OF CAPE TOWN

Date of submission: 19 February 2018

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DECLARATION

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Acknowledgements

Firstly, my sincere gratitude to my supervisor, Darron West, for his insightful guidance in respect of the preparation of this dissertation. My grateful appreciation also to the Department of Finance & Tax at the University of Cape Town for their patience in this regard.

Secondly, acknowledgement needs to be given to my employer, PwC, for the financial assistance provided that allowed me to undertake this course.

Finally, to each of you who supported me wholeheartedly in this endeavour, who encouraged me to see it through and who never let me forget why I started, I offer my heartfelt thanks. Your contribution was invaluable and without you this may never have seen the light of day. I shall not list you here – you know who you are.

James Maule

Cape Town, February 2018

Abstract

In 1992 the Taxation Sub-Committee of the South African Institute of Chartered Accountants noted that one of the primary problems facing the taxation of derivatives used as hedges was the capital/revenue distinction, due to the fact that the application of well-established legal principles to these new derivative instruments and investment strategies could lead to inequitable results. Notwithstanding recommendations that special rules be developed to govern the taxation of derivatives used as hedges, little has changed.

The South African Revenue Service have stated in their 2014 *Tax Guide for Share Owners* that the sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets, ostensibly on the basis that such assets derive no return for the holder and are therefore only held to be realised at a profit.

This study seeks to investigate whether or not the sale of a futures contract used as a hedge against losses on an underlying share investment, held as a capital asset, should be taxed on revenue account or if in fact an argument can be made for the gain realised on the derivative to be treated as capital in nature.

Against a background on the mechanics of traded futures contracts and the adopting of a 'short position', consideration will first be given to existing South African precedent and the authority cited by SARS in support of the expressed revenue treatment. Alternative arguments proposed by writers, based on the analogous treatment of insurance proceeds or the practice of 'following the underlying asset', will be considered against both South African and international support. This study will then consider the application of common law principles of the capital/revenue determination to identify arguments applicable to futures hedging. It is submitted that some of these common law principles identified, in particular those relating to a taxpayer's purpose, as compared with his or her intention, would provide a cogent argument in this regard.

The above findings will then be critically evaluated to determine what, on balance, the correct tax treatment in the circumstances should be bearing in mind the words of Friedman J in *ITC 1450* (1988) 51 SATC 70 at 76, and Smalberger JA in *CIR v Pick n Pay Employee Share Purchase Trust* (1992) 54 SATC 271 at 279:

'when all is said and done, whatever guidelines one chooses to follow, one should not be led to a result in one's classification of a receipt as income or capital which is ... contrary to sound commercial and good sense.'

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CHAPTER 1 INTRODUCTION

1.1. Background

In 1992, a report compiled by the Taxation Sub-Committee of the South African Institute of Chartered Accountants ('SAICA') noted the uncertainty that existed regarding the tax treatment of derivatives used as hedges in South Africa.¹

The SAICA report (1992) set out that one of the primary problems facing the taxation of derivatives used as hedges in South Africa was the capital/revenue distinction, due to the fact that the application of well-established legal principles to these new derivative instruments and investment strategies could lead to inequitable results.² By way of example, the SAICA report (1992) refers to the fact that the nil return (in the form of interest or dividends) derived in respect of these derivative instruments, the three month short-term nature of the holding of the derivative instruments and the daily 'mark-to-market' settlement requirements (both required by the rules governing the derivatives) are all indicative of an asset that is itself 'revenue' in nature.³ Similarly the fact that a 'profit' is anticipated on a hedge if it has been correctly entered into, could mean that the hedge should be construed as a 'scheme of profit-making' such that all resultant profits were revenue in nature.⁴

Subsequent to the SAICA report (1992), in July 1994 a Sub-Committee of the Tax Advisory Committee ('TAC') issued a '*Consultative Document on the Tax Treatment of Financial Arrangements*', in response to the difficulty of taxing modern financial arrangements using general tax principles developed prior to their advent. This document suggested that, in the context of derivatives hedging:

*'Special hedging rules for hedging instruments relating to ... portfolios of assets ... appear to be practically difficult to legislate for or administer. However it is intended to examine foreign jurisdictions' legislation and practices at a later stage'*⁵

¹ South African Institute of Chartered Accountants, *Report on the tax treatment of futures and options*, (23 October 1992), 26.

² *Ibid* at 6.

³ *Ibid* at 19-20.

⁴ *Ibid* at 24.

⁵ Sub-committee of the Tax Advisory Committee, *Consultative Document on the Tax Treatment of Financial Arrangements*, (20 July 1994), 71. Up until this point, little had been done in this regard. See the reference in 1.2 of the SAICA report to page 140 of the report of the Stals Commission of

Notwithstanding these comments, little has changed in the last 20 years.

Even though the utilisation of derivatives as hedges is not a new practice amongst taxpayers in South Africa, there remains a distinct lack of legislative guidance in the Income Tax Act, 58 of 1962 ('the Act')⁶ on how to classify gains made on these hedges for tax purposes. The Act, for example, only provides for the specific treatment of revenue gains made on foreign exchange hedges, in terms of section 24I, and this section does not make provision for hedging gains to be capital in nature.

In their 2017 *'Tax Guide for Share Owners'* ('the Share Owners Guide'),⁷ the South African Revenue Service ('SARS') states the following in paragraph 3.4.6 under the heading 'Low or nil return', in the context of general principles to be considered when deciding on a matter of capital or revenue interpretation:

'The sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets (ITC 1756; Wisdom v Chamberlain (Inspector of Taxes))'

The concept of 'Low or nil return' refers to a general principle that assets which derive no return for the holder (such as dividends or interest) are likely only held in order to be realised at a profit, and should accordingly be treated as a giving rise to revenue receipts when sold. The statement above is the only guidance given by SARS on the treatment of gains made when hedging with derivatives.

Inquiry, where it was commented that *'the tax authorities could not provide the committee with clear guidelines as to how futures and options transactions would be treated for tax purposes in the South African context'*.

⁶ This study takes into account all relevant tax legislative amendments up to and including the amendments brought about by the Taxation Laws Amendment Act No. 17 of 2017. All references to 'section' and 'paragraph' are to sections of the Act and paragraphs of the Eighth Schedule thereto, unless the context indicates otherwise.

⁷ This 5th issue dated 16 February 2017, followed on the 1st draft from 2006, the 2nd version from 2008, the 3rd from 2012 and the 4th dated 17 February 2014. All five versions of this document which have been issued however contain the same statements in regards to the revenue nature of futures hedging. Whilst the forward for this share owners guide states that *'[t]his guide provides general guidance on the taxation of share owners. It does not go into the precise technical and legal detail that is often associated with tax, and should not, therefore, be used as a legal reference. It is not an "official publication" as defined in section 1 of the Tax Administration Act 28 of 2011 and accordingly does not create a practice generally prevailing under section 5 of that Act. It is also not a binding general ruling under section 89 of Chapter 7 of the Tax Administration Act'*, it is likely that the statements made in 3.4.6 are still indicative of the viewpoint which SARS will adopt at the outset of any review of a taxpayer's futures hedging transaction, and therefore warrants the closer investigation conducted in this study.

1.2. Problem Question

Given that the inequalities referred to in the SAICA report (1992) could still arise, the lack of legislative guidance provided and furthermore considering the view expressed in the SARS Share Owner's Guide, this study seeks to address the following question: is it possible to hedge with a derivative on capital account? Put differently, can one make a capital gain on a derivatives hedge?

In order to address this question, it is proposed to investigate whether or not the sale of a futures contract used as a hedge against losses on an underlying share investment, held as a capital asset, should be taxed on revenue account or if in fact an argument can be made for this gain to be treated as capital in nature.

1.3. Objectives of the study

This study will focus on the gains made on individual equity futures contracts (hereafter referred to as 'Single Stock Futures'),⁸ entered into as a hedge against anticipated losses in value on the same underlying share (that is the subject of the Single Stock Futures contract) which is held as a capital investment, where the shareholder does not wish to (or cannot) completely disinvest from (i.e. sell) such shares.⁹

Given the absence of any legislative determination or definitive legal precedent regarding the tax treatment of hedging of this sort, there is no legal certainty as to the correct tax treatment of gains made in the manner described above. As such, a gap exists in the current body of tax knowledge. The aim is to contribute to this general body of tax knowledge by trying to determine whether a taxpayer could successfully treat gains made on a futures contract, used to hedge a capital share investment, as capital in nature.

This need for clarity becomes especially pressing when one considers that the applicable tax treatment for capital gains leads to a more favourable result (i.e. lower effective tax rate) for the taxpayer than if these gains were to be taxed on revenue account. The outcome of this research therefore stands to materially benefit the taxpayer. Furthermore, in the context of a portfolio in a collective investment scheme ('CIS'), be it a CIS in securities or for that

⁸ The use of the phrase '*The sale of futures contracts...*' by SARS in the Share Owners Guide may be misleading. What is in fact being taxed here is the *gain* made on the Single Stock Futures contract, irrespective of how it is closed out. The mechanics of how this gain is realised, through the variation margin that needs to be paid over the life of the derivative, are considered in 2.2 below.

⁹ For example, the taxpayer may believe in the long term fundamentals of the company and not wish to disinvest completely, or could in fact be 'locked in' to his or her shareholding and precluded from selling for a period of time, in accordance with the terms of a previous merger transaction through which the shares were acquired.

matter a hedge fund,¹⁰ it is only gains made on capital account in the portfolio that are not taxable.¹¹ To the extent then that the fund manager enters into hedging transactions using Single Stock Futures, in order to hedge a particular underlying share investment held on capital account, the outcome of this research as to whether such gains may be treated as capital in nature is equally relevant.

1.4. Methodology

This doctrinal study will begin, in chapter two, with an introduction to futures contracts and a brief explanation of the mechanics of Single Stock Futures, as prescribed by the South African Futures Exchange ('SAFEX') in its capacity as the regulating exchange. The chapter will also consider the manner in which a gain may be realised when adopting of a 'short position' with Single Stock Futures, as well as the basic principles of hedging and how the desired objective may be realised using Single Stock Futures.

This study will then proceed in chapter three with a brief review of some existing South African decisions regarding the taxation of gains made from derivative instruments and/or gains derived from the employment of hedging strategies.

Chapter four will analyse the view and authority proffered in the SARS Share Owners Guide for the proposed revenue classification of gains made when hedging a capital share investment with Single Stock Futures contracts.

Chapter five will then set out a discussion of alternative arguments which should also be considered when determining the income tax nature of a futures hedging gain. This will consist of reviewing the alternative analogous arguments proposed by certain writers, considering any case law that substantiates these positions and comparing the tax treatment in certain selected international jurisdictions.

Chapter six will then consider certain fundamental common law principles of the capital and revenue determination found in the South African jurisprudence, in order to identify any arguments which might be applicable to futures hedging. Whilst the decisions handed down in previous judgments unquestionably would have depended on the specific facts and

¹⁰ A portfolio of a CIS includes, for tax purposes, both a CIS in securities and a declared CIS in terms of the section 1 definition. A 'portfolio of a declared collective investment scheme' is defined in section 1 to mean *'any portfolio comprised in any declared collective investment scheme contemplated in Part VII of the Collective Investment Schemes Control Act'*. In terms of Government Notice No. 141 issued by National Treasury on 25 February 2015, the business of a hedge fund was declared to be a collective investment scheme for purposes of the Collective Investment Schemes Control Act.

¹¹ The portfolio of a CIS is only able to disregard capital gains in terms of paragraph 61(3). Any gains made on income account would be taxable.

circumstances of the relevant taxpayers in question, it is submitted that the arguments and common law principles identified in these sources (whilst not attempting to provide a universal solution or simple checklist), would nonetheless provide a good indication as to how a court could view a question on the capital or revenue nature of gains made hedging a capital share investment with Single Stock Futures contracts.

Chapter seven will then weigh up the arguments in the preceding four chapters, both for and against the capital nature of gains made hedging a capital share investment with Single Stock Futures, in order to determine what, on balance, the correct tax treatment should be.

Finally, chapter eight will contain a summary of the issue raised, the conclusions drawn and recommendations for further research.

1.5. Limitations to the study

This study will only look at one example of a hedging strategy, with one example of a derivative instrument, and will furthermore only consider the tax treatment for gains made in this regard.

The hedging strategy considered will be the practice of entering into a Single Stock Futures contract to ‘short sell’ a company’s shares already held, where it is anticipated that the value of the shares may decline in the future but it is not desired (or possible) to sell the actual shares themselves, in order to preserve the performance of the investment.

No consideration will be given to other common hedging practices such as ‘going long’ with Single Stock Futures to hedge the acquisition price of a share *not yet held*,¹² or other potential hedges such as, for example, foreign exchange hedges,¹³ or the hedging of trading stock still to be acquired or which is currently held.¹⁴

All other derivatives such as, for example, option contracts, swap agreements or agricultural derivatives are also excluded from this study. The research would equally be relevant to

¹² For the sake of completeness SAICA (*op cit* note 1) at 22, notes that international precedent determines the tax treatment of the profit or loss on such a hedge with reference to the nature of the underlying anticipated transaction. See also *ITC 1498* (1989) 53 SATC 260, discussed in 3.2 and 5.3 below, where a gain made whilst hedging the cost of acquisition of a capital asset was treated as capital in nature since the court decided that the forward exchange contracts hedge should ‘*assume the character of their originating cause*’.

¹³ These are not selected for the study because their inclusion would require consideration of section 24I which, it is submitted, does not fit within the ambit of this study and would better be evaluated in a separate research paper.

¹⁴ It is submitted that gains realised hedging the acquisition of trading stock would likely be seen to be revenue in nature, and so are not useful for purposes of this study which seeks to consider whether such gains can be capital in nature.

gains made hedging an underlying share *portfolio* with index futures contracts,¹⁵ whose use in the market is more ubiquitous. Only Single Stock Futures, as a specific subtype of forward contract, will however be considered. This is because the precise scenario on which SARS has expressed a strong, if perhaps unsubstantiated, view in the Share Owners Guide relates to Single Stock Futures, and also because Single Stock Futures allow for a ‘simple’ and ‘direct’ hedging example to be considered first (where a standardised, traded forward contract to sell the underlying share held is used to hedge anticipated losses on that particular share).

The treatment of losses realised on derivatives hedges is equally important (especially if a taxpayer seeks to treat such losses as revenue deductions) but this question will however be left as a matter for further research (to keep this study within required limits).

Finally, no consideration will be given to speculators or investors in Single Stock Futures alone – the focus of this study will only be on hedging a capital share portfolio using Single Stock Futures.

¹⁵ A derivative instrument whose value is based on price movements of a basket of equities.

CHAPTER 2 HEDGING WITH FUTURES

2.1. Introduction

In his book *Politics*, Aristotle recounts one of the earliest written records of using ‘futures’ in the story of a poor philosopher from Miletus named Thales. According to this anecdote Thales was criticised for his poverty, which apparently showed that philosophy was of no use. Thales however:

‘knew by his skill in the stars while it was yet winter that there would be a great harvest of olives in the coming year; so, having a little money, he gave deposits for the use of all the olive-presses in Chios and Miletus, which he hired at a low price because no one bid against him. When the harvest time came, and many were wanted all at once and of a sudden, he let them out at any rate which he pleased, and made a quantity of money. Thus he showed the world that philosophers can easily be rich if they like, but that their ambition is of another sort.’¹⁶

Thales therefore secured for himself (forward purchased) the exclusive right of use of these olive-presses in the future when the harvest would be ready, and because he correctly anticipated an increase in demand for olive-presses once the harvest was gathered, the canny philosopher ended up ‘in the money’.

Amongst the oldest known traded derivatives were the rice futures traded on the Dojima Rice Exchange in Osaka, Japan. These have been traded since the beginning of the eighteenth century.

In South Africa, traded Single Stock Futures were introduced by the SAFEX in 1999. These derivatives are now offered on approximately 600 JSE Securities Exchange (‘JSE’) listed companies.¹⁷

2.2. Entering into Single Stock Futures through the SAFEX

Single Stock Futures contracts are, at their core, forward purchase agreements whereby one party agrees to purchase listed shares from another party (who agrees to sell), at a specified

¹⁶ Aristotle, *Politics*, translated by Benjamin Jowett, book 1, chapter XI, n.d. Available: <http://classics.mit.edu/Aristotle/politics.1.one.html> [2014, January 1].

¹⁷ The JSE overview to Single Stock Futures. Available: <https://www.jse.co.za/trade/derivative-market/equity-derivatives/single-stock-derivatives/single-stock-futures> [2018, February 15].

price and on a specified future date. What makes a Single Stock Futures contract unique is that it is a forward purchase agreement concluded via an exchange (in this instance, the SAFEX).¹⁸ The conclusion of the Single Stock Futures contract is therefore governed, *inter alia*, by the ‘Derivative Rules’ for the SAFEX,¹⁹ as well as the Single Stock Futures contract specifications as set out by the JSE. As a result, the SAFEX regulates the implementation and operation of these Single Stock Futures contracts entered into by taxpayers.²⁰ Since a Single Stock Futures contract is an agreement to buy or sell one hundred shares in the stock underlying the derivative, at a certain future point in time, the notional value of the Single Stock Futures contract is, in the ordinary course, equal to one hundred times the value of the share underlying the futures contract.

When a taxpayer chooses to enter into a Single Stock Futures contract it is either to actually deliver (or to take actual delivery of) the underlying share contracted for upon expiry of the contract (referred to as ‘physically settled’ futures contracts), or alternatively to settle the Single Stock Futures contract in cash. Upon expiry the cash difference between the prevailing market spot price and the agreed contract price for the underlying share changes hands (referred to as ‘cash settled’ futures contracts).²¹

A physically settled Single Stock Futures contract entered into on the SAFEX always involves one party agreeing to sell the underlying share on a future date (adopting what is known as a ‘short position’), and another party agreeing to purchase that share on that future date (a ‘long position’). Upon the ultimate expiry of the contract, the short position would be required to perform through delivery of such underlying share. Conversely, performance by the long position entails the purchase of the underlying share by making payment of the ‘mark-to-market’ price²² for that share on the trading day immediately preceding the delivery day.²³

¹⁸ As opposed to a forward purchase concluded in terms of an ‘over the counter’ contract between the parties.

¹⁹ JSE, *Derivative Rules*, 28 April 2017 (hereafter the ‘Derivative Rules’). Available: <https://www.jse.co.za/content/JSERulesPoliciesandRegulationItems/DerivativesRules> [2018, February 15]

²⁰ They are therefore standardised contracts with set specifications regarding size (the number of shares per contract) and set expiry dates for the contracts.

²¹ In terms of paragraph (a) of the definition of ‘futures contract’ in the Derivative Rules, this is a contract where a person agrees to deliver the underlying instrument to (or receive it from) another person at an agreed price on a future date. In terms of paragraph (b) of this definition, a ‘futures contract’ also includes a contract where a person will pay to (or receive from) another person an amount of money according to whether, on the future date, the price or value of the underlying instrument is higher or lower than the agreed price on that future date.

²² The Derivative Rules define ‘mark-to-market’ as meaning the ‘revaluation of a position in the exchange contract at its current market value’.

²³ Rule 8.40.7 of the Derivative Rules provides that on the expiry of a physically settled futures contract the holder of a long position in the exchange contract shall buy the underlying instrument

In the case of cash settled futures contracts, upon expiry it is only the cash difference between the prevailing market spot price and the agreed contract price for the underlying share which is paid. The 'short position' holder makes payment to the 'long position' if the value of the underlying share has *risen* over the term of the contract. Where the price of the underlying has *decreased* over this period, the opposite is true, and it is the 'long position' holder who is required to make payment of this decrease in value to the 'short position' holder.²⁴

Once entered into, it is possible for the holder of a Single Stock Futures contract to exit the contract before the expiry date (known as 'closing the position'), by adopting an equal and opposite position in the same exchange contract.²⁵ Alternatively, the holder may decide to keep the contract until the expiration date and then 'roll the contract' (i.e. close the current contract and open a new, identical contract for a new future expiry date).

Importantly however it should be noted that the *economic benefit* of both physically settled and cash settled contracts is received over the life of the contract through the effect of the required 'margin payments', and not solely upon settlement on the expiry date.

The SAFEX places accessory obligations on the parties to a Single Stock Futures contract to make certain payments, known as 'margin payments', both when entering into the contract and then subsequently on a daily basis for the duration of the contract. These margin payments are made in order to protect the relative parties involved, as well as to protect the integrity of the SAFEX.²⁶ These margin payments are required as security in order to ensure that performance is actually made on the future date.

The margin payments prescribed by the SAFEX are as follows:

and the holder of a short position shall sell the underlying instrument, at the price equal to the expiry price.

²⁴ The Derivative Rules define a 'short position', in relation to futures contracts, as a position where the contracting party is '*obliged to make delivery of the underlying instrument at the agreed price on the future date or to pay an amount of money if, on the future date, the price or value of the underlying instrument is greater than the agreed price*'. Conversely, a 'long position' is defined as the situation where the individual is '*obliged to take delivery of the underlying instrument from the seller at the agreed price on the future date or to pay an amount of money to the seller if, on the future date, the price or value of the underlying instrument is less than the agreed price*'.

²⁵ Refer to the definition of 'close out' in the Derivative Rules. For example, a 'long' position in an exchange contract (i.e. a position where one agrees to acquire the shares underlying the future) is cancelled by entering into a 'short' position in the same exchange contract (i.e. a position in terms of which one agrees to sell such shares underlying the future).

²⁶ The SAFEX acts as the clearing house for all futures positions traded on the exchange.

- An initial deposit with the SAFEX, payable on conclusion of the futures contract, known as the ‘initial margin’,²⁷ and
- Additional payments to be made thereafter, on a daily basis, known as the ‘variation margin’. The amount to be paid on a daily basis is determined through a process known as ‘marking-to-market’.²⁸ This entails the payment, on the first day of the contract, of the difference between the price agreed in the futures contract and the market value of the underlying shares at the close of the first day. For each day thereafter, payment of the difference between the market value at the close of the previous day and the market value at the close of that day is made.²⁹

Upon expiry of a Single Stock Futures contract, or on the closing of a position, the economic effect of all cash flows representing margin payments effected by the parties over the period of the contract should reflect the total profit or loss to the holders of the reciprocal futures contract.

In the present instance, it is the variation margin payments received by the short position holder on a correctly placed hedge, before the position is closed out, that represent the gains which are being considered in this study.

The effect of variation margin payments is best explained by way of the following basic example, using a physically settled futures contract:

- The taxpayer enters into a Single Stock Futures contract on day 1 in terms whereof he agrees to sell 100 of the shares underlying the contract for R1 000 in three months’ time. The market value of the 100 shares on day 1 is also R1 000.
- On day 30, if the market value of the underlying shares:

²⁷ The amount of initial margin required is approximately 10% - 15% of the value of the underlying shares. This initial margin is in essence an estimate of the maximum amount that is likely to be lost in one day, and remains on deposit for as long as the open position is maintained.

²⁸ Rule 8.60.2 of the Derivative Rules provides that the variation margin shall be paid as a result of marking-to-market of an open position.

²⁹ The idea behind variation margin is that each contract is ‘settled’ each day, and thus only retains one day’s worth of credit risk, which remains offset by the initial margin deposited with the clearing house. The margining system is therefore effective in ensuring that both buyer and seller are constantly up-to-date in their profits and losses, thereby mitigating the risk of either party defaulting on a payment.

- i. Has increased by R30 to a value of R1 030, the taxpayer/seller would have been required to pay daily variation margin payments totalling R30 (over the preceding 30 days) to the purchasing counterparty (via the SAFEX).³⁰
 - ii. Has alternatively decreased by R20 to a value of R980, the purchaser would have been required to make daily variation margin payments to the taxpayer/seller totalling R20 over the period.³¹
- On day 90, when the taxpayer/seller is required to close out the Single Stock Futures contract, if the market value has remained unchanged since day 30, then the taxpayer tenders delivery of the underlying shares in exchange for the payment by the purchaser of the amount equal to the market value on the close of the day immediately preceding the delivery day (being either R1 030 or R980 in the above example).

Economically, the taxpayer has sold the underlying shares for the agreed R1 000 price, and the counterparty has paid the same agreed price, when the effect of the variation margin payments is added (or subtracted as the case may be) from the final market value price actually paid on delivery.

In the case of a cash settled futures contracts, the effect of the daily variation margin is that final performance upon expiry is only the payment of the difference between the market value at the close of the previous day and the market value on the date of expiry. The balance of the cash difference between the prevailing market spot price on expiry, and the originally agreed contract price for the underlying share, would already have been paid to the party who was 'in the money' by virtue of the daily variation margin payments effected.

³⁰ Where the price of stock has risen subsequent to the conclusion of the Single Stock Futures contract, the purchaser may be concerned that the seller would not honour the Single Stock Futures contract because he may be tempted to dispose of the underlying shares in the market for more than the agreed price of R1 000. In that case, the purchaser receives security in the form of the variation margin payments from the seller.

³¹ Where the price of the underlying stock has dropped since the conclusion of the Single Stock Futures contract, the seller may be concerned that the purchaser would rather acquire the underlying shares in the market for the lesser value (i.e. R980), than honour the agreed Single Stock Futures contract. The seller therefore receives security, in the form of the variation margin payments from the purchaser.

2.3. The concept of 'hedging'

The concept of 'hedging', in the sense of *'to insure oneself against loss, as in a bet, by playing something on the other side'*, dates from 1670's.³²

One of the most notable developments in this regard was the formation in the nineteenth century of the forerunner to the present day Chicago Mercantile Exchange (the world's largest modern futures exchange), in order to standardise a practice that had developed in the area. At around that time, agricultural commodity producers and merchants in America's mid-west had started to enter into contracts to establish the price of grain commodities to be delivered at a specific date in the future, before the commodities were harvested (i.e. a forward contract). Both the producers and the merchants did this in order to protect themselves against subsequent unfavourable price fluctuations, which were frequently caused by surpluses and shortages of these grain products. These contracts therefore enabled both the producers and the merchants to 'cash forward' and insulate themselves from the risk of adverse price change.

The hedge is a procedure used to offset or counterbalance risk (such as, for example, price risk) associated with an underlying transaction. For the risk to be managed with the hedge, an instrument is required whose value displays a high degree of inverse correlation with the value of the position hedged.³³

In the modern commercial environment, a hedge would therefore be most simply described as follows:

*'To use two compensating or offsetting transactions to ensure a position of breakeven; to make advance arrangements to safeguard oneself from loss on an investment'*³⁴

In the context of a share investment, a hedge may therefore be utilised by the share investor to mitigate the risk of potential losses which are anticipated to occur.

³² Refer to the definition provided for the term 'Hedge' in the Online Etymology Dictionary. Available: <http://www.etymonline.com/index.php?term=hedge> [2014, January 2].

³³ Sub-committee of the Tax Advisory Committee (*op cit* note 5), at 63.

³⁴ Black's Law Dictionary, 2007 8th Edition. See also the Oxford Online Dictionary: *'Protect oneself against loss on (a bet or investment) by making balancing or compensating transactions'*. Available: <http://www.oxforddictionaries.com/definition/english/hedge> [2014, November 26]. Merriam-Webster's online dictionary definition of 'hedge' as *'to protect oneself from losing or failing by a counterbalancing action'* accords with this. Available: <http://www.merriam-webster.com/dictionary/hedge> [2014, November 26].

According to the JSE, one of the reasons why investors in the stock market make use of Single Stock Futures is to 'hedge' their portfolio. In the view of the JSE:

*'Hedgers seek to reduce risk by protecting an existing share portfolio against possible adverse price movements in the physical (or spot) market. Hedgers have a real interest in the underlying shares and use futures as a means of preserving their performance.'*³⁵

This is precisely the scenario envisaged in this study. Whilst a gain is realised on the Single Stock Futures contracts (which SARS, according to the Share Owners Guide, proposes to tax on revenue account), they are entered into in order to: (i) guard against losses in value in an underlying capital investment, brought about by adverse share price movements; and (ii) preserve the growth performance which that share had already generated.

This objective is achieved when entering into a short position in respect of the underlying shares held, which the shareholder doesn't wish to actually sell, because the shareholder receives a variation margin payment over the life of the contract if the value of the shares does drop as anticipated. The shareholder has therefore been able to *hedge* the fluctuations in the underlying share price, and may be said to be 'hedging' a long position (the investment) by entering into a short position (the sale) in respect of that share.³⁶

³⁵ JSE, *'Powerful tools for investing, speculating and hedging'*. Available: <https://www.intrepidcapital.co.za/Portals/0/JSE%20Documents/Brochure%20-%20Equity%20SSF.pdf> [2018, February 15].

³⁶ Mathematically, the return from a short position should be equivalent to that of owning (being long) 'a *negative amount*' of the underlying instrument.

CHAPTER 3 SOUTH AFRICAN CASE LAW ON DERIVATIVES HEDGING

It is appropriate to start this analysis with a brief review of some existing South African decisions regarding the taxation of gains made from derivative instruments and/or gains derived from the employment of hedging strategies. Whilst these may not directly answer the question at hand, they are still a source to which reference can and should be made when determining the nature of gains made hedging a capital share investment with Single Stock Futures.

3.1. Income Tax Case No 43

In *ITC 43* (1925),³⁷ the first South African case on the taxation of futures, the taxpayer (a country storekeeper who entered into transactions in grain and other produce as part of his business) had accepted an offer for the future delivery of grain. When there was a sudden rise in the price of grain, the suppliers (facing a loss on these futures contracts) paid the taxpayer certain amounts as consideration for their cancellation. The taxpayer took the view that these amounts were ‘gamblers in futures’ and as isolated, speculative transactions did not fall to be included in his gross income. The taxpayer’s argument was in effect that these amounts did not relate to his profit-making activities. This was, it is submitted, a flawed approach to adopt.

On appeal against their inclusion as gross income by the Commissioner, the court held that the profit realised by the taxpayer (as a dealer in produce) with a futures contract for grain was itself also a ‘deal in produce’ and fell within the scope of his business. The amounts were therefore held to be taxable, as it was the court’s view that the profit depended very much on the knowledge the appellant had acquired through his occupation as a dealer in produce.³⁸ To the extent that the decision was based upon an assessment of the closeness of connection to the taxpayer’s profit-making activities this case does not offer much assistance in addressing the problem question.

3.2. Income Tax Case No 340

In *ITC 340* (1935),³⁹ the taxpayer made gains using forward exchange contracts which had been entered into in order to meet amounts of Pound Sterling for which his trading business

³⁷ 2 SATC 115.

³⁸ *Ibid* at 115.

³⁹ 8 SATC 362.

was liable in terms of orders for the import of goods from the United Kingdom, made in connection with that business.

The court was of the view that the taxpayer had not only intended to mitigate potential loss, but in fact had an intention to make a profit from the forward exchange contracts as well. However, it was ultimately unnecessary for the court to decide on this aspect. Since the orders were an integral part of the taxpayers business (i.e. the acquisition of trading stock), the profit derived on the forward exchange contracts taken out in respect thereof was seen by the court to be part of the taxable profit derived from that business.⁴⁰ Similar to the previous decision, the closeness of connection to the profit-making activities drove the decision in this case. This is also therefore of limited use in the present instance.

3.3. Income Tax Case No 1498

In *ITC 1498* (1989),⁴¹ the taxpayer made a gain hedging the cost of acquisition of a capital asset in the form of a printing press from the United States of America. The taxpayer had hedged its Dollar denominated foreign capital expenditure by making use of forward exchange contracts. Jennett J held that the gains realised were of a capital nature since *'there is no reason why the foreign exchange contracts which relate to the repayment of the loan for the purpose of acquiring the printing press should not assume the character of their originating cause'*.⁴²

This case is therefore of far more assistance in addressing the problem question and will be considered again in more detail in 5.3 below.

3.4. Income Tax Case No 1756

In *ITC 1756* (1997),⁴³ futures contracts were entered into by the taxpayer to hedge the cost of acquisition of an intended long-term share portfolio. On an appeal by the taxpayer against the inclusion of gains made on these futures contracts in its gross income, the court expressed the opinion that the evidence led by the taxpayer did not adequately place it in a position to be able to adjudicate on whether the gains in question resulted from a scheme of profit-making, and had it been required to answer the question on its merits (it was not, due to the case being decided on a technicality), the court indicated that it would have had

⁴⁰ *Ibid* at 365.

⁴¹ 53 SATC 260.

⁴² *Ibid* at 265.

⁴³ 65 SATC 375.

no option but to find against the taxpayer on the basis that it had failed to discharge its onus of proof.

As one of the authorities cited by SARS in support of their comments in the Share Owners Guide, this case is examined in more detail in 4.2 below.

3.5. Income Tax Case No 1223

In *ITC 1223* (1974),⁴⁴ the taxpayer company was set up as a family investment vehicle to maintain the family in the future. As part of the diversification of the investment portfolio, the taxpayer invested in shares in various listed companies. Due to concerns over the potentially imminent decline in share prices in the market, the taxpayer however disposed of all of these share investments (at a profit) within one year of their acquisition.

Notwithstanding the short holding period, the court found that the profit realised on the disposal of the shares in question (other than those acquired in newly listed companies and disposed of shortly after their listing) was capital in nature because the shares had been disposed of in order to protect the taxpayer's capital and not as part of a profit-making scheme.⁴⁵ The applicability of this decision to answering the problem question is therefore also potentially problematic, given that hedging with Single Stock Futures contracts (though achieving the same economic result) avoids the need to liquidate an entire investment.

In the next chapter we will consider in more detail the SARS' position stated in their Share Owners Guide, and the authority cited in support thereof.

⁴⁴ 37 SATC 24.

⁴⁵ *Ibid* at 28-29.

CHAPTER 4 THE SARS VIEW

4.1. Introduction

Given its inclusion under the heading '*Low or nil return*' in the Share Owners Guide, in the context of general principles to be considered when deciding on a matter of capital or revenue interpretation, one is left with the impression that SARS considers the fact that futures contracts derive no return for the holder (such as dividends or interest) to mean that, *ipso facto*, their acquisition and sale should be treated as a revenue transaction.⁴⁶

In order to consider whether SARS' stated position in their Share Owners Guide should be accepted as a proper exposition of the law in this regard, this study continues with a review of the authority cited in support of the taxation of the sales of futures contracts on revenue account even where used as a hedge against losses on underlying shares held as capital assets.⁴⁷

4.2. Income Tax Case No 1756

The Appellant taxpayer in *ITC 1756* (1997) was a trust established during 1974 for the benefit of the donor's grandchildren. Upon the death of the donor some years later the trust inherited her major shareholding in a private company. When the value of this asset was subsequently realised during October 1987, the trustees determined that the R15 million realised should be invested in the share market, so that the portfolio could be professionally administered for the donor's grandchildren '*with growth potential as the main object*'.⁴⁸

The investment strategy was to acquire 'blue chip' shares. However the prevailing economic collapse in world stock markets in late 1987 hindered the trust in its ability to acquire the shares which it sought. The portfolio administrators utilised by the trustees felt that the combination of the desired intention to acquire a long-term share portfolio, and the prevailing political and economic uncertainty, necessitated a 'dual strategy' of investing

⁴⁶ This, and other similar factors which are not *per se* definitive (such as the 'fruit and tree' analogy) will be dealt with in more detail in Chapter 6 below.

⁴⁷ The authority cited by SARS is *ITC 1756* (1997) (*supra* note 43), decided in the Cape Tax Court, and the English Court of Appeal decision in *Wisdom v Chamberlain (Inspector of Taxes)* [1969] 1 All ER 332.

⁴⁸ *ITC 1756* (1997) (*supra* note 43) at 378. The trustees determined that the share portfolio was to be managed according to the certain guidelines, *inter alia*, that maximum capital growth was a priority, that a medium- to long-term investment philosophy was to be followed which was not speculative in nature, that any changes in investments were to be carried out to preserve capital values or income generating potential and that professional portfolio administrators were to be utilised, and that they should be given full discretion to ensure the optimisation of these agreed investment objectives.

available cash on hand in short-term deposits, whilst simultaneously hedging against possible increases in the price of the unavailable shares sought, through the acquisition of 'All Share Futures' contracts.

The aim of this strategy was to secure the highest possible income return in the short-term (via the high yielding short-term cash deposits selected), and to ensure the long-term future dividend stream of the trust by fixing the cost at which the desired shares would be purchased as and when they became available in due course.⁴⁹ It was felt by the trustees that this dual strategy would best manage the risk inherent in building up the intended long-term portfolio too quickly.

In deciding to enter into these futures contracts, the trustees of the Appellant followed the advice of the portfolio administrators, who had explained that these contracts should be acquired in order to maintain an adequate income stream for the trust through the cash investments while still gaining access to the desired blue chip shares which were, at that time, not readily available in the necessary quantity. The trustees were assured that the use of the futures contracts was not speculative.⁵⁰ The object of the futures contracts was therefore to manage the risks inherent in building up the intended long-term share portfolio, by hedging the cost of acquisition of the assets. It was not to derive profits by trading in the futures contracts.

The relevant 'All Share Futures' contracts were therefore purchased in February 1988, and subsequently sold in March 1989. Total gains of R537 085 were realised on the sale of these contracts.

In the 1992 year of assessment the Appellant realised some of the shares in its portfolio. The trustees contended that the gains made on the realisation of these shares were capital in nature and are therefore not taxable.⁵¹ The Commissioner disagreed with this contention and included gains in the amount of R1 241 667 in the assessment of the Appellant's taxable income for the 1992 year. In addition however to the gains realised on the sale of the shares in the portfolio the Respondent also included in the 1992 year of assessment the R537 085 in gains realised in March 1989 *on the sale of 'All Share Futures' contracts*. For present purposes, only the gains realised on the sale of 'All Share Futures' contracts (and not the

⁴⁹ *Ibid* at 378.

⁵⁰ *Ibid* at 382. In the face of conflicting testimony from the Appellant's two witnesses, the court accepted that, on balance, the futures contracts were entered into to insure the trust against a rise in share prices.

⁵¹ The trustees realised the shares to, firstly, finance building renovations on a commercial investment property which the Appellant owned and secondly because certain of the shares disposed of no longer fit with the Appellant's portfolio requirements.

decision regarding the capital or revenue nature of the gains made from the realisation of shares in the investment portfolio) are relevant.⁵²

The court found that the determination of the taxability of gains made on the sale of 'All Share Futures' contracts raised a novel issue which had not yet received the attention of our courts. Unfortunately, in the opinion of the court, the evidence led by the Appellant did not adequately place it in a position to be able to adjudicate on whether the gains in question resulted from a scheme of profit-making.⁵³ In order to make such a determination, the court was of the view that it would need to consider both the precise nature and operation of the 'futures market', as well as the particular transactions entered into by the Appellant. The Appellant failed to adduce sufficient evidence on both counts.

What the court then said in this regard was that, had it been required to answer the question on its merits, it would have had no option but to find against the Appellant on the basis that it had *failed to discharge the onus of proof* which it bore and in terms of which it was required to show, on the balance of probabilities, that the Respondent had incorrectly included the amount of R537 085 in its taxable income. That question was however, not required to be answered on its merits once the court had established that the 'All Share Futures' contracts were in fact sold by the Appellant on 15 March 1989, since the profit on such sale accrued during the tax year which ended on 28 February 1990 (and did not as a result form part of the Appellant's taxable income for the tax year ended 29 February 1992, where it had been included by the Respondent).⁵⁴

4.3. Wisdom v Chamberlain (Inspector of Taxes)

In the English decision in *Wisdom v Chamberlain (Inspector of Taxes)* (1969)⁵⁵ the taxpayer was advised that it was important to guard against a loss in the value of his capital

⁵² Which, incidentally, were held to have been disposed of on capital account by the Appellant. As such the gains of R1 241 667 made in the 1992 year were capital in nature and did not fall to be included in the gross income of the taxpayer. The court was satisfied that, on the evidence before it, the trustees of the Appellant were not engaged in a scheme of profit-making on the sale of the shares in the portfolio, and that furthermore they did not, at any stage, have a secondary or alternative (dual) purpose of making profits out of the shares of the trust.

⁵³ See in this regard however the comments of certain writers that the court upheld the argument that the period for which a financial instrument is held cannot in and of itself be decisive of the nature of the investment (Olivier, L. 2010. *Law of Taxation*, Annual Survey of South African Law, at page 947).

⁵⁴ *ITC 1756* (1997) (*supra* note 43) at 386 to 388. In terms of section 5(1) of the Act, a taxpayer is only liable for the normal tax which can be levied upon taxable income received by or which accrues to him in that year of assessment. Consequently, the Appellant's objection against the inclusion of the gains made from the sale of the 'All Shares Futures' contracts in March 1989 as part of the assessment of taxable income for 1992 was upheld. In the court's view, not doing so would require the Appellant to have to pay tax on an amount not received by, or accrued to, it in the relevant year of assessment.

⁵⁵ *Supra* note 47.

assets which could be occasioned in the event of a devaluation of the Pound Sterling.⁵⁶ He was advised to make another investment which would maintain its value against the US Dollar, which other investment should be saleable at a profit in the future in the event that there was any drop in the Pound Sterling value.⁵⁷

Therefore, the other investment was to serve as a hedge against the loss which would be occasioned by such a drop in value of the taxpayer's Pound Sterling assets. The assets selected for investment were ingots or bars of silver.⁵⁸

When the threat of a Pound Sterling devaluation had lifted, and coincidentally when the price of silver had also risen significantly, the taxpayer decided that the silver ingots should be sold, which duly realised a total profit of some £48 000.⁵⁹

The commissioners for income tax determined that this profit was derived from an '*adventure in the nature of trade*', and was therefore taxable,⁶⁰ notwithstanding the fact that it was accepted that the taxpayer's original intention in purchasing the silver was to act as a hedge against devaluation. This adventure in the nature of trade was, in the opinion of the commissioners, indicated *inter alia* by the fact that the nature of the silver ingots invested in was not that of an income-producing asset suitable for a long-term investment.⁶¹

On appeal by the commissioners,⁶² the Court of Appeal took the view that the transactions were entered into '*on a short-term basis for the purpose of making a profit out of the purchase and sale of a commodity*'. This was for the court a clear adventure in the nature of trade because '*the object of the transaction was to make a profit*'. The fact that the reason for wanting to make a profit was that it was expected that a loss would be made on devaluation, did not change the fact that '*the motive and object of the whole transaction*

⁵⁶ In 1961 (and again 1964 and 1966) the Pound Sterling came under pressure since the exchange rate against the US Dollar was considered too high.

⁵⁷ *Wisdom v Chamberlain (Inspector of Taxes)* (1969) (*supra* note 47) at 334-335.

⁵⁸ *Ibid* at 335. This was in the opinion of the taxpayer's financial advisor a stable commodity, which had not varied in value by more than 5% in the previous six years, and which would maintain its value and be sold at a good profit against the US Dollar if the United Kingdom devalued its Pound Sterling.

⁵⁹ *Ibid* at 335.

⁶⁰ In terms of the prevailing legislation, tax was exigible in the United Kingdom in respect of 'any trade carried on in the United Kingdom'. The definition of 'trade' in turn included 'every trade, manufacture, adventure or concern in the nature of trade'. This definition therefore enlarged the ambit of the taxing section, because the activity need not be a 'trade' in order to be taxable, provided it was an 'adventure in the nature of trade'.

⁶¹ *Wisdom v Chamberlain (Inspector of Taxes)* (1969) (*supra* note 47) at 336. This view as to the unsuitability of the ingots for long term investment was strengthened by the fact that their acquisition was financed by high interest loans.

⁶² The taxpayer's objection to the commissioner's assessment having been upheld by the court *a quo* on the basis that because it was a *hedge* against devaluation, it was *not* a trading adventure. Refer to *Wisdom v Chamberlain (Inspector of Taxes)* [1968] 2 All ER 714.

was to buy on a short-term basis a commodity with a view to its re-sale at a profit.⁶³ It was not, in the mind of the court, any less of a trading adventure merely by virtue of the fact that it was something to offset a loss occasioned by (i.e. to act as a hedge against) devaluation. The fact that the 'hedge' was seemingly entirely unrelated to the underlying asset being protected clearly played a significant role in this decision.⁶⁴

In the next chapter we will consider arguments for the determination of the tax nature of a derivatives hedge based on analogy.

⁶³ *Wisdom v Chamberlain (Inspector of Taxes)* (1969) (*supra* note 47) at 336.

⁶⁴ See 7.2.2 below for further comment on the impact which this has on the suitability of this authority for SARS' expressed view.

CHAPTER 5 DETERMINING THE TAX NATURE OF A DERIVATIVES HEDGE BY ANALOGY

5.1. Introduction

This chapter will set out various arguments which, it is submitted, should be taken into consideration when determining the nature of any gains made by a taxpayer when hedging losses on underlying shares held as capital assets with a derivative.

These arguments determine the tax treatment of the derivative hedge by means of comparison and may be broadly classified as follows:

- The derivative hedge is akin to an insurance contract, and the tax treatment should follow this analogy; or
- The tax treatment of the derivative hedge should follow the analogous tax treatment of the underlying asset.

These arguments will be discussed in more detail under separate headings in this chapter.

5.2. The derivative hedge is akin to an insurance contract, and the tax treatment should follow this

5.2.1. The 'substitution' guideline

The common thread underlying this argument is that where an amount received is intended to act as an effective 'substitute' for something else lost or given up, the income tax nature of this receipt needs to be determined with reference to this substitution.

This so-called 'substitution' guideline developed into South African tax law when the need for a new method of determining the capital or revenue nature of a receipt arose because none of the general guidelines developed to that point found precise application. The principle is based on English jurisprudence, viz the decision in *Burmah Steam Ship Co Ltd v IRC* (1930).⁶⁵ This case dealt with damages which were awarded in compensation for a

⁶⁵ (1930) 16 TC 67 (Court of Sessions), 1931 SC 156. This test appears to have been adopted into South African law as far back as 1942 – refer for example to *ITC 527* (1942) 12 SATC 430. It is noted that this idea is not just seen in our tax law, or in the English law from which it is derived, but is also seen in Australian tax law. In the case of *FCT v Dixon* (1952) 86 CLR 540 the court says at 568: '*But it is intended to be, and is in fact, a substitute for – the equivalent pro tanto of – the salary or wages which would have been earned and paid if the enlistment had not taken place. As such, it must be income, even though it is paid voluntarily and there is not even a moral obligation to continue making the payments. It acquires the character of that for which it is substituted and that to which it is added.*'

delay in delivering a ship, which damages were based on an estimate of the loss of profits. These damages were held to fall within ‘profits or gains’, and were therefore assessable, since the court found that they:

‘must go, as a matter of proper commercial accounting to “fill the hole” in the appellant’s profits’⁶⁶

The test to be applied as laid down in this case therefore consists of the following essential question:

‘Which hole was the receipt to fill, a hole in the profits or a hole in the assets?’⁶⁷

If the amount received in substitution fills a hole in the profits of the taxpayer, the payment will generally be regarded as income. Similarly if it fills a hole in the capital structure of the taxpayer, the receipt would be regarded as capital in nature.

Whilst originally developed in the context of damages, this guideline is today applied to the receipt of an amount:

- constituting damages (i.e. an amount paid by one person to another, as compensation for any loss or damage suffered by the latter as a result of the unlawful act or breach of contract of the former);⁶⁸
- as compensation for the renunciation of a right;⁶⁹ or

⁶⁶ Lord Clyde stated as follows at 71: *‘Suppose someone who chartered one of the Appellant’s vessels breached the charter and exposed himself to a claim of damages at the Appellant’s instance, there could, I imagine, be no doubt that the damages recovered would properly enter the Appellant’s profit and loss account for the year. The reason would be that the breach of the charter was an injury inflicted on the Appellant’s trading, making (so to speak) a hole in the Appellant’s profits, and the damages recovered could not therefore be reasonably or appropriately put by the Appellant – in accordance with the principles of sound commercial accounting – to any other purpose than to fill that hole.’*

⁶⁷ See also *Estate A G Bourke v CIR* 1991 (1) SA 661 (A), 53 SATC 86 where Hoexter JA confirms this test at 93 as follows: *‘a test which is sometimes applied is to ask the question whether the compensation was designed to fill a hole in the taxpayer’s profits, or whether it was intended to fill a hole in his assets’.*

⁶⁸ See for example *ITC 723* (1951) 17 SATC 496 where the court comments as follows at 496: *‘It seems clear that an amount received such as the present, by way of damages ... is income and not capital, if the transaction out of which the claim for damages arose is a transaction which, had it been completed, would have resulted in an income and not in a capital gain or loss as the case might be.’*

⁶⁹ See for example *CIR v Illovo Sugar Estates Ltd* 1951 (1) SA 306 (N), 17 SATC 387 at 393 where the court stated that because the canefields in question (which were requisitioned by the military and naval authorities) had a long life span and were *‘an essential part of the equipment of the cane-grower’s income-producing machine’* (and therefore part of his capital) the compensation received for the premature termination of the leases over these farms (i.e. the renunciation of a right over these farms) was capital in nature.

- in terms of an insurance contract.⁷⁰

It is the last of these, namely the contract of insurance, which it is proposed is applicable to the futures hedge in question in this dissertation.

The essential element of the ‘substitution’ guideline is the *function* which the substituted amount fulfils in the hands of the recipient taxpayer. It is this element which must be determined for the application of the rule to yield an answer as to the capital or revenue nature of the amount received.

However, given the direct correlation which is drawn between the amount replaced and the amount received in substitution, in certain instances it is also necessary to consider the actual *nature* of that which is lost in order to apply the substitution guideline properly.⁷¹

Given the statements in *ITC 594 (1945)* (where the court determined that the nature of an amount which is received in terms of an insurance policy takes its character from the nature of the amount which it replaces),⁷² and given that the analogy drawn to futures hedging is that it is akin to an insurance contract, it is submitted that one should in the present context evaluate the gain derived from the futures position both in terms of the *function* which it fulfils and the *nature* of the amount lost and substituted.

5.2.1.1. *Function fulfilled by the substituted amount*

The decision in *Tauber & Corssen (Pty) Ltd v SIR (1975)*⁷³ illustrates how, in the application of the substitution guideline, determining the function of the compensation in the hands of the recipient aids in determining the tax nature of the receipt. In this case an agent who agreed not to sell products in competition with its principal for a period of two years after the termination of their agency agreement, and who was compensated as a result, was seen to have agreed to a reduction in the scope of its *income-producing machine*. Consequently, the compensation received was paid in respect of the sterilization of the taxpayer’s rights to deal in the competitive products, and was held to be a receipt of a capital nature. It should be noted that the amount was not paid as compensation *in lieu* of future commissions which were lost, and was equally not capital in nature merely because it was compensation for the termination of the agency agreement itself (i.e. compensation for the

⁷⁰ See *ITC 594 (1945)* 14 SATC 249 at 250, also discussed below, where the court determined that the nature of an amount which is received in terms of an insurance policy takes its character from the nature of the amount which it replaces (i.e. the amount which would have been received but for the occurrence of the event insured against).

⁷¹ Refer to *Estate A G Bourke v CIR (1991)* (*supra* note 67).

⁷² *Supra* note 70 at 250.

⁷³ 1975 (3) SA 649 (A), 37 SATC 129.

loss of a capital asset), but was rather capital in nature because it functioned to sterilize the taxpayer's rights to deal in competitive products.⁷⁴

The following instances further exhibit how the *function* which the substituted amount fulfils can determine the tax nature of the receipt:

- Damages paid to a lessor to compensate for the capital costs incurred in effecting structural changes to the leased premises, necessary to be able to lease it once again, were capital in nature because the damages functioned to compensate the taxpayer for the decrease in the value of his income-producing asset;⁷⁵
- A settlement paid to a taxpayer in respect of a claim for damages for a failed joint venture was revenue in nature, because the joint venture was a scheme of profit-making and the settlement functioned to terminate the taxpayer's claim for compensation for the revenue amounts that would otherwise have been derived;⁷⁶ and
- Where the taxpayer receives an amount as compensation for a restraint placed on his right to claim damages for the reduction in his capacity to earn income, the receipt is capital in nature since it functions to compensate the taxpayer for a renunciation of his right to claim damages stemming from the injury to his income-producing ability.⁷⁷

As can be seen, this determination of the nature of the compensatory amount on the basis of the function which the amount fulfils in the hands of the taxpayer is dependent upon the facts.

Often, this factual determination is simply made (incorrectly, it is submitted) with reference to the mechanism used to formulate the quantum of the compensatory amount paid. For example, damages paid to a taxpayer for personal injury which meant that the taxpayer was unable to work could be either revenue or capital in nature depending upon whether the

⁷⁴ The court says at 140: *'What the parties intended, therefore, was a payment of a sum of money to restrain the appellant, for a period of two years, from earning income by the sale of all products competing ...'*

⁷⁵ See *ITC 1038* (1963) 26 SATC 123 at 129-131.

⁷⁶ See *ITC 723* (1951) (*supra* note 68) at 498 where the court states: *'It suffices to say that the appellant has not satisfied the Court ... that the joint venture was not a venture entered into for the purpose of a profit-making scheme and that being so ... any sum which the appellant recovered by way of settlement of an action for damages brought against the builder for his breach of the joint venture is income and not capital.'*

⁷⁷ See *ITC 1289* (1979) 41 SATC 149 at 152-153 where the court says: *'The appellant had a reputation of being an outstanding sales promoter which, in my view, is the appellant's ability to earn income and is comparable to his 'income-producing machine'. The tarnishing of his reputation is, therefore, of a capital nature in that his ability to earn income is diminished. The agreement not to sue is a restraint to claim compensation for his reduced capacity to earn income.'*

formulation of such damages was with reference to lost income or lost income earning potential. The function of said damages could be seen to act as compensation for lost income (and be revenue in nature) if simply calculated with reference to lost income, or as compensation for the taxpayer's loss of his income earning potential (and capital in nature) if calculated with reference to the depreciation in value of his income earning machine.

5.2.1.2. *The nature of the amount which is lost and substituted*

The test in *Burmah Steam Ship* (1930), considering the *function* of the substituted amount, is however not always conclusive. In *Estate A G Bourke v CIR* (1991),⁷⁸ Hoexter JA stated that '*the fact that what is plugged is a hole in assets, does not by itself, conclude the inquiry*'. It is also necessary to consider the actual *nature* in the hands of the taxpayer of that which is lost.

The court refers to Broomberg's *Tax Strategy*,⁷⁹ where the author states as follows:

'Of course, it is not sufficient to establish that the compensation is being paid in order to fill a hole in the taxpayer's assets. It is necessary, in addition, to ascertain the true nature of that asset in the recipient's hands. More particularly, was the asset, prior to its destruction or damage, an asset of a capital nature or was it floating capital? If it was floating capital, such as trading stock, standing crops, or consumable stores (like petrol, oil and so forth) the compensation will, obviously, be of a revenue nature, and will be subject to tax. In short, it is only where the payment received is to fill a hole in the capital assets of the taxpayer that the payment will escape the tax net'

In the case of *Estate A G Bourke v CIR* (1991) the taxpayer was compensated, *inter alia*, for the destruction in a fire of pine trees grown as part of a timber plantation business which was being conducted. Applying the *Burmah Steam Ship* (1930) test of identifying the function fulfilled by the compensatory amount leads to the conclusion that the amount received was as compensation for the destruction of an asset (namely, the pine trees). Counsel for the taxpayer submitted that prior to their being felled, this asset formed part of the income providing structure of the taxpayer and the compensation received was therefore capital in nature.

However, on the basis of the nature of the business carried on by the taxpayer in relation to these trees, the Appellate Division found that they formed part of the 'floating capital' of the

⁷⁸ *Supra* note 67 at 93.

⁷⁹ 2nd Edition (1983) at 199-200.

taxpayer's business and the compensatory amount received in respect of their destruction was revenue in nature. Hoexter JA stated as follows:

'It is clear, in my opinion, that the pine trees on the property represented a trading asset of the trust ... that having regard to the essential nature of the business of the trust and the syndicate the pine trees on the property constituted trading stock as defined in s 1 of the Act'.⁸⁰

The principle applied was that the nature of the substituted amount was determined by the nature (in the hands of the taxpayer) of the asset replaced.

The following instances further exhibit how the *nature* of that which is lost in the hands of the taxpayer can determine the tax nature of the substitute receipt:

- Where a tangible asset is damaged or destroyed, recourse should be had to the nature of the profit which would have been made, had that asset been realised, in order to determine the capital or revenue nature of the compensation in the hands of the taxpayer. Where an intangible asset such as an agency agreement is cancelled, the nature of the compensation received is decided by the question of whether or not the contract formed a major part (though not necessarily the whole) of the structure of the taxpayer's business. If so, the compensation is capital. If not, and the cancellation of the agreement doesn't affect a major part of the business of the taxpayer, then the compensation could be seen to merely be for lost profit (and therefore revenue in nature).⁸¹
- Where compensation is paid for the expropriation of rights, which expropriation amounted to the sterilisation of a capital asset, the compensation was viewed as capital in nature.⁸²

⁸⁰ *Supra* note 67 at 95.

⁸¹ *Broomberg on Tax Strategy*, 5th edition (2012) at 247-248, and the reference to *ITC 1557* (1992) 55 SATC 218 where the tax court stated that *'where the true nature of the transaction is that a company ... is paid compensation for giving up, or closing down a particular branch of its business ... the compensation is capital of nature. It matters not whether the business closed down is the whole, or a significant part of the business'*.

⁸² In *CIR v Illovo Sugar Estates Ltd* (1951) (*supra* note 69) the nature of the canefields in the economy of Illovo Sugar was such that they formed an essential part of the income producing machine, and the compensation for the loss thereof was capital in nature. Conversely, the nature of the sugarcane itself that was destroyed was trading stock in the hands of the taxpayer and the compensation in respect thereof was revenue in nature.

- In contrast, compensation paid to the lessor in substitution for the rental not received in terms of a rental agreement that was breached, was revenue in nature.⁸³

From the above, it becomes clear that the application of these guidelines as distinct from one another becomes somewhat of a matter of degree, which could, it is submitted, lead to uncertainty.

5.2.2. Professional commentary on the insurance analogy argument

In the first of his series of articles on the subject, Byala (1993) submits that:

*‘any receipt or accrual resulting from the hedging of a capital asset will itself be of a capital nature; for example, a put option to protect against the diminution in value of a long-term interest bearing investment’.*⁸⁴

Byala (1993) sees this sort of hedging transaction as being akin to an insurance policy, and the determination of whether the receipt is capital or revenue in nature is dependent upon whether the proceeds received are designed to *‘fill a hole in income or in capital’*. In the learned author’s view, provided there is a genuine hedging intention, *‘amounts received or accrued will be regarded as simply restoring a capital asset to its original value and thus not be subject to tax’.*⁸⁵ The case of *Taeuber & Corssen (Pty) Ltd v SIR* (1975) *supra* is cited as support for this statement.

Hutton (1998:166) refers to the views of Byala (1993),⁸⁶ and makes reference to the *Burmah Steam Ship* (1930) case as authority for the insurance analogy postulated. By way of further illustration of this argument Hutton (1998) then contrasts the following two South African tax cases:

- In *ITC 594* (1945) *supra*,⁸⁷ where insurance proceeds were considered to be revenue in nature since they were recovered in respect of *lost profits* resulting from a fire, Ingram CJ (with reference to the *Burmah Steam Ship* (1930) case, amongst others) applied the idea that the compensatory amount received *‘assumes the character of the accrual for which it is substituted’*.

⁸³ In *ITC 312* (1934) 8 SATC 154 the court says at 156: *‘The contract was a contract of lease, and it seems to me that a lump sum paid in lieu of, or as compensation for, the balance of rent due for the period stipulated, is a sum paid under and by virtue of the letting of the property’*.

⁸⁴ Byala, B. 1993. ‘Financial futures and options I’ *Tax Planning* 7(5):101-106 at 104.

⁸⁵ *Ibid* at 104.

⁸⁶ Hutton, S. 1998. ‘The Taxation of Derivatives in South Africa’ *The Taxpayer* 47:163-171.

⁸⁷ *Supra* note 70.

- The case of *ITC 942* (1960)⁸⁸ is then distinguished from *ITC 594* (1945) *supra*. The proceeds of an insurance policy taken out by a company over the life of its director and shareholder were held to be capital in nature since the purpose of the policy was to preserve the *income-making machine* on the death of the insured (should the company owe a large sum of money on loan account to the deceased, which could lead to the company's liquidation if any attempt was made by his executors to compel payment of this loan account at the time of his death).

Whilst Brincker (2011) also makes reference to this insurance argument (questioning whether the taxpayer is filling a hole in profits or in the income earning structure) in order to determine the character of the proceeds realised from a derivative hedging transaction, he is of the view that this argument should be relegated. He states at 4.1.4 under the heading of 'Hedging and quasi-insurance' that:

'It is not correct to merely use the argument that a derivative should be seen to be similar to an insurance contract and, for that reason, that the proceeds arising from the derivative contract entered into as a hedge for an underlying capital asset should thus also be capital in nature'.⁸⁹

Brincker's (2011) criticism is based on the idea that an insurance pay out for loss of profits would still be revenue in nature, or that continuous hedges could be seen as a profit making scheme (notwithstanding that they were ostensibly linked to an underlying capital asset).

In Brincker's (2011) view, the better argument to determine the character of the proceeds realised from a derivative hedging transaction should focus on the nature of the underlying asset. This is considered further in 5.3 below.

5.3. The tax treatment of the derivative hedge should follow the tax treatment of the underlying asset

5.3.1. Professional commentary on following the nature of the underlying asset

Hutton (1998) states that:

'the character of the proceeds of a hedging transaction should follow the character of the underlying asset or exposed hedge'.⁹⁰

⁸⁸ 24 SATC 446.

⁸⁹ Brincker, TE. 2011. *Taxation Principles of Interest and other Financing Transactions*. Issue 9. Chapter W – *Derivative Instruments*:W-8-2.

⁹⁰ Hutton (*op cit* note 86) at 167.

Hutton (1998) also places reliance on *ITC 1498* (1989) and on the idea that gains made on derivatives should ‘assume the character of their originating cause’.⁹¹ In further support of this Hutton (1998) cites *Caxton Limited* (no 8386), an unreported decision of the Transvaal Income Tax Special Court in August 1988, where losses made on forward exchange contracts taken out in respect of the acquisition of a capital asset were held to be capital in nature (and therefore non-deductible), and *ITC 340* (1935) where it was decided that gains made using forward exchange contracts to hedge the acquisition of trading stock were held to constitute taxable business profit..⁹²

The premise of this argument is therefore that the tax treatment of the derivative hedge should be analogous to the tax treatment of the underlying asset.

Hutton (1998) is also of the view,⁹³ rightly, it is submitted, that there is economic merit in linking the tax treatment of the underlying capital investment and the hedging instrument. To do otherwise would distort the efficacy of the hedge (were the hedging gains taxable and the underlying losses capital in nature and non-deductible). It is submitted that it could also prompt taxpayer’s to try and apply differential treatment to gains as opposed to losses, which could ultimately be unfair to both the taxpayer and the *fiscus*.

Byala (1993) submits that the decision in *ITC 1498* (1989) offers support for the notion that this argument can be extended to hedges of capital assets, albeit that the statement does not appear to be definitive, to the extent that:

*‘the South African courts have recognised that a hedging transaction may result in capital receipts or accruals’.*⁹⁴

Both Byala (1993) and Hutton (1998) agree that the taxpayer must prove a genuine hedging intention before being able to claim that the character of the proceeds of a hedge follow the character of the underlying asset or exposure hedged.⁹⁵

⁹¹ *ITC 1498* (1989) (*supra* note 41) concluded that a gain made hedging the cost of acquisition of a capital asset was capital in nature.

⁹² Hutton (*op cit* note 86) at 167-168 citing *ITC 340* (1935) (*supra* note 39).

⁹³ Hutton (*op cit* note 86) at fn 16 on page 168.

⁹⁴ Byala (*op cit* note 84) at 105.

⁹⁵ Byala (*op cit* note 84) at 104-105 and Hutton (*op cit* note 86) at 168-169. The authors both suggest that in order to evidence such a genuine hedging intention something more than the mere *ipse dixit* of the taxpayer is required. Byala is of the view that the accounting guidelines for a hedge should be complied with. These entail that the hedge should form part of a non-trading portfolio; that the position hedged is specifically identifiable and exposes the enterprise to price risk; that the transaction is designated as a hedge; and that there is a high degree of correlation at inception (and on an ongoing basis) between the changes in value of the hedging instrument and the opposite changes in value of the hedged item. Hutton suggests that the taxpayer would need to show a match in the nature, extent and duration of the two transactions (the underlying transaction and the hedge) as well as the likely effectiveness of the hedge (by showing a high degree of correlation between changes in the value of the hedge and changes in the value of the underlying position).

Byala (1993) and Hutton (1998) note also that this idea is expressed in the SAICA report (1992), where it was concluded that:

'It would appear ... that in appropriate circumstances it is possible for an investor in gilts or equities to use futures or options as effective hedges of capital assets on an after tax basis. Provided a sufficiently close link can be demonstrated between the underlying capital investment and the hedging instrument, it would appear that the hedging transaction is of a capital nature'.⁹⁶ (emphasis added)

Brincker (2011) also makes reference to *ITC 340* (1935) and *ITC 1498* (1989), but cautions in regards to *ITC 340* (1935) that whilst the profits derived from the forward exchange contracts were held to be revenue in nature (because they were incidental to the normal business operations of the taxpayer), one should bear in mind that the court also found (on the facts) that the taxpayer had a definite intention to make a profit from the forward exchange contracts. In Brincker's (2011) view, one should be careful to rely on *ITC 340* (1935) as authority for the idea that the hedging gain was revenue in nature purely because the underlying asset was trading stock being acquired. The taxpayer also had a separate profit motive.⁹⁷

Brincker (2011) also refers to *ITC 1498* (1989) as the '*first time that it was clearly indicated that a derivative should be categorised on the same basis as its originating cause*'; however he clarifies that one should also be careful when relying on the decision in *ITC 1498* (1989) as authority for the idea that the '*hedging of a capital asset will always result in the proceeds of the derivative being deemed to be of a capital nature*'.⁹⁸

At best, in Brincker's (2011) view, *ITC 1498* (1989) was decided in favour of the taxpayer because the court was of the view that the forward exchange contracts in question were not integral to the business of the taxpayer, and he submits that the real test should instead be an enquiry into:

'the intention of the taxpayer in hedging the underlying asset, and whether that intention is in itself of a capital nature, and is consistent with the holding of the underlying capital asset'.⁹⁹

⁹⁶ SAICA (*op cit* note 1) at 26.

⁹⁷ *Ibid* at W-8-1.

⁹⁸ *Ibid* at W-8-2.

⁹⁹ *Ibid*. Brincker equally points out at W-9 that the surrounding circumstances would need to support the taxpayer's stated intention to hedge an underlying asset. Merely stating that a derivative instrument has been entered into in respect of such an asset is insufficient. To satisfy this burden of proof the taxpayer would need to show a sufficiently close link between the two. This determination would likely consider the correlation between the hedging instrument and the asset, the extent to

Brincker (2011) is also in support of the idea that the tax treatment of the underlying capital investment should be linked to the tax treatment of the hedging instrument in order to bring about tax neutrality.¹⁰⁰

Finally, Coetsee (1995) also appears to suggest that, on the basis that the taxpayer can prove his intention to protect a long term investment, the character of the proceeds of the hedge should follow the character of the underlying asset. Coetsee (1995) submits that, whilst not tested in court, the same principles as were applied in *ITC 1498* (1989) should apply to derivatives entered into to hedge capital assets.¹⁰¹

It would appear then that all of the authors noted above are of the view that the tax treatment of the derivative hedge should follow the (capital) tax treatment of the underlying asset, provided the requisite intention is evident.

Byala (1993) and Hutton (1998) are of the view that there needs to be a ‘genuine hedging intention’ in respect of an underlying capital asset (demonstrated with reference to the accounting standards), whilst Coetsee (1995) requires a similar ‘intention to protect’ an underlying capital investment. Brincker (2011) phrases it differently – an enquiry into the capital intention in respect of *the hedge as well as the hedged asset*. Brincker (2011) requires a capital intention with both for the tax treatment of the derivative hedge to follow that of the underlying asset.¹⁰²

5.3.2. International comparisons

In the absence of definitive precedent for the notion that the tax treatment of the derivative hedge should follow that of the underlying asset, it falls to consider whether comparable international precedent could provide support in this regard.

The international jurisdictions discussed below provide useful examples of how the question of the taxation of a derivative hedge is dealt with elsewhere. The jurisdictions are chosen because they were all originally considered by both SAICA and the Sub-Committee of the Tax Advisory Committee when the questions around the taxation of derivatives hedges first arose.¹⁰³ They are also considered to be useful comparative jurisdictions because they share common taxing principles with South Africa (i.e. they distinguish between capital and revenue and they have a capital gains tax), they have formal derivatives

which the hedge mitigates the risk perceived and the duration over which the two transactions were entered into.

¹⁰⁰ *Ibid* at W-9.

¹⁰¹ Coetsee, D. 1995. The taxation of derivatives. *Accountancy SA* September 1995:11-13 at 11-12.

¹⁰² The authors note that a court would not regard a taxpayer's *ipse dixit* as decisive in such an enquiry, but would instead examine all relevant facts and circumstances.

¹⁰³ See 3.3 of the SAICA report and 4.4 of the TAC consultative document.

exchanges (similar to the SAFEX) and they have issued some form of guidance on hedging transactions.

5.3.2.1. United Kingdom

In terms of Statement of Practice 03/2002 entitled ‘Tax Treatment of Transactions in Financial Futures and Options’, it is stated that:

*‘a financial futures ... transaction which is clearly ancillary to a trading transaction on current account will give rise to trading profits or losses. In contrast, a financial futures ... transaction which is clearly ancillary to a transaction which is not a trading transaction on current account will be capital’.*¹⁰⁴ (emphasis added)

In order for a futures position to be classified as an ancillary (hedging) transaction for purposes of this Statement there must be, *inter alia*, another underlying transaction (or several other underlying transactions), the intention to ‘*eliminate or reduce risk*’ in respect of the underlying transaction(s) and the futures position must be ‘*economically appropriate to the elimination or reduction of risk*’.

Determining whether a hedging transaction is ‘*economically appropriate*’ requires an enquiry into whether the hedge is, by virtue of the relationship between fluctuations in the price of the hedging instrument and fluctuations in the value of the underlying transaction, one which may reasonably be expected to be appropriate to be used to eliminate or reduce risk.

As can be seen from the above, a derivatives hedge that appropriately eliminates risk (by virtue of the inverse relationship between fluctuations in the price of the hedging instrument and fluctuations in the value of the underlying) will be seen to be ancillary to the underlying transaction, and the tax treatment of the derivatives hedge will be determined with reference to the tax treatment of this underlying transaction. Importantly, this includes the situation where a capital asset is hedged.¹⁰⁵

¹⁰⁴ Paragraph 9 of Statement of Practice 03/2002 published by Her Majesty’s Revenue & Customs on 30 September 2002. Available: <https://www.gov.uk/government/publications/statement-of-practice-3-2002/statement-of-practice-3-2002> [2015, June 21].

¹⁰⁵ The Statement provides the following examples of futures hedging positions that would be capital in nature: a taxpayer holding gilts or a broadly based portfolio of UK equities selling gilt futures or FTSE 100 index futures to protect the value of its capital in the event of a fall in the value of gilt-edged securities generally, or a fall in the market. Conversely, the Statement provides the example that a taxpayer’s futures transactions which are incidental to its trading activity (for example, a manufacturer entering into transactions to reduce the risk of fluctuations in the price of raw materials) would be revenue in nature and the profits and losses from these transactions would be taken into account as part of the profits and losses of the trade.

5.3.2.2. United States of America

The tax treatment of hedging transactions was originally entirely a matter of case law. In the 1955 Supreme Court decision in *Corn Products Refining Co. v. Commissioner*,¹⁰⁶ it was held that gains and losses on hedging transactions were revenue in nature which matched the character of the gain or loss to the hedged item. These gains and losses were made buying and selling commodities futures contracts and were revenue in nature because the derivative hedges formed a vital part of the taxpayers business, insuring it against fluctuations in corn prices which insulated it against increases in the cost of acquiring its trading stock.¹⁰⁷

The rationale applied was that since the hedging transactions formed an integral part of the business model used to acquire inventory, they fell (on a wide reading) within the stock-in-trade exclusion in section 1221(a)(1) of the US Tax Code, and were not capital assets.¹⁰⁸

Despite this decision, in the 1993 Tax Court case of *Federal National Mortgage Association v Commissioner for Internal Revenue*¹⁰⁹ the Inland Revenue Service submitted that the taxpayer was required to treat its losses incurred in hedging interest obligations to debenture holders as capital on the basis of a second 1988 Supreme Court decision in the case of *Arkansas Best Corp. v. Commissioner for Inland Revenue*.¹¹⁰ The Tax Court disagreed however, permitting ordinary tax treatment for these hedging transactions entered into on the basis that the hedge was a ‘surrogate’ transaction of the underlying (revenue) obligation to pay interest.¹¹¹

¹⁰⁶ 350 U.S. 46 (1955). Available: <https://supreme.justia.com/cases/federal/us/350/46/case.html> [2016, January 5].

¹⁰⁷ The underlying corn was utilised in the business to manufacture products such as syrups, sugars and oils. The sale of these products (under contracts requiring shipment in thirty days at a set price or at market price on the date of delivery, whichever was lower) meant that the taxpayer was particularly exposed to increases in corn prices. It is noted that these commodities futures were only partial hedges, against an increase in prices, since the sales model did not allow for hedging against a price decline.

¹⁰⁸ Regulation section 1.1221-1(a) of the Code of Federal Regulations states that the term ‘capital assets’ includes all classes of property not specifically excluded by US Code section 1221. Available: <https://www.law.cornell.edu/cfr/text/26/1.1221-1> [2016, January 5]. US Code section 1221(a)(1) excludes from capital assets all stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer. Available: <https://www.law.cornell.edu/uscode/text/26/1221> [2016, January 5].

¹⁰⁹ 100 T.C. 541 (1993).

¹¹⁰ 485 U.S. 212 (1988). The Supreme Court created doubt as to the interpretation of US Code section 1221 with this case, insofar as they applied a far more narrow reading than in the *Corn Products Refining* (1955) decision and held that the gain or loss on the sale or exchange of an asset was capital in nature unless the asset fell specifically within one of the enumerated exceptions in US Code section 1221. Available: <https://supreme.justia.com/cases/federal/us/485/212/> [2016, January 5].

¹¹¹ *Federal National Mortgage Association* (1993) (*supra* note 109) at 579 where the court held that the ‘hedging transactions bear a close enough connection to its section 1221(4) mortgages to be excluded from the definition of capital asset’.

In 1994, new hedging regulations were issued in the form of US Code section 1221(a)(7), excluding these transactions from the ambit of capital assets.¹¹² The primary purpose of these hedging character rules is to allow a taxpayer to match ordinary (revenue) gains and losses from the hedge with ordinary gains and losses from the hedged items, thereby avoiding character mismatches.

To qualify for this hedging treatment, the taxpayer must satisfy two requirements. Firstly, the hedged item must be an ordinary asset (or borrowing), and the hedge must be entered into in the course of the taxpayer's normal trade or business to manage the risk of price change or currency fluctuations.¹¹³ Secondly, the hedge and hedged item must be properly and timeously identified.¹¹⁴ If both requirements are met, gains and losses on the hedge are revenue in nature.

Both the *Corn Products Refining* and the *Federal National Mortgage Association* cases, as well as the subsequently added US Code section 1221(a)(7), therefore appear to support the contention that reference should be made to the tax treatment of the underlying position in order to determine the tax treatment of the hedging transaction. It is noted though that both the US Code and the cited cases only deal with revenue hedges. None of these are applied in the context of a capital gain made on a hedge. Presumably however the taxpayer would argue that a hedge not timeously designated as such, or a hedge not taken out in connection with a business, would be capital in nature (which could match the treatment of the underlying position).

5.3.2.3. *Australia*

In Australia, the tax authorities have stated the following regarding derivatives hedging:

‘It is accepted, as a general rule, that the entering into futures transactions by a businessman may be regarded as an integral part of the business where the quantity of goods covered by the futures transactions corresponds by and large to the estimated production and where there is a subsequent sale of goods of the kind covered by the trading. Any profit or loss arising from the ‘closing-out’ of futures

¹¹² US Tax Code section 1221(a)(7) specifically excludes from the definition of capital asset ‘any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into’. Available: <https://www.law.cornell.edu/uscode/text/26/1221> [2016, January 5].

¹¹³ Regulation section 1.1221-2(b) of the Code of Federal Regulations. Available: <https://www.law.cornell.edu/cfr/text/26/1.1221-2> [2016, January 5].

¹¹⁴ US Tax Code section 1221(a)(7).

*transactions is to be regarded as arising from the business and taken into account in determining the gross proceeds of the business*¹¹⁵

The relevant ruling therefore specifies that, for a futures transaction to be regarded as a hedge in Australia, (i) the quantity of goods covered by the futures contract hedge needs to correspond to the estimated production; and (ii) there needs to be a subsequent sale of goods of the kind being hedged. The outcome of the underlying transaction is therefore a decisive factor in classifying the derivative position adopted as a hedge.¹¹⁶ The principle applied is that the taxation of the profit or loss realised on the derivatives hedge should follow the nature of the taxation applied to the underlying transaction.

It should be borne in mind though that the relevant ruling appears to have been issued with mainly the treatment of commodity futures in mind.¹¹⁷ Furthermore, it also appears to be aimed at hedging in a business context since the gains or losses are not treated as capital in nature but are rather '*taken into account in determining the gross proceeds of the business*' (i.e. revenue in nature).¹¹⁸

It is therefore submitted that this guidance has little bearing on the hedging of a share investment and offers little help in this regard.

¹¹⁵ Tax Ruling IT 2228 – 'The Taxation of Futures', paragraphs 22-26, issued on 12 December 1985. Available: <https://www.ato.gov.au/law/view/document?docid=ITR/IT2228/NAT/ATO/00001> [2015, December 18].

¹¹⁶ Refer to the SAICA report on page 15, and the TAC consultative document on page 64.

¹¹⁷ The TAC consultative document on page 64.

¹¹⁸ One could argue that this is not vastly dissimilar from the court's reasoning in *ITC 43* (1925) (*supra* note 37).

CHAPTER 6 COMMON LAW ‘FIRST PRINCIPLES’ RELEVANT FOR DETERMINING THE TAX NATURE OF A DERIVATIVES HEDGE

6.1. Introduction

This chapter examines precedent from South African case law to identify certain common law ‘first principle’ guidelines laid down by our courts.

It should be remembered that these are only guidelines (as opposed to absolute tests) for the determination of whether a receipt or accrual is capital or revenue in nature. The courts have oft recognised that there is no ‘*simple and universally valid litmus test*’,¹¹⁹ no ‘*single, infallible test of invariable application*’,¹²⁰ in this regard.¹²¹ The question as to whether ‘*income falls on the one side of the ill-defined borderline between capital and revenue or on the other being “a matter of degree depending on the circumstances of the case”*’.¹²²

The taxpayer therefore always bears the onus of proving that a particular amount is of a capital nature.¹²³ To discharge this onus the taxpayer would need to establish his case on ‘*a balance or a preponderance of probabilities*’.¹²⁴

6.2. Intention

In our jurisprudence on the determination of the income tax nature of a receipt or accrual, it is the subjective enquiry into the taxpayer’s intention that is often held up as conclusive ‘*unless some other factor intervened to show that when the article was sold it was sold in pursuance of a scheme of profit-making*’.¹²⁵

¹¹⁹ As per the words of Kriegler AJA in *CIR v Guardian Assurance Co South Africa Ltd* 1991 (3) SA 1 (A) at 19.

¹²⁰ Per Smalberger JA in *CIR v Pick n Pay Employee Share Purchase Trust* (1992) 54 SATC 271 at 279.

¹²¹ In the words of Southwood AJA in *CSARS v Wyner* (2003) 66 SATC 1 at para 7: ‘*There is no single all-embracing test of universal application for determining whether a particular receipt is one of a revenue or capital nature*’.

¹²² *Guardian Assurance Co* (1991) (*supra* note 119).

¹²³ Section 102 of the Tax Administration Act, 28 of 2011.

¹²⁴ *CIR v Middelman* (1989) 52 SATC 323 at 325.

¹²⁵ The dicta of Wessels JA in *CIR v Stott* (1928) 3 SATC 253 at 262.

This is referred to as the ‘golden rule’ by certain authors,¹²⁶ though it could equally be referred to as the ‘golden thread’ running through several of the guidelines outlined below.¹²⁷

This reference to the taxpayer’s subjective intention being conclusive does however require that the taxpayer’s evidence be tested against the objectively determinable facts surrounding the transaction in question.¹²⁸ The *ipse dixit* of the taxpayer as to his intention or purpose should also not be *‘lightly regarded as decisive’*¹²⁹ since *‘it may be coloured by self-interest’*.¹³⁰

6.2.1. The ‘Golden Rule’

The determination of whether the proceeds from the disposal of an asset are of a capital nature hinges on the intention with which that asset was initially acquired. Where it was acquired with the intention of holding a capital asset, the subsequent disposal is simply the realisation of such capital asset and the proceeds are capital in nature.

According to the Appellate Division in *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste* (1978) the sale of an asset acquired with a view to:¹³¹

‘holding it either in a non-productive state or in order to derive income from the productive use thereof, and in fact so held, constitutes a realisation of fixed capital and the proceeds an accrual of a capital nature’.¹³²

6.2.2. Circumstantial indicators

In *Bloch v SIR* (1980) it was said that:

‘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’.¹³³

Given that these characteristics can, to some extent, be objectively measured and since a taxpayer’s *ipse dixit* as to his subjective intention should not simply be accepted,¹³⁴ a court

¹²⁶ De Koker, AP and Williams, RC. *Silke on South African Income Tax* at 3.2 [2016, January 14]. The SARS Share Owners Guide refers to this at 3.2.1 as the *‘most important factor’*.

¹²⁷ Refer for example to the determination of whether the taxpayer is conducting a business, carrying out a scheme of profit-making or disposing of fixed or floating capital.

¹²⁸ *Malan v KBI* (1983) 45 SATC 59 at 77.

¹²⁹ *ITC 1185* (1972) 35 SATC 122 at 123.

¹³⁰ *Capstone 556 (Pty) Ltd v CSARS* [2014] 4 All SA 179 (WCC) at 183.

¹³¹ 1978 (1) SA 101 (A), 39 SATC 163.

¹³² Corbett JA in his dissenting judgement at 181.

¹³³ (1980) 42 SATC 7 at 18.

¹³⁴ *ITC 1185* (1972) (*supra* note 129).

would likely look to test or confirm any stated capital intention against these objectively determinable indicators which may be gleaned from the surrounding circumstances. If the taxpayer's evidence is not contradicted by these objective indicators (and there is no other reason to disbelieve his evidence), he will have discharged a significant portion (if not all) of the onus of proof which he bears.¹³⁵

6.2.2.1. *Length of the holding period and the 'for keeps' test*

When determining capital or revenue, the courts have previously held that an indicative sign of a capital asset is that it is 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 ...'*¹³⁶

Given the above, if the length of holding is however short and the reason for disposing is not something unforeseen or unexpected, it can cast doubt upon the stated intention that the asset in question was held (and disposed of) as a capital asset.

If one has reference to the equivalent position in the United Kingdom, the HMRC 'Business Income Manual' No. 20310 also identifies the interval of time between purchase and sale as a 'badge of trade'. A taxpayer who acquires an asset and holds it for many years is said to be in a stronger position to argue that it is a capital investment than someone who sells soon after acquisition. Similarly, an intention at the time of purchase to sell quickly suggests the idea of turning assets over for profit. Even where no such intention is admitted or demonstrated, the fact that a sale takes place after a short period of ownership creates an adverse inference.¹³⁷

Broomberg (1998) is however of the view that the intention not to hold an asset 'for keeps' is not, by itself, decisive.¹³⁸ SARS has also acknowledged that the length of time that an asset is held can be an unreliable indicator of the capital or revenue nature of the proceeds from its disposal, stating that:

'While a lengthy holding period may be indicative of a capital intent, the period of holding is far less important than other factors such as the

¹³⁵ *CIR v Middelman* (1989) (*supra* note 124) at 327.

¹³⁶ Trollop AJ in *Barnato Holdings v SIR* (1978) 40 SATC 75 at 91.

¹³⁷ Available: <https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim20310> [2016, January 14]. The short period of ownership in *Wisdom v Chamberlain* (1969) (*supra* note 47) was a factor in favour of trading.

¹³⁸ Broomberg, EB. 1998. 'Capital, Revenue, Intention, Motive and Contemplation' *Tax Planning* 12(3) at 71.

*taxpayer's intention in buying and selling the asset, and the manner in which the asset is dealt with.*¹³⁹

It is submitted that the length of time for which an asset is held is therefore not necessarily decisive in determining whether the proceeds arising on its realization are income or capital in nature.¹⁴⁰

6.2.2.2. *Negligible or non-existent return*

Similarly, if the asset has either no, or a low, economic return then it can also cast doubt upon a stated capital intention, given that it is expected that a capital asset should be one which is held in order to produce an 'economic utility'.

An asset which generates a negligible return is often considered to (only) have been held in order to dispose of it at a profit (i.e. held with a revenue intention).¹⁴¹

This is equally relevant where the asset does not produce any income (such as a futures contract).¹⁴² It is submitted however that the taxpayer's intention (and purpose) must still be taken into account in this regard.¹⁴³ As to a taxpayer's purpose, it is submitted that where the purpose is not to carry on a trade but to save or safeguard an investment, the proceeds of the sale can still be capital in nature.¹⁴⁴

If one again has reference to the equivalent position in the United Kingdom, the HMRC 'Business Income Manual' No. 20260 identifies assets which yield no income or so-called

¹³⁹ SARS *Comprehensive Guide to Capital Gains Tax*, Issue 5, 2014 (the 'CGT Guide') at 17, citing the examples of *Natal Estates* (1975) (*infra* note 149, where land held for 50 years was trading stock) and *ITC 1185* (1972) (*supra* note 129, where property held for 7 months was capital in nature).

¹⁴⁰ *LHC Corporation of SA (Pty) Ltd v CIR* (1950) 17 SATC 125 at 134; *CIR v Richmond Estates (Pty) Ltd* (1956) 20 SATC 355 at 366.

¹⁴¹ *Yates Investments (Pty) Ltd v CIR* (1956) 20 SATC 368 at 371/2.

¹⁴² See the *CGT Guide* (*supra* note 139) at 15 and the examples of undeveloped land, Krugerrands or diamonds cited there.

¹⁴³ See the *CGT Guide* (*supra* note 139) at 24/5 and the cases cited there in relation to Krugerrands, where the emphasis is placed on both the intention of the taxpayer upon acquisition and the reason for the sale of the Krugerrands, notwithstanding the inference (created by their non-existent return) that these assets are only purchased for resale at a profit.

¹⁴⁴ See *Wyner v Commissioner, SARS* [2002] JOL 9457 (C) at 6: 'In *ITC 1283 41 SATC 36 a Portuguese resident of Angola fled to Namibia. Since he could not export currency, he bought coffee beans and exported these to Namibia. In this way he smuggled his capital out in coffee beans. When he converted the coffee beans into South African currency, he made a profit. The court held that his purpose was not to carry on a trade but to save as much as he could of his investments in Angola. Similarly, the appellant's purpose was not to carry on a trade but to safeguard her investment. The sale to her should be seen as a device for turning her inchoate title into one that was transmissible*'. It is submitted that reference in the *CGT Guide* (*supra* note 139) at 15 to the proceeds in *ITC 1283* being held to be of a capital nature as the taxpayer's intention was merely to salvage his capital and not to carry on a business is incorrect.

‘pride of possession’ as also bearing the ‘badge of trade’, and are considered to be ‘*normally dealt in by way of trade*’.¹⁴⁵

6.3. Scheme of profit-making

6.3.1. The taxpayer’s ‘revenue’ intention

In the section above, the taxpayer’s capital intention when acquiring an asset was said to be decisive in determining the capital nature of the profits realised on its disposal.

Where the taxpayer’s subjective intention upon acquiring that asset is *to sell it* (usually at a profit), this intention is once again said to be decisive. This is described as a ‘scheme of profit-making’.

The asset is in this instance said to be held on revenue account and the proceeds realised are revenue in nature and fall to be taxed as part of the gross income of the taxpayer.

The Appellate Division describes a ‘scheme of profit-making’ as follows in *Elandsheuwel Farming* (1978):

*‘In its normal and most straightforward form (a profit-making scheme) connotes the acquisition of an asset for the purpose of reselling it at a profit. This profit is then the result of the productive turn-over of the capital represented by the asset and consequently falls into the category of income. The asset constitutes in effect the taxpayer’s stock-in-trade or floating capital’.*¹⁴⁶

This notion of, upon acquisition, having an intention to dispose of the asset is mirrored in the income tax definition of ‘*trading stock*’, which refers *inter alia* to anything acquired for purposes of sale or exchange.¹⁴⁷

It is further possible that where an asset is initially acquired as a capital asset (with the requisite capital intention), but then subsequently disposed of *in pursuance of a scheme of profit-making*, the proceeds realised will again be classified as revenue in nature. This is referred to as a so called ‘change of intention’.

¹⁴⁵ Available: <https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim20260> [2016, January 14]. See also *Wisdom v Chamberlain* (1969) (*supra* note 47). The purchase of the silver ingots in this matter looked to the court more like an ‘*an adventure in the nature of trade*’ than an investment (and was taxed accordingly) because, *inter alia*, it was in the mind of the court (while it lay in a vault) *otherwise useless* to the taxpayer.

¹⁴⁶ *Elandsheuwel Farming* (1978) (*supra* note 131) at 180-181.

¹⁴⁷ Refer to the section 1 definition of ‘trading stock’ in the Act.

6.3.2. *The taxpayer's change of intention*

To determine whether there has been a change of intention in the intervening period since acquisition, one must consider whether the taxpayer, in disposing of the asset, intended to pursue a scheme of profit-making with the asset as his 'stock-in-trade'. The mere decision to sell an asset of a capital nature does not convert that asset to one of an income nature otherwise *'every taxpayer who decided to realise a fixed capital asset and then proceeded to do so would find himself having to pay tax on his profit'*.¹⁴⁸

What must be considered in determining this intention on disposal are the activities of the taxpayer in relation to the asset and the light these activities throw on his *ipse dixit* as to his intention, in order to determine whether the taxpayer has crossed the proverbial Rubicon.¹⁴⁹

It is important to remember however that, as the Appellate Division stated in *John Bell & Co v SIR* (1976), a:

'mere change of intention to dispose of an asset hitherto held as capital does not per se subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and so render its proceeds gross income. For example, the taxpayer must already be trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is taken into or used as his stock – in – trade'.¹⁵⁰

This reference to something 'more' being required to metamorphose the character of the asset is described by the same court in a subsequent case as *'something indicating that the disposal is in reality in pursuance of some trade or business or scheme for making profit'*.¹⁵¹ For the learned judge in that instance this was indicated by the surrounding circumstances and the way in which the change of intention was manifested.

It is therefore also required that one determine from the surrounding facts whether the taxpayer has undergone a change intention in respect of the asset in question. If, on review of these surrounding circumstances or the way in which the disposal is manifested or carried out, the alleged change of intention may be said to have occurred then the disposal will be

¹⁴⁸ *Elandsheuwel Farming* (1978) (*supra* note 131) at 189.

¹⁴⁹ *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A) at 202/3.

¹⁵⁰ (1976) 38 SATC 87 at 103.

¹⁵¹ Refer to the separate judgement of Trollip AR supporting the majority in *Elandsheuwel Farming* (1978) (*supra* note 131) at 177.

held to be on revenue account, because once again a scheme of profit-making is being pursued.

6.3.3. Pursuance of a scheme of profit-making

The relevant consideration in determining whether a profit-making scheme is being pursued can be phrased as follows:

*'receipts or accruals bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for',*¹⁵²

For the majority of the Appellate Division bench in *Pick n Pay Employee Share Purchase Trust* (1992), the determination of whether these receipts or accruals bear the imprint of revenue (i.e. were designedly sought for and worked for) involved more than a simple objective assessment of the conduct of the taxpayer and whether this evidenced the conducting of a business. What was also required was a subjective assessment of the taxpayer's objective, and whether this meant that the business was conducted as part of a scheme of profit-making.¹⁵³

In deciding on the subjective aspect of this enquiry, it should be noted that:

*'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',*¹⁵⁴

Smalberger JA describes the determination of the subjective element as follows in *Pick n Pay Employee Share Purchase Trust* (1992):

*'The application of (the scheme of profit-making) test involves a consideration of the objectives of the taxpayer ... and what its purpose, or if there was more than one, what its dominant purpose was',*¹⁵⁵

The emphasis in the subjective enquiry should therefore be placed on the question of whether the taxpayer's *purpose* was to make a profit with the transaction, as opposed to emphasising what other possibilities the taxpayer foresaw and with which he reconciled

¹⁵² *Pick n Pay* (1992) (*supra* note 120) at 280. It was on this basis that the majority of the court ruled, at 281, that the gain in question was capital in nature.

¹⁵³ *Pick n Pay* (1992) (*supra* note 120) at 280. See also Olivier, L. 2012. 'Capital versus Revenue: Some Guidance'. *De Jure* 45(1) at 173-175.

¹⁵⁴ *Secretary for Inland Revenue v Trust Bank of Africa Ltd* 1975 (3) SA 652 (A), 37 SATC 87 at 669.

¹⁵⁵ *Pick n Pay* (1992) (*supra* note 120) at 280.

himself.¹⁵⁶ Where more than one purpose exists, recourse must be made once again to the dominant purpose.

In considering the presence or absence of this profit-making purpose, it is submitted that it is not sufficient for the taxpayer to merely hope for an eventual profit as an incidental by-product of the pursuit of another objective, or to reconcile him- or herself with the possibility that a profit may arise.¹⁵⁷ Only if a genuine purpose to make a profit exists, will the amount received be revenue in nature. It is further submitted that, once again, all relevant surrounding facts and circumstances must be considered to determine whether the taxpayer's purpose is the pursuit of a scheme of profit-making.

6.3.4. The intersection between 'intention' and 'purpose'

6.3.4.1. 'Mixed intentions' and 'dominant purpose'

If upon the acquisition of an asset, a taxpayer's intentions may be said to be 'mixed' then the determination of the income tax nature of the proceeds requires one to '*give effect to the dominant factor operating to induce him to effect the purchase*'.¹⁵⁸

So in a situation where the taxpayer was found to have a dominant *purpose* upon acquiring an asset which is something other than a profit motive, the gain realised on the disposal of the asset was held to be capital in nature.¹⁵⁹

¹⁵⁶ *Pick n Pay* (1992) (*supra* note 120) at 281.

¹⁵⁷ The following from *Pick n Pay* (1992) (*supra* note 120) at 281 is relevant in this regard: '*While they might have contemplated the possibility of profits, it was not the purpose of either the company in founding the Trust, or the trustees in conducting the affairs of the Trust, to carry on a profit-making scheme. The sole purpose of acquiring, holding and selling the shares was to place them in the hands of eligible employees. The forfeiture provision was not intended to yield a profit. Its purpose was to deter unwanted resignations. A different conclusion might have been justified if the making of profits was inevitable. But this was not the case. The prospects of profits were highly problematical. They depended upon the degree of success achieved by the scheme. If it had operated to its full potential, and there had been no forfeitures, there would probably have been no profits. But even accepting that forfeitures were inevitable, whether they resulted in profits being made depended on when they occurred in relation to the date of acquisition of the shares and the state of the market at the time of forfeiture. And the overall profits would depend further on whether other purchases and sales resulted in profits or losses. There were thus a number of variables which could influence the profit factor. That profits were not inevitable is proved by the fact that in the 1985 year of assessment the operation of the scheme showed a loss of R70 619. In my view, therefore, any receipts accruing to the Trust were not intended or worked for, but purely fortuitous in the sense of being an incidental by-product. They were therefore non-revenue*'.

¹⁵⁸ See in this regard for example *COT v Levy* (1952) 18 SATC 127 and *CIR v Paul* (1956) 21 SATC 1.

¹⁵⁹ *CIR v Middelman* (1989) (*supra* note 124) at 329. The dominant and overriding purpose of the taxpayer's share dealings in this instance was to secure the highest dividend income attainable, and consequently the disposal of such shares was held to be on capital account. In *COT v Levy* (1952) (*supra* note 158) at 135/6 the court found in favour of the taxpayer's claim that the gain realised was capital in nature, notwithstanding that it was accepted that the taxpayer had in mind when he purchased the shares in question that they would appreciate in value. This was on the basis that his dominant purpose in acquiring the shares was to obtain a good revenue from them. The court was satisfied that this was borne out by the fact that he had already decided at the time of acquisition to develop the property of the company in order to obtain a better return from it. In *CIR v Paul* (1956)

To determine whether a particular purpose is ‘dominant’ may be difficult.¹⁶⁰ An objective will be seen to be the ‘dominant purpose’ if all the other alternative objective(s) present are entirely secondary, and, though contemplated, do not materially persuade the taxpayer to act.¹⁶¹ When acquiring an asset however a taxpayer is not required to ‘*exclude the slightest contemplation of a profitable resale of the asset*’.¹⁶²

When determining if a purpose is ‘dominant’, in the sense that all other are secondary, our courts have also stated the following however:

*‘Whether or not a purpose is dominant in the sense that another co-existing purpose may be effected at a profit without attracting liability for tax, is a matter of degree depending on the circumstances of the case. A purpose may be a main purpose without being dominant in this sense. I shall not attempt a precise definition of the distinction, but there would, I consider, be such a main purpose where there is a further purpose simultaneously pursued by way of an additional, albeit subsidiary activity calculated and intended to yield a profit.’*¹⁶³

Put differently, where a taxpayer has more than one co-existing purpose, his ‘main purpose’ (even if it is, for example, to hold the asset as capital) may not be his dominant purpose (and thereby determine the income tax nature of any proceeds upon a disposal) where his other purpose is aimed at the pursuit of activities that are intended to be profitable (even if such other contemporaneous activities pursued are subsidiary to his ‘main purpose’).¹⁶⁴

This sentiment is echoed by Broomberg (1998): while he agrees that an ‘*intention to buy and resell is not enough to determine the nature of the proceeds ... if there was a purpose to be served which is not concerned with whether or not a profit would be made*’, he does

(*supra* note 158) at 9, citing the *Levy* case, the court found that the taxpayer had acquired the property in question as a capital investment, even though he contemplated disposing of the surplus land acquired (over and above his own requirements) to best advantage. This contemplation was as a result of the fact that the seller of the land in question refused to sell unless the whole property of 167 acres was purchased by the taxpayer, and because the taxpayer in turn, unable to finance such a large purchase, needed to sell the balance of the land purchased to finance the deal. On the basis however that his dominant purpose was to obtain for himself a smallholding, not to make a profit from the sale of surplus land, the taxpayer was seen to have acquired the property in question as a capital investment.

¹⁶⁰ *Bloch v SIR* (1980) (*supra* note 133) at 14.

¹⁶¹ *De Koker Silke* (*op cit* note 126) at 3.4 [2016, January 14].

¹⁶² *Secretary for Inland Revenue v The Trust Bank of Africa Ltd* (1975) 37 SATC 87 at 107. In the words of the court: ‘No one, however, readily buys property if he expects that he will eventually have to sell it at a loss’.

¹⁶³ *African Life Investment Corporation (Pty) Ltd v SIR* (1969) 31 SATC 163 at 175.

¹⁶⁴ See also in this regard 3.2.3 of the SARS Share Owners Guide where it is stated that: ‘A profit will be of a revenue nature when you have a secondary or alternative purpose of making a profit’, with reference to *CIR v Nussbaum* (1996) 58 SATC 283 at 291.

acknowledge that if a profitable resale was contemplated it makes the taxpayer's task of proving that there is no scheme of profit-making more difficult.¹⁶⁵

6.3.4.2. *Applying the taxpayer's 'purpose'*

Our courts have previously relied upon a taxpayer's purpose in the determination of the capital nature of the proceeds on the disposal of an asset, notwithstanding the taxpayer's intention upon acquisition of the asset.¹⁶⁶

In the case of *Berea West Estates (Pty) Ltd v SIR* (1976),¹⁶⁷ a so called 'realisation company' was incorporated in order to acquire thirteen beneficiaries' undivided half share in the property of their deceased father's estate, as well as to acquire the undivided half share of the property which the deceased had donated to an *inter vivos* trust on their behalf. This company was then to facilitate the disposal of this property (which was otherwise proving difficult to achieve) and to effect a proportional distribution of the net profits amongst the shareholders (who were the relevant beneficiaries of the trust and the estate).¹⁶⁸

Holmes JA held that the court was entitled, when considering whether the company was a realisation company or carrying on business of trading for profit, to look at the facts leading up to its incorporation and to its memorandum and articles.¹⁶⁹

On this basis, the court decided that the company was a realisation company because its *purpose* was solely to facilitate the realisation of the property to best advantage on behalf of the beneficiaries and to ensure the exclusive distribution of the proceeds amongst such beneficiaries. The company was simply the means whereby and through which the interests of its shareholders were properly realised.¹⁷⁰ Consequently, the profit realised was capital in nature despite the intention of the company to acquire the property in question for the purposes of resale.¹⁷¹

¹⁶⁵ Broomberg (*op cit* note 138) at 71.

¹⁶⁶ See also SAICA (*op cit* note 1 at 24-25) where it is submitted that the identification of a capital profit should not be done with reference to intention but that instead the motive test should prevail.

¹⁶⁷ 1976 (2) SA 614 (A).

¹⁶⁸ *Ibid* at 50-51.

¹⁶⁹ *Ibid* at 61.

¹⁷⁰ *Ibid*.

¹⁷¹ In *Malone Trust v SIR* 1977 (2) SA 819 (A) the appellate division again decided in favour of the taxpayer and held that the proceeds from the realisation of the land by the trust in question were capital in nature, notwithstanding that the trust acquired the land from the deceased Mr Malone's estate in order to (i.e. with the intention of) having it sold. The court's decision was again based on the purpose for setting up the trust – in this instance this was in order to ensure not only that the land was realised to best advantage, but also to protect the interests of the deceased's children by ensuring that the proceeds were not dissipated by the deceased's estranged spouse. See also *ITC 1223* (1974) (*supra* note 44) at 28/29, where despite the fact that the taxpayer company (originally set up as a family investment vehicle) disposed of all of its share investments within one year of their acquisition at a profit, the court emphasised that the taxpayer's *purpose* in acquiring the investments

More recently, the Supreme Court of Appeal has refined this approach to the application of purpose in the determination of the capital or revenue nature of proceeds derived on the disposal of an asset, in the case of *CSARS v Founders Hill (Pty) Ltd* (2011).¹⁷²

The court was of the view that where an asset is transferred to another taxpayer so that that taxpayer might realise that asset (i.e. the taxpayer acquires with the intention to dispose), the proceeds from such realisation would only be capital in nature where there was a ‘*real justification*’ (in addition to the purpose of realising the asset) for the transfer to (and interposition of) the new taxpayer.¹⁷³

The court concluded that where such a real justification exists, the realisation of the property was not the main purpose of the interposition.¹⁷⁴ Since the taxpayer in *Founders Hill* (2011) had no such real justification, its main purpose was considered to be the realisation of the property which amounted to the operation of a business in a scheme of profit-making. The proceeds of the disposal were therefore held to be revenue in nature.

The implication remains that where a taxpayer acquires an asset with the intention to dispose of it, but for good reason the taxpayer’s main or dominant purpose can be said to be something other than the realisation of that asset, the proceeds of its disposal can still be capital in nature.

6.3.4.3. *The difference between intention and purpose*

The taxpayer’s *intention* on acquisition of an asset is often held up as conclusive.¹⁷⁵ Similarly, a profit-making scheme is only said to exist where the taxpayer’s *purpose* was to make a profit.¹⁷⁶ Given the importance of these terms, the variable use thereof and the lack of judicial definition is unfortunate.¹⁷⁷

was to acquire and hold a long term investment, and moreover its *purpose* in disposing of the shares was in order to protect its capital and not as part of a profit-making scheme.

¹⁷² (2011) 73 SATC 183.

¹⁷³ *Founders Hill* (2011) (*supra* note 172) at paragraph 49. In the case of *Berea West Estates* (1976) (*supra* note 167) this real justification was the joint ownership of the property which made the realisation difficult. In the case of *Malone Trust* (1977) (*supra* note 171) this real justification was the need to protect the proceeds from dissipation by the estranged spouse.

¹⁷⁴ *Founders Hill* (2011) (*supra* note 172) at paragraph 53.

¹⁷⁵ *Stott* (1928) (*supra* note 125).

¹⁷⁶ *Pick n Pay* (1992) (*supra* note 120) at 280.

¹⁷⁷ The Appellate Division has previously said: ‘*Contemplation is not to be confused with intention In a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose*’. Refer *Pick n Pay* (1992) (*supra* note 120) at 281. See also *ITC 1185* (1972) (*supra* note 129) where Miller J states the following: ‘*It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer were*’. See also *Nienaber JA in CSARS v NWK 2011 (2) SA 67 (SCA)* at para 51, with reference to *Hippo Quarries (Tvl) (Pty) Ltd v Eardley* 1992 (1) SA 867 (A) at 877, where the court confirms that both ‘motive’ and ‘purpose’ differ from ‘intention’.

The Oxford Dictionary of English defines the concept of intention as *'the aim or plan; the conceptions formed by directing the mind towards an object'*.¹⁷⁸ Purpose is defined as the *'reason for which something is done'*.¹⁷⁹ Similarly, De Koker (2016) describes intention as: *'the direction of the mind to an object or resolution and must not be confused with mere contemplation'*.¹⁸⁰ In regards to purpose, the authors note: *'Purpose is of central importance in the context of a 'scheme of profit-making' – it signifies the object ... that the taxpayer had in mind'*.

Whilst South African jurisprudence has not (yet) attempted to place definitions on these terms, the courts in New Zealand have described a taxpayer's purpose as being:

'... the object which he has in view or in mind ... in ordinary language purpose connotes something added to intention and the two words are not ordinarily regarded as synonymous'.¹⁸¹

A taxpayer's intention could therefore be said to be the *plan* which he formulates when he applies his mind to the achievement of his purpose. His purpose in turn would be the object which he had in mind or, put differently, the *reason* behind his formulated intention.

It is submitted that referring to a taxpayer's *purpose* with the acquisition and/or disposal of an asset (in other words, his reason for acquiring or disposing of the asset) in order to characterise the nature of the proceeds received could result in a more equitable application of the taxation laws, as opposed to solely concentrating on his *intention* (which might be described as his plan for the asset, in order to achieve his purpose). This would align closely with the determination of whether the taxpayer has entered into a profit-making scheme,

¹⁷⁸ 'Intention', *Oxford Dictionary of English*, 2005 2nd Edition revised, Oxford: Oxford University Press. *Black's Law Dictionary*, 2007 8th Edition defines 'intention' as *'the willingness to bring about something planned or foreseen; the state of being set to do something'*. Similarly, 'intent' is the *'mental resolution or determination to act'*.

¹⁷⁹ Definition of 'purpose' in the *Oxford Dictionary of English* (*supra* note 178). *Black's Law Dictionary* (*supra* note 178) defines 'purpose' as *'an objective, goal or end'*.

¹⁸⁰ De Koker *Silke* (*op cit* note 126) [2016, January 20].

¹⁸¹ De Koker *Silke* (*op cit* note 126)) [2016, January 20] citing *Plimmer v CIR* (1958) NZLR 147 where the taxpayer, in order to acquire ordinary shares in a company, was also required to purchase certain preference shares in issue. Since these were unwanted, it was the taxpayer's intention (upon acquisition) to dispose of these preference shares as soon as possible. Notwithstanding this intention, the court ruled that the preference shares were not acquired for the *purpose* of selling them (rather only because he could not acquire the ordinary shares without acquiring the preference shares). In this regard, *Plimmer's* case is not vastly dissimilar to *CIR v Paul* (1956) (*supra* note 158). See also SAICA *Integritax* 1421 *Purpose, Intention, Object and Motive* (Issue 83, July 2006). Available: https://www.saica.co.za/integritax/2006/1421_Purpose_intention_object_and_motive.html. [2015, January 20]. In the more recent decision of *Wellington Regional Stadium Trust v Attorney-General* (2005) 1 NZLR 267 (also referred to in the *Integritax* article cited above), a New Zealand court found that a charitable trust established to raise loan funding for the construction of a new sports stadium (which also then raised additional funds for the maintenance of the stadium through the sale of memberships, corporate boxes, naming rights, signage and sponsorships), did not trade with the *purpose* of making a profit since its profit objective was limited to making sufficient profits to meet its financial commitments.

which also requires an investigation into the taxpayer's *purpose* (i.e. whether it is to make a profit) in order to render the proceeds received subject to tax on income account.¹⁸²

6.4. Further common law guidelines

6.4.1. Originating cause

The originating cause for a receipt relates to the work or activity which a taxpayer performs in order to receive an amount. It can be said to be the *quid pro quo* which the taxpayer gives for the receipt.¹⁸³ This can include:

'a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these'.¹⁸⁴

This reference to an 'originating cause' was originally coined by Watermeyer CJ in the *Lever Bros* (1946) case in the context of an investigation into the *source* of a receipt or accrual. It was however subsequently referred to by our courts as a guideline for the determination of the capital or revenue *nature* of a receipt for tax purposes by considering the *nature of the source*. Corbett AJ put it as follows in *Tuck v CIR* (1988):

'In a case such as the present, however, it seems to me that most problems of characterisation could appropriately be dealt with by applying the simple test indicated by Watermeyer CJ in the passage quoted from his judgment in the Lever Bros case viz by asking what work, if any, did the taxpayer do in order to earn the receipt in question, what was the quid pro quo which he gave for the receipt?'.¹⁸⁵

A receipt or accrual generated by a taxpayer through the carrying on of a business, through his or her own physical or mental exertion or through the employment of his or her capital

¹⁸² As set out by the Appellate Division in *Pick n Pay* (1992) (*supra* note 120) at 280.

¹⁸³ *CIR v Lever Bros and Unilever Ltd* (1946) 14 SATC 1 at 18-9: 'the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income ... this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them'.

¹⁸⁴ *Ibid.*

¹⁸⁵ (1988) 50 SATC 98 at 113. In *CSARS v McRae* (2001) 64 SATC 1 at 6-7 the court explained this consideration of the *nature of the source* as follows: 'The court found on the facts of Tuck's case that the quid pro quo given by the employer had two main elements. Firstly, there was an element of service given to the company ... which element was of a revenue nature. Secondly there was an element of restraint of trade, which required the employee to refrain from competing with his employer as a prerequisite for receiving shares. The restraint of trade element was of a capital nature'.

can therefore ostensibly be considered to be revenue in nature because of the revenue nature of the *quid pro quo* given.¹⁸⁶ It is respectfully submitted however that the ‘simple test’ to which Corbett JA refers is in reality nothing more than a composite of pre-existing guidelines for the determination of the capital or revenue nature of a receipt (the operation of a business guideline and the productive employment of capital guideline, which includes the application of a taxpayer’s own capital in the form of his or her skill or labour) that had already long since been settled in their own right by the time judgement was given in Tuck’s case.¹⁸⁷

6.4.2. Capital productively employed

One of the oldest guidelines formulated for the determination of whether an amount was income or capital in nature comes from Wessels JA in *COT v Booysens Estates Ltd* (1918):

*‘Income is, as a rule, revenue derived from capital productively employed’.*¹⁸⁸

The learned judge then went on to elucidate in this paragraph that this guideline relates to profit derived from ‘a thing’, without ‘the thing’ changing owners, which should be considered income rather than capital.

The foundation of this guideline is therefore the question of whether there has been a productive utilisation of the capital of the taxpayer,¹⁸⁹ without, it is submitted, a disposal of that capital by the taxpayer.¹⁹⁰ This objectively determinable act would then have as a

¹⁸⁶ See in this regard *CIR v King* (1947) 14 SATC 184 at 194 where Watermeyer CJ says ‘*income, in the ordinary sense of the word, is the product or fruit of a man’s labour or of his capital or of both*’ and before that *CIR v Visser* (1937) 8 SATC 271 at 277 where Maritz J had previously indicated that ‘*Income may also be described as the product of a man’s wits and energy*’.

¹⁸⁷ It is also noted that Meyerowitz is of the view that it is the nature of the underlying transaction as opposed to the nature of the *quid pro quo* that determines the character of a receipt. He states as follows in *Meyerowitz on Income Tax 2007-2008* at paragraph 8.11: ‘*only an enquiry into the object (origin and end) of the receipts or accruals in question is capable of ascertaining the capital or revenue nature. In other words, it is not so much the nature of the quid pro quo for the receipt or accrual as rather the nature of the transaction from which the receipt or accrual flows to which one must resort when determining the issue*’.

¹⁸⁸ (1918) 32 SATC 10 at 15. This position was then supported by Innes CJ in the Appellate Division judgement in this case (at 25) where he stated: ‘*Profit or gain may be made in many ways; men may earn it by their labour, by their wits, by their capital. Many of the forms of profit specified in the definition are the product of skill or labour; but, speaking generally, profit otherwise derived must be in whole or in part of the product of capital if it is to be of the nature of income, and thus included in the definition*’.

¹⁸⁹ Including his or her own ‘capital’, in the form of the taxpayer’s personal skills or labour. Any remuneration for a taxpayer for the application of this personal capital would be revenue in nature. See for example Broomberg (*op cit* note 81) at 51 where the learned author says: ‘*the income of a professional practice is, inherently, the fruits of the labour of the professional practitioner, the products of his skill, wit, intellect and so forth*’.

¹⁹⁰ To the extent that there are separate guidelines which have been developed to determine the income tax nature of a receipt arising from the disposal of an asset, it is submitted that the productive employment of capital guideline is focused on the classification of receipts or accruals arising from the utilisation of capital otherwise than by way of disposal. In *ITC 598* (1945) 14 SATC 267 at 268 the

consequence the receipt or accrual of an amount, which amount would, accordingly, be treated as income for tax purposes.

What makes this guideline useful, is that it is based solely upon whether or not an objectively determinable act has been performed by the taxpayer with his or her capital,¹⁹¹ and furthermore whether there is a direct causal connection between the receipt in question and the act performed sufficient to say that the act gave rise to the receipt.

By way of example, a taxpayer would be said to productively employ his or her capital without disposing of it where he or she provided the use thereof to another in exchange for a return. This could be through the provision of a loan; the letting of immovable property; or the licensing of intellectual property. The interest, rental and royalty returns generated would in these cases be considered to be an income in nature.¹⁹² An investment by a taxpayer into shares would equally constitute a capital productively employed by reason of the fact that this too delivers a return.¹⁹³

6.4.3. 'Fruit' vs 'tree' analogy

The reference in income tax to the 'fruit' and the 'tree' is a reference to a metaphor which is sometimes used as an indicator of capital productively employed.

In *CIR v Visser* (1937) this was explained as follows:

'Income is what capital produces, or is something in the nature of interest or fruit as opposed to principal or tree'.¹⁹⁴

The courts will therefore, in determining the tax character of a receipt or accrual, seek to identify whether the amount represents the 'fruit' (i.e. the return) derived from a 'tree' (i.e. an income-producing asset), in which case the receipt or accrual is of a revenue nature (in

court put this as follows: 'As a broad proposition it may be stated that income is revenue derived from capital productively employed. ... This is a concise statement of the proposition that the fruits derived from invested capital are income. Such revenue-producing capital may, however, be realised, and realised at a profit. The question may then arise, is the amount realised merely an enhancement of the original capital or is the resultant profit a profit on revenue account'.

¹⁹¹ The subjective intention of the taxpayer is not relevant, merely the question as to whether the receipt is the result of the productive utilisation of the taxpayer's capital.

¹⁹² Refer to *Silke* (op cit note 126) at 3.1: 'often the determination whether a receipt or an accrual is of an income or a capital nature will be obvious. Thus amounts received by a taxpayer for allowing the use of an asset to some other person ... interest, rents, royalties, all partake of the nature of income and fall within the definition of gross income. As long as the amount is received for the right of use of an asset without any change in ownership of the asset, it is in the nature of income'. Available:

[http://classic.mylexisnexis.co.za/nxt/gateway.dll/7b/ae/vaa/f2nk?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://classic.mylexisnexis.co.za/nxt/gateway.dll/7b/ae/vaa/f2nk?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [2016, January 14].

¹⁹³ Refer also to *Meyerowitz* (op cit note 187) at 8.142: 'In the case of civil fruits there is a receipt or accrual when the rents, interest or dividends become due and payable. When they are received or accrue they will be income, being the wealth produced by the capital productively employed'.

¹⁹⁴ *CIR v Visser* (1937) (supra note 186) at 276.

other words the result of capital productively employed). Where however the receipt or accrual is as a result of the disposal of the tree itself, the amount would in the ordinary course be of a capital nature.

Maritz J cautions in *CIR v Visser* (1937) however that the application of this guideline is often difficult given that what is 'tree' in one taxpayer's hands may be 'fruit' for another.¹⁹⁵ The distinction which the learned judge was making is equally applicable when one considers the difference between 'fixed' and 'floating' capital, which we shall consider in the next section. The disposal of an income-producing asset (which would be a 'tree') could very well still give rise to a revenue receipt for the taxpayer (similar to a 'fruit') if the nature of that income-producing asset was 'floating capital' (i.e. trading stock) in the taxpayer's hands.¹⁹⁶

6.4.4. 'Fixed' vs 'floating' capital

When characterising a receipt or accrual on the basis of the economic distinction (in relation to the carrying on of a business) between 'fixed capital' and 'floating capital', the following description is appropriate:

*'Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it remains intact.'*¹⁹⁷

In short, the receipt from a disposal of fixed capital is capital in nature.¹⁹⁸ Conversely, the receipt from a disposal of floating capital is revenue in nature. Assets that are fixed capital would, per the definition above, be classified objectively on the basis that they represent the employment of capital which is not consumed through the carrying on of a business but rather retain their nature permanently whilst deriving a return. Floating capital by contrast would be identifiable because it is consumed in the carrying on of a business, and changes form continually (from stock to cash and back into new stock).

Although this distinction has been acknowledged by the courts, it does not appear to have been a very *'fruitful test for the characterization of a particular asset as being either of an*

¹⁹⁵ See *CIR v Visser* (1937) (*supra* note 186) where the following illustration of this point is given: *'Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset'*.

¹⁹⁶ This is explained as follows in *CSARS v Van Blerk* (2000) 62 SATC 131 at 135: *'The proceeds of the sale are not to be determined by whether the fruits or corpus has been sold but rather by means of examination of the nature of the transactions and the intention with which they were undertaken'*.

¹⁹⁷ Innes CJ in *CIR v George Forest Timber Co Ltd* 1924 AD 516 at 524.

¹⁹⁸ Assuming it is simply the realisation of a capital asset to best advantage.

income or of a capital nature'.¹⁹⁹ This guideline is in reality seldom used, with reference instead being made to the intention with which the asset was acquired and held (and disposed of) by the taxpayer.²⁰⁰ It may perhaps therefore be more apt to refer to the concepts of 'fixed' and 'floating' capital as indicative factors to be taken into account in the determination of this intention, than as a guideline in their own right.

The words of Smalberger JA in *Pick n Pay Employee Share Purchase Trust* (1992) should also be remembered:

'Where no trade is conducted there cannot be floating capital'.²⁰¹

This guideline is therefore only relevant where a taxpayer needing to classify the income tax nature of a receipt is engaged in the operation of a business.

6.4.5. Operation of business

This guideline is well established, and has been considered numerous times in South African jurisprudence over the years. As a basic premise, where a receipt or accrual is:

"a gain made by an operation of business in carrying out a scheme for profit-making," then it is revenue derived from capital productively employed and must be income'.²⁰²

In *Stephan v CIR* (1919),²⁰³ Mason J approved the following definition of 'business' as being *'anything which occupies the time and attention of a man for the purpose of profit*'.²⁰⁴ It is therefore necessary to consider whether, on an objective assessment, the transactions carried out (giving rise to the gain in question) in fact amount to the operation of a business. It is also however necessary to consider the subjective element, in terms of which it should be decided on the basis of all the relevant facts and circumstances whether the taxpayer has carried out that business with the requisite profit motive.²⁰⁵

¹⁹⁹ De Koker *Silke* (*op cit* note 126) at 3.14 [2016, January 20].

²⁰⁰ The question being whether it was acquired with the subjective intention to hold for a return, or to sell for a profit.

²⁰¹ *Pick n Pay* (1992) (*supra* note 120) at 283 with reference to *Sekretaris van Binnelandse Inkomste v Aveling* 1978 (1) SA 862 (A) at 880-881.

²⁰² The Scottish case of *Californian Copper Syndicate v Inland Revenue* (1904) 41 Sc LR 691 at 694, cited with approval in, *inter alia*, *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 453 and *Stott* (1928) (*supra* note 125) at 257. See also the recognition of this guideline in the words of Maasdorp JA in *COT v Booysen's Estates* (1918) (*supra* note 188): *'the transaction is not one in the course of business of a person who deals in land..., and the profit made is not income*'.

²⁰³ (1919) 32 SATC 54 at 61.

²⁰⁴ Citing *Smith v Anderson* (1880) 15 Ch.D. 258.

²⁰⁵ See for example the comments in *Crowe v CIR* (1930) 4 SATC 133 at 139 to the effect that in *COT v Booysens* (1918) (*supra* note 188) *'the Chief Justice applied the test of purpose or intention*'.

The objective assessment requires one to take cognisance of the fact that the operation of a business may require, in the case of an individual, an element of ‘continuity’,²⁰⁶ and that the transactions performed are ones regularly and continually carried out in the operation of that business. It is also possible, and should be noted, that while a taxpayer may ostensibly acquire and dispose of an asset for a ‘secondary’ purpose, the transaction could still be considered to be part of the operation of the business and fall to be taxed on revenue account.²⁰⁷

The frequency with which a taxpayer transacts may assist with the determination of whether a receipt is capital or revenue in nature. If the taxpayer buys and sells frequently, this can be seen to be an indicator of a business and a revenue intention.²⁰⁸ However, an isolated transaction outside of the ordinary course of the taxpayer’s business is not *ipso facto* capital in nature.²⁰⁹ The test remains an investigation into the intention or motive behind the transaction and whether there is a scheme of profit-making involved.²¹⁰ The scale and frequency with which transactions are effected should not therefore be seen to be conclusive. They can however be an important indicator in showing whether a taxpayer has a revenue intention.²¹¹

The subjective assessment requires that, notwithstanding whether a taxpayer is seen to be objectively carrying on a business, the receipts or accruals derived will only be revenue in nature if this business was conducted with ‘*a profit-making purpose, as part of a profit-making venture or scheme*’.²¹²

²⁰⁶ Refer to *CIR v Lydenburg Platinum Ltd* (1929) 4 SATC 8 at 16-17 where Stratford JA stated that: ‘continuity ... is a necessary element in the carrying on of a business in the case of an individual but not of a company’.

²⁰⁷ Refer to *African Life Investment Corporation (Pty) Ltd v SIR* (1969) (*supra* note 163) at 176: ‘Where the sale of shares held as an investment is in fact contemplated as an alternative method of dealing with them for the purpose of making a profit...or ... where it is one of the appointed means of a company’s gains...that is a secondary ... purpose of their acquisition... It would nevertheless be part of the business operations contemplated for the production of income’. See also *CIR v Nussbaum* (1996) (*supra* note 164) for another example of a ‘secondary profit-making purpose’.

²⁰⁸ Refer however to *Stephan v CIR* (1919) (*supra* note 203) at 59 where a single salvage transaction was held to be taxable because of the apparent profit-making motive. The court stated that: ‘The whole thing was an adventure or concern of the nature of a business or trade; the profits arising therefrom come within the very words of the definition of income, and arise from the productive use of capital employed to earn them’.

²⁰⁹ See for example *ITC 43* (1925) (*supra* note 37) where a speculation in futures was taxed on revenue account despite being an isolated transaction. The court held that, although different to the transactions ordinarily undertaken this speculation was still within the scope of the taxpayer’s business.

²¹⁰ De Koker *Silke* (*op cit* note 126) at 3.15 [2016, January 14]. Refer also to *ITC 382* (1937) 9 SATC 439 at 440: ‘So far as the question of isolated transactions is concerned, this has been settled by numerous decisions in the Supreme Court and in this Court [the Tax Court], and that if a profit arises out of trading it is taxable notwithstanding the fact that the transaction is an isolated one.’

²¹¹ *CIR v Nussbaum* (1996) (*supra* note 164) at 292.

²¹² *Pick n Pay* (1992) (*supra* note 120) at 280. See also *Broomberg* (*op cit* note 138) at 71 where the author is of the view that the guideline set down in *Californian Copper Syndicate* (1904) (*supra* note 202), namely the operation of a business in carrying out a scheme of profit-making, presupposes

For the same reason, a taxpayer's proceeds derived from the sale of an asset may still be regarded as income even where they are not carrying on a trade or business.²¹³ Where a single transaction is involved, be it for an individual or a juristic person, it has been held to be more appropriate to simply consider whether there is a profit-making scheme.²¹⁴

that the distinguishing factor in this guideline is the purpose to make a profit. Refer also to 6.3.3 above.

²¹³ De Koker *Silke* (*op cit* note 126) at 3.15 [2016, January 14].

²¹⁴ *Natal Estates* (1975) (*supra* note 149) at 198 and *Elandsheuwel Farming* (1978) (*supra* note 131) at 118 as cited by Smalberger JA in *Pick n Pay* (1992) (*supra* note 120) at 280.

CHAPTER 7 CRITICAL EVALUATION OF THE ARGUMENTS

In this chapter, the necessary application and critical evaluation of the different arguments considered will be made, in order to conclude on the problem question of whether a taxpayer could treat gains realised on a derivatives hedge of a capital investment on capital account.

7.1. Existing South African case law on derivatives hedging

When considering the existing South African decisions regarding the taxation of gains made from derivative instruments and/or gains derived from the employment of hedging strategies, it becomes apparent that whilst some may assist in answering the question of whether a taxpayer can use a derivative to hedge against losses on an underlying share investment on capital account, none of them is necessarily conclusive.

The taxpayer in *ITC 43* (1925) was held to have made revenue gains hedging the cost of acquisition of trading stock for his produce trading business. The taxpayer's flawed argument that these were fortuitous gambles was dismissed. The court's decision was that the gains were realised as a result of his skill and business knowledge.

Similarly, the taxpayer in *ITC 340* (1935) was held to have made revenue gains hedging the foreign exchange difference on the cost of acquisition of trading stock from overseas. The court was of the view that the profit derived on these forward exchange contracts was part of the taxable profit derived from the business.

The revenue conclusion in these decisions appears to have been reached on the basis that the derivatives in question were used in relation to the taxpayers' businesses. To the extent that the decisions were based upon an assessment of the closeness of connection to the taxpayers' profit-making activities they do not offer much assistance in addressing the problem question. While taxpayers' could try to argue that the hedging of a share investment is capital in nature if the investment is not used as part of a 'profit-making activity', it should be acknowledged that these cases could be viewed as distinguishable on the facts to the extent that they both related to the hedging of an acquisition cost. The line of reasoning applied by the courts does not therefore bring us closer *per se* to an answer in the present instance (where the assets are already held).

The taxpayer in *ITC 1498* (1989) was, by contrast, determined to have made a capital gain hedging the foreign exchange risk associated with the cost of acquisition of a capital asset (to be used in his business) from overseas. This case is certainly more on point, and provides support for the notion that it is possible to hedge with a derivative on capital account.

The court in *ITC 1498* (1989) held that the gains realised on the foreign exchange hedge of the taxpayer's liability for capital expenditure should assume the character of this liability, on the basis that this is the 'originating cause' for the derivative entered into. It must be acknowledged however that this case could potentially also be distinguished on the facts from the matter at hand, on the basis that this too related to hedging the *cost of acquisition* of a capital asset (i.e. hedging the liability), as opposed to hedging a loss in value of a capital asset already *held*. It is submitted that whilst taxpayers should view this decision as conceptually supporting the idea of being able to hedge with a derivative on capital account, caution should be exercised in viewing this judgement as decisive were another court ever required to adjudicate the case where a taxpayer used a derivative to hedge against losses on an underlying share investment.²¹⁵

In *ITC 1756* (1997) futures contracts were entered into by the taxpayer to hedge the cost of acquisition of an intended long-term share portfolio. To the extent that this case involved hedges relating to the acquisition of a share portfolio investment, as opposed to the acquisition of a capital asset for a business, it could have proved even more useful than *ITC 1498* (1989) in answering the problem question. The issue of whether the profit on the hedge was capital or revenue in nature was unfortunately not one on which the court needed to pronounce judgement however. Moreover, the court indicated that had it been required to conclude on this, it would have been required to find against the taxpayer (i.e. to conclude that this was a revenue profit) on the basis that insufficient evidence was adduced by the taxpayer to prove that this was not a scheme of profit-making. This would then suggest a potential negative answer to the problem question, but as will be discussed further in 7.2.1 below this case should, it is submitted, also not be taken as the definitive final word.

In *ITC 1223* (1974) the court found that the profit realised on the disposal of shares held for a short period of time was capital in nature because the shares had been disposed of in order to protect the taxpayer's capital. Whilst this 'mitigation of loss' did realise a profit (and therefore derived precisely the same outcome as hedging with a derivative), and while this profit was held to be capital in nature because it wasn't realised as part of a profit-making scheme, it wasn't realised through a *hedge of the shares with a derivative*.

Consequently, this decision could equally be distinguished on the facts from the problem question. It leaves open the issue of whether gains or losses realised hedging underlying shares held *with a derivative* (though achieving the same economic result as *ITC 1223* (1974), but through different means in order to avoid incurring the expense and opportunity costs of liquidating an entire investment) would (or should) be subject to different taxation.

²¹⁵ As a Tax Court case, this decision is not binding on other courts and would only be of indicative value for a future court (and then only to the extent that it was faced with a similar set of facts).

7.2. The SARS view

SARS puts forward the view in the Share Owners Guide that because futures contracts derive no return for the holder (such as dividends or interest), the sale of futures contracts should be taxed on revenue account. SARS contends that this should be the case even if used as a hedge against losses on underlying shares held as capital assets.

In support of the view, SARS cites *ITC 1756* (1997) and the English Court of Appeal decision in *Wisdom v Chamberlain (Inspector of Taxes)* (1969). It is, with respect, debateable whether these cases actually offer direct support for the stated position.

7.2.1. Critique of reliance on *ITC 1756*

The court in *ITC 1756* (1997) was not required to make what it described as the ‘novel’ determination of the capital or revenue nature of the gains made on the sale of the futures contracts (a question which had up until that point not been considered in South African jurisprudence, and which has, hitherto, not come up for determination again). This was because the revenue authority had, in the matter in question, incorrectly attempted to include these gains which were made in March 1989 (i.e. which were received or accrued during the 1990 year of assessment) in the 1992 year of assessment. The court instead noted however that:²¹⁶

‘In order to determine that issue the court would have to consider the precise nature and operation of the ‘futures market’ as also the particular transactions entered into by the appellant. The evidence led in this matter as also the argument presented did not adequately place the court in a position to decide whether or not the gains in question resulted from a scheme of profit-making. Had the court been required to answer the question on its merits the court would have had no option but to find that the appellant had failed to discharge the onus which rests upon it of proving that the respondent was wrong in including the amount of R537 085 as part of appellant’s taxable income’. (own emphasis)

It is submitted that the court did not explicitly state in its *ratio decidendi*, nor imply in an *obiter dictum*, that (as per the Share Owners Guide) a gain made by a taxpayer on ‘*the sale of futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets*’. The court merely pointed out, correctly it is respectfully submitted, that such a capital or revenue determination would require a precise

²¹⁶ *ITC 1756* (1997) (*supra* note 43) at 386.

examination of both the legal nature of futures contracts as well as the mechanics of their operation within the confines of the prescribed regulatory trading environment. The court also points out that an equally precise interrogation of the taxpayer's intention, manifested as always in the transactions which are implemented, would need to be determined (presumably, in the accepted manner set out in our case law). The court's statement merely shows that the Appellant in *ITC 1756* (1997) had simply failed, in respect of the sale of the futures contracts, to lead sufficient evidence in respect of the above issues in order to discharge the evidentiary burden which it bore as the taxpayer and to allow the court to be able to adjudicate in its favour on the merits of the matter (had it been required to do so).²¹⁷

Moreover, the case in *ITC 1756* (1997) dealt with the hedging of a *long futures position* adopted by a taxpayer looking to acquire an asset (but which it was, through no fault of its own, unable to purchase directly from the outset), so as to guarantee for itself the acquisition cost (purchase price) of that asset. This is different to, and can be distinguished from, the hedging by a taxpayer of the value of an investment already owned, as described in the Share Owners Guide, through the adopting of *short futures positions* to mitigate any risk of loss should the value of the investment decline.

For these reasons, the reference to *ITC 1756* (1997) as support for the stated view in the Share Owners Guide that the sale of all futures contracts is likely to be on revenue account, even if used as a hedge against losses on underlying shares held as capital assets, appears open to question.²¹⁸

7.2.2. Critique of reliance on Wisdom

The Court of Appeal's view that the transaction could not be classified as a pure investment, and therefore fell on the side of an adventure in the nature of trade, appears to be based upon the notion that this purchase of bullion 'looked' more like 'an adventure in the nature of trade' than an 'investment' because, *inter alia*, it: (i) produced no income; (ii) was only held for a short period of time; and (iii) was (while it lay in a vault) otherwise 'useless' to the taxpayer.²¹⁹

²¹⁷ It is submitted that, had further evidence been led before the court, it may well have been able to find in the taxpayer's favour in this regard. The court's tacit confirmation that the period for which a financial instrument is held is not decisive in determining its nature lends support to this view.

²¹⁸ Once again, it should also be remembered that this is a Tax Court case and as such other courts are, in the future, not bound to follow this decision as legal precedent.

²¹⁹ Refer to the 'Business Income Manual' No. 20260 on the HMRC website. Available: <http://www.hmrc.gov.uk/manuals/bimmanual/BIM20260.html>, [2014, November 9]. Refer also to the articles on <http://www.taxationweb.co.uk/tax-articles/business-tax/the-badges-of-trade.html> and <http://www.tax.org.uk/tax-policy/tax-adviser-articles/2001/sales-of-assets-or-trading> which both classify *Wisdom* (1969) as a 'motive' case (i.e. the taxpayer's 'profit motive' was decisive).

SARS' inclusion of this case under the heading '*Low or nil return*' in their discussion in the Share Owners Guide on how to determine a capital or revenue gain, appears to indicate that they have a similar feeling towards Single Stock Futures as the court in *Wisdom* (1969) had to silver ingots, when these are used as hedges. The question is however whether these principles are applicable.

It is submitted that the principles in the *Wisdom* (1969) case may not necessarily be determinative for a South African taxpayer entering into futures contracts to hedge a capital share investment,²²⁰ for the following reasons:

- While it is true that Single Stock Futures do not deliver a return in the same way that a share would do with its dividend yield, it is incorrect to propose that this characteristic is *per se* definitive in branding an asset as no longer capital in nature.²²¹
- It is also true that a Single Stock Future is not held for a long period of time, but this fact should not on its own be held to be decisive and should not be held up as the final word in any capital/revenue debate.²²² It is a matter of degree.²²³
- The fact that the taxpayer hedged Pound Sterling capital assets against devaluation using ingots of silver, which were unrelated to the underlying portfolio hedged, was a significant factor that contributed towards the court's view that this was a trading adventure (i.e. a simple short-term acquisition with a view to a re-sale at a profit). This should be distinguished from a hedge of an underlying share position using Single Stock Futures, and *Wisdom* (1969) should not be seen as suitable authority for the view that such a hedge should also be seen to be revenue in nature.

²²⁰ It should also be remembered that as a case decided in the United Kingdom, the decision sets no binding precedent in South Africa. It can, at most, be used as a useful guidance or reference source by the courts in this country.

²²¹ Refer to the oft quoted *dicta* of Corbett JA in *Elandsheuwel Farming* (1978) (*supra* note 131) at 118, where he explains that '*the sale of an asset acquired with a view to holding it either in a non-productive state or in order to derive income from the productive use thereof, and in fact so held, constitutes a realisation of fixed capital and the proceeds an accrual of a capital nature*' (own emphasis).

²²² *LHC Corporation of SA* (1950) (*supra* note 140) at 134; *CIR v Richmond Estates* (1956) (*supra* note 140) at 366.

²²³ It should be remembered that the SAFEX imposes rules on persons entering into futures positions, which rules require that these position be closed out on a regular basis. Any disposal by the taxpayer is therefore not necessarily of his own volition, but is rather forced upon him because of his decision to acquire Single Stock Futures regulated by the SAFEX.

- There is precedent for South African taxpayers hedging inflation with Krugerrands (similar to the hedging in *Wisdom* (1969) of the devaluation of the Pound Sterling with silver ingots) on capital account.²²⁴
- It is also, in the view of the author, misleading to say that Single Stock Futures entered into in order to hedge an underlying investment are ‘useless’ for the taxpayer because they offer no income yield or ‘pride of possession’.²²⁵ The Single Stock Futures serve a very obvious and ready purpose merely by being held, precisely because they allow the taxpayer to minimise financial loss in the event of a fall in the value of the underlying investment.

Once again therefore, the authority cited as support for the stated view in the Share Owners Guide appears to be open to question.

7.3. Determining the tax nature of the derivative hedge by analogy

7.3.1. *The derivative hedge is akin to an insurance contract*

Insurance proceeds compensate, make good or act as a ‘substitute’ for an insured loss. In the same way, the anticipated profit on the derivative hedge is intended to compensate, make good or act as a ‘substitute’ for the underlying value which is lost upon the devaluation of the share investment.²²⁶

The income tax nature of the receipt on the derivative hedge may, so the argument goes, therefore be determined in an analogous manner to that of the insurance receipt – with reference to the *function* of this compensatory or ‘substituted’ amount. The essential question is whether the *compensation was designed to fill a hole in the taxpayer’s profits, or whether it was intended to fill a hole in his assets.*²²⁷ If the amount received in substitution fills a hole in profits, the payment is regarded as income. Where it fills a hole in the capital structure, the receipt is capital in nature.

On the basis that the *function* of the substituted amount is to compensate for the anticipated decrease in the value of the share investment being hedged, as opposed to compensating for any anticipated loss of income (dividends) received from the investment, the compensation would be said to fill a hole in the taxpayer’s assets and be capital in nature.

²²⁴ Refer to *CIR v Nel* (1997) 59 SATC 349, where the taxpayer who had purchased Krugerrands as a hedge against inflation (and held them for a period of eleven years during which time they appreciated significantly in value), sold them in order to raise funds. The Court held that the coins were held on capital account and as such the profit on their sale was not subject to income tax.

²²⁵ Such as one would have if one were to invest in an artwork or sculpture.

²²⁶ Byala (*op cit* note 84) describes this as: ‘*simply restoring a capital asset to its original value*’.

²²⁷ *Burmah Steam Ship* (1930) (*supra* note 65).

In certain instances it is also necessary to consider the actual *nature* of that which is lost, in the hands of the taxpayer in question, in order to determine whether the result obtained from applying the *function* test above remains determinative of the character of the compensatory or 'substituted' amount.²²⁸ Were the nature of the share investment to be stock-on-hand or floating capital for the taxpayer, then the nature of the substituted amount received would be revenue. However, to the extent that any hypothetical profit from its sale would not be revenue in nature (since it is not held as part of a profit-making scheme), then true nature of this share investment for the taxpayer is fixed, not floating, capital and the substituted amount received for its decrease in value remains a capital receipt.

Byala (1993) sees the determination of whether the derivative hedging receipt is capital or revenue in nature as being dependent upon whether the proceeds received are designed to '*fill a hole in income or in capital*'. Hutton (1998) similarly confirms that both the function of the substituted amount and the nature of that which is replaced need to be considered.²²⁹ SAICA (1992) has also previously indicated that to the extent that proceeds from an insurance policy taken out to cover capital assets are not taxable, it is misleading to regard any profit derived from a hedging transaction as revenue in nature merely because it is taken out to cover downside risk.²³⁰ It is submitted that these statements further support the above position.

There is therefore an argument, compelling in both its logic and the equitable result which it achieves, that the proceeds from the derivative hedge of a capital share investment may be treated as capital in nature.

It is however important to note that no direct tax precedent exists for the position that a hedge is analogous to an insurance policy, and that *ipso facto* the tax treatment of these two should therefore be the same. A taxpayer seeking to rely on this insurance analogy argument, as the basis for a capital tax position adopted, should be mindful of this fact.

It should also be noted that Brincker (2011) relegates the use of the insurance analogy to classify proceeds on a derivative hedge of a capital asset as capital in nature, given that an insurance pay out (for an insured capital asset) could be determined with reference to a loss of profits and would therefore still be revenue in nature, or that continuous hedges (notwithstanding that they were ostensibly linked to an underlying capital asset) could be seen as a profit-making scheme making the associated proceeds revenue in nature once more.²³¹

²²⁸ *Estate A G Bourke v CIR* (1991) (supra note 67).

²²⁹ Hutton (*op cit* note 86).

²³⁰ SAICA (*op cit* note 1) at 4.4.3 on page 25.

²³¹ Brincker (*op cit* note 89).

7.3.2. The tax treatment of the derivative hedge should follow the tax treatment of the underlying

Hutton (1998) argues that a gain made on a derivatives hedge should assume the character, for tax purposes, of the underlying asset or the exposed hedge. Applied in the present context, this argument is therefore that the tax treatment of the derivative hedge of the capital share investment should follow the (capital) tax treatment of the underlying shares.

As support for this argument Hutton (1998) cites the same *ITC 340* (1935) (where the taxpayer used FECs to hedge the acquisition of trading stock, and in so doing realised gains that were taxed as revenue), and *ITC 1498* (1989) (where the taxpayer used FECs to hedge the foreign exchange risk on a debt incurred in acquiring a printing press in US Dollars), discussed in 7.1 above.

As previously stated, *ITC 1498* (1989) does offer support for the notion that it is possible to hedge with a derivative on capital account. Both *ITC 340* (1935) and *ITC 1498* (1989) however related to the hedging of a liability (the *cost of acquisition*) as opposed to the hedging of an asset already held. Applying Hutton's (1998) argument, the gains realised from these derivative hedges could be said to have assumed their character from the 'exposed hedge' as much as they did from the 'underlying asset'.

Brincker (2011) also supports the argument that in order to determine the character of the proceeds realised from a derivative hedging transaction one should focus on the nature of the underlying asset. He is however also cautious to place too much reliance on *ITC 340* (1935) or *ITC 1498* (1989). In his view, the fact that the taxpayer in *ITC 340* (1935) had a separate profit motive gave rise to the revenue treatment of the gains realised in respect of the derivative hedge, and the court in *ITC 1498* (1989) only found the gains to be capital in nature because the FECs were not seen as integral to the taxpayer's business. This suggests that neither of these decisions were definitively reached, in his view, purely because of the revenue or capital nature of the assets underlying the hedges.

For Brincker (2011), the real test is whether the taxpayer has a true capital intention with both the derivative hedge *and* the underlying asset. On the basis that the taxpayer could discharge the burden of proof in this regard (through evidencing, for example, a sufficiently close link between the hedge and the underlying, the extent to which the hedge mitigates the risk perceived and the duration for which the derivative hedge is entered into) it could

be possible to successfully treat the proceeds of a derivative hedge of a capital share portfolio as capital in nature.²³²

If regard is had to the above case law, and the commentary on this argument, it is once again noted that no definitive tax precedent exists for adopting a capital position in respect of a derivative hedge of an underlying asset held, based solely on its capital nature. Similarly, there is no precedent for what is required to be shown in order to discharge the burden of proof of showing a ‘true capital intention’ with the derivative hedge. Taxpayers may therefore again need to exercise circumspection if seeking to rely on this argument.

In the absence of definitive precedent in South Africa, support may however be found in the United Kingdom where an ancillary futures hedge (provided it appropriately eliminates risk) is taxed on the basis of the tax treatment of the underlying transaction. This specifically includes the situation where index futures are used to protect the value of an investment against a fall in the market. Gains on the derivative hedge will in this instance be taxed on capital account.²³³

Hutton (1998) and Brincker (2011) do both also motivate this argument for analogous tax treatment on the basis of the economic merit of linking the tax treatment of the underlying capital investment and the hedging instrument. To do otherwise would, in their view, distort the efficacy of the hedge. This is a compelling submission, in both its logic and the equitable result which it achieves, which should be borne in mind by taxpayers seeking to adopt a capital position in respect of a derivative hedge based on the capital nature of the underlying assets.

7.4. Common law ‘First Principles’

7.4.1. The taxpayer’s intention and circumstantial indicators of intention

7.4.1.1. Intention

Judicial precedent sets out that the taxpayer’s subjective intention upon acquisition of an asset is the most important factor in the determination of the capital or revenue nature of any receipt from its disposal. The taxpayer’s own *ipse dixit* should not however necessarily be accepted as the final word, as any stated subjective intention may be designed to serve

²³² This ‘intention’ requirement is supported by other authors too. SAICA looks for ‘a sufficiently close link between the underlying capital investment and the hedging instrument’; Byala and Hutton require a ‘genuine hedging intention’ and Coetsee ‘refers to an intention to protect’.

²³³ The US Tax Code and case law, and Australian tax rulings, are less helpful (with the US precedent only dealing with the taxation of revenue hedges on the basis of the underlying, and with the Australian ruling being directly aimed at commodities hedges).

self-interest. This stated intention must therefore also be tested against objectively determinable facts.

Moreover, any stated *capital* intention on the part of the taxpayer must be evaluated to determine whether a scheme of profit-making was in fact being pursued with the asset in question.

Notwithstanding an ostensible subjective capital intention being present on the acquisition of the derivative used as a hedge, the taxpayer in question may on the basis of what follows still be held to realise revenue gains on its disposal.

7.4.1.2. *Circumstantial indicators*

It is possible to argue that gains realised on a derivative hedge should be treated as revenue in nature, based on two circumstantial indicators of the taxpayer's intention – the fact that no return (interest or dividends) is derived in respect of these derivative instruments, and the relatively short three month nature of the holding of the derivative instruments (which is known at inception). The existence of these factors appears to be favoured by SARS in concluding that a derivative hedge should always be taxed on revenue account.

It is accepted however in our jurisprudence (and on certain occasions even by SARS) that these factors remain mere 'indicators' that support or refute a taxpayer's stated intention. They are not decisive tests.

Furthermore, the Appellate Division has confirmed that the holding of an asset with a capital intention *can* include holding it in a non-productive state (as would be the case for any derivative instrument acquired) and not just in order to derive income therefrom.²³⁴

It should also be remembered that the fact that the derivative is not held 'for keeps' and that it is disposed of within three months of its acquisition is as a consequence of the JSE requirement that derivatives traded on the SAFEX be closed out every quarter. The disposal is not therefore as a result of the taxpayer's choice. Brincker (2011) states that '*the period of holding a derivative is not necessarily decisive to determine the nature of the proceeds upon its subsequent disposal*'. Even though derivatives are only held for short period time, they are often repeatedly 'rolled over' in order to hedge for a longer desired period. Brincker (2011) suggests that the proceeds realised from such successive derivative transactions should not be seen to be of a revenue nature merely '*because a taxpayer cannot afford an*

²³⁴ *Elandsheuwel Farming* (1978) (*supra* note 131).

expensive hedge for a longer term period, ... as the intention is always to run over derivatives on a continuous basis.²³⁵

It is submitted as correct therefore that neither the lack of a return, nor the length of the holding period, should be seen to be decisive when determining the income tax nature of a derivatives hedge.

7.4.2. Scheme of profit-making and the taxpayer's purpose

7.4.2.1. Scheme of profit-making

If the derivative is acquired with the outright intention of selling to make a profit, then the taxpayer's subjective intention is once again determinative and the proceeds are revenue in nature. Where the derivative is acquired to be held as a capital asset, but then subsequently dealt with and disposed of in pursuance of a profit (a so called 'change of intention'), the proceeds can still be seen to be revenue in nature. The taxpayer is described in these instances as pursuing a scheme of profit-making.

The most compelling argument as to why the gains or losses realised on the disposal of the derivative, entered into as a hedge, should be classified as revenue in nature is based on the fact that the derivative is acquired with the intention to dispose of it at a 'profit', if the hedge has been correctly entered into. The taxpayer's actions (in hedging with the derivative) therefore constitute, so the argument goes, a scheme of profit-making.²³⁶

In the present instance the hypothetical taxpayer in question will be said to have pursued a scheme of profit-making (either from the outset or subsequent to a change of intention) where the gain (profit) realised on the derivative hedge is not seen to be 'fortuitous', but rather 'designedly sought for and worked for'. This in turn requires a further subjective assessment of what the taxpayer's *purpose* (or potentially his dominant purpose) was, and whether it may be said that this purpose was to make a profit.

7.4.2.2. The impact of the taxpayer's 'purpose'

A taxpayer's *intention* on acquiring an asset might also be described as his *plan* for the asset.²³⁷ This plan in turn may be said to be aimed at achieving his *purpose*, which would be the *reason* behind his intention.

²³⁵ Brincker (*op cit* note 89).

²³⁶ SAICA (*op cit* note 1) also confirms this: '*since a hedger's intention is to prevent a loss by entering into an instrument with an equal but opposite position, this is (on a strict interpretation of present case law) nothing short of a scheme of profit-making which may lead one to conclude that all futures or option transactions will be revenue in nature*'.

²³⁷ Being the 'plan' which he has formulated through the application of his mind to the attainment of his goal.

In the present instance the taxpayer in question acquires the derivative as a hedge for an underlying share investment. Whilst viewing this in isolation may suggest he acquires the derivative with the intention of disposing of it at a profit, it is submitted that this should not be viewed as an isolated transaction precisely because this is a hedge of an underlying position. A hedge of this sort does not take place in isolation. It could, it is submitted, therefore be said that his intention (plan) upon acquisition is to utilise the derivative as a hedge, for the purpose (reason) of mitigating downside loss on the underlying equity investment. To the extent that his purpose (reason) for acting was ostensibly not to make a profit from the disposal of the derivative but rather to mitigate against downside loss on the underlying shares, such profit could potentially be described as fortuitous and not something 'designedly sought for and worked for'. The taxpayer is trying to reduce the diminution of his or her estate, as opposed to trying to grow his or her patrimony further. Any profits realised on the hedging position are merely a means to an end, and not *per se* the end in and of themselves. Acceptance of this argument would mean that the taxpayer would not be said to have pursued a scheme of profit-making. The resultant gains or losses on the disposal of the derivative would then be capital in nature.

Where however the efficacy of the taxpayer's hedging strategy depends directly upon his or her ability to make a profit on the disposal of the derivative selected, it is acknowledged that it could be difficult to successfully argue that such profit was not 'designedly sought for and worked for'. This creates the situation where it would likely be said that the taxpayer has more than one intention, and more than one purpose, in acquiring the derivative (i.e. a hedging intention for the purpose of mitigating loss, and a disposal intention for the purpose of realising a profit).

In order to determine therefore whether this should constitute a scheme of profit-making, taxed on revenue account, it must be determined whether the profit purpose identified was his 'dominant purpose'. A 'dominant purpose' has been described as the one to which all other alternatives are entirely secondary, and, though contemplated, do not materially persuade the taxpayer to act. This description of a 'dominant purpose' creates the impression that a taxpayer could entertain and foresee the possibility of making a profit (and reconcile him-/herself with this reality) without *per se* being viewed as having the *dominant* purpose of making a profit. It is submitted however that taxpayers should recognise the difficulties that can arise when it comes to proving that there is no scheme of profit-making where they have more than one co-existing purpose, and one of them is calculated at yielding a profit.

Notwithstanding this, our courts have however previously relied upon a taxpayer's co-existing *purpose* as grounds for the determination of the capital nature of the proceeds on the disposal of an asset, even though the taxpayer also had a profit-making purpose (i.e. the

taxpayer acquired an asset with the intention of disposing of it to best advantage).²³⁸ More recently, our jurisprudence has been expanded in this regard to the extent that a taxpayer who acquires an asset with the intention of disposing of it (i.e. has a profit-making purpose) may only rely on this 'co-existing purpose' argument (in order to found a claim that the proceeds derived are still capital in nature) if there is a *real justification* for the acquisition and disposal of the asset *other than the pure realisation of that asset*.²³⁹ Where such a real justification exists, the realisation of the asset will not be treated as the taxpayer's dominant purpose. In this instance, it is submitted that the other, co-existing purpose will be considered to be dominant and will allow for the proceeds derived from the disposal to be classified accordingly.

In the present case it is submitted that such a real justification for the acquisition and disposal of the derivative in question, other than pure realisation at a profit, could arguably be found in the hedging purpose for which the derivative is acquired. The derivative is acquired to mitigate downside loss on the underlying equity investment, without incurring the expense and opportunity costs of liquidating the entire investment or where the taxpayer is contractually precluded from selling the underlying investment. This hedging purpose would then be dominant, and would mean that the taxpayer would not be said to have pursued a scheme of profit-making with the derivative. The resultant gains on the disposal of the derivative would then be capital in nature.

SAICA (1992) confirmed that the application of well-established legal principles to investment strategies that utilise derivative instruments could lead to all resultant profits being treated as revenue in nature. The report also confirmed that this could lead to inequitable results, and stated that the tax treatment of the profit from the hedge should not be done with reference to intention but that instead the motive test should prevail.²⁴⁰ It is submitted that referring to a taxpayer's *dominant, hedging purpose* with the acquisition and disposal of the derivative in order to characterise the nature of the proceeds received could result in a more equitable application of the taxation laws, as opposed to the result obtained solely concentrating on *intention*. Making reference to the taxpayer's purpose in this way would also align closely with the existing determination of whether the taxpayer has entered into a scheme of profit-making (which also requires an evaluation of purpose).

²³⁸ See *Berea West Estates* (1976) (*supra* note 167) and the decision that the *purpose* of the realisation company in question was to facilitate the realisation of the property to best advantage on behalf of the beneficiaries, and to ensure the exclusive distribution of the proceeds amongst such beneficiaries. To this end the profit was held to be capital in nature.

²³⁹ See *Founders Hill* (1972) (*supra* note 172).

²⁴⁰ SAICA (*op cit* note 1 at 24-25).

7.4.3. General guidelines

7.4.3.1. *Originating cause*

If the steps which the taxpayer takes in order to receive an amount are considered to be 'revenue' in nature, then the amount received will similarly be revenue in nature. Where these steps constitute the conducting of a business or an enterprise, or some other form of 'work' (in the sense of the active application of the taxpayer's own physical or mental efforts or the application of his or her capital to earn income), the revenue character of these efforts will result in their product also being treated as revenue.

To the extent that the taxpayer hedging a capital share investment with a derivative is not however conducting a business or an enterprise, it is submitted that this guideline will only indicate a revenue result where the originating cause for the receipt from the disposal of the derivative can be said to be the taxpayer's 'work' (using his wits and/or capital) performed to earn the receipt.

Whilst it is by no means certain that this would be the case, conceptually the taxpayer's correct identification and acquisition of an appropriate derivative to act as a hedge could be said to be the result of the application of his wits and skill, which could potentially constitute the 'work' performed to earn the receipt.

7.4.3.2. *Capital productively employed*

The focus of this guideline in determining the tax nature of an amount received is on whether such amount was derived from the (productive) *utilisation* of the capital of the taxpayer. This productive utilisation constitutes either the provision of the use of this capital to another in exchange for a return, or through the use of this capital to acquire an asset that derives a return. The application of this guideline does not however extend to the classification of an amount derived from the *disposal* of an asset acquired with the taxpayer's capital. Where the capital of the taxpayer is used to acquire a derivative which results in a profit on its disposal (i.e. where the hedge is successful), such profit is not as a result of the productive employment of capital. This guideline does not therefore appear to be of assistance in classifying the revenue or capital nature of a gain realised on a derivatives hedge.

7.4.3.3. *'Fruit' vs 'tree' analogy*

This 'fruit' and 'tree' metaphor is an application of the 'capital productively employed' guideline above. In this application, the focus is on whether the amount received constitutes a return on an asset held, as opposed to an amount received from the disposal of the asset

itself. Since any gain derived on a successful hedge would result from the disposal of the derivative,²⁴¹ this guideline also appears to not be of assistance in classifying the revenue or capital nature of such a gain realised.

7.4.3.4. *'Fixed' vs 'floating' capital*

This guideline determines the nature of a receipt from the disposal of an asset by making reference to the nature of the asset itself. A relatively permanent asset that is not consumed through the carrying on of a trade or business (so called fixed capital) would give rise to a capital receipt upon disposal. The disposal of an asset that is consumed in the carrying on of a trade or business (so called floating capital) would give rise to a revenue receipt. While this guideline seeks to classify the tax nature of a receipt derived from the disposal of an asset, which could theoretically apply to an amount received on the disposal of a derivative, it is submitted that this guideline is only relevant where a taxpayer is engaged in the operation of a trade or a business. The courts have previously indicated that where no trade is conducted there cannot be 'floating capital'. This guideline does not therefore appear to be of assistance in classifying the revenue or capital nature of a gain realised on a derivative outside of the operation of a business.

7.4.3.5. *Operation of a business*

In essence, this guideline requires a two-fold consideration – whether there is the operation of business, and if so whether it is a scheme for profit-making. Any amounts received in respect thereof would be revenue in nature.

It is submitted that in the ordinary course, one would not expect hedging activities conducted with derivatives to always constitute a 'business'. However, a business could ostensibly entail *'anything which occupies the time and attention of a man for the purpose of profit'*. Theoretically therefore, a series of hedging transactions entered into by an individual taxpayer could constitute the carrying on of a 'business' provided an element of continuity was present and the transactions performed were ones regularly and continually carried out in the operation of that business. Such an individual who, for example, regularly entered into multiple Single Stock Futures short positions contemporaneously, in respect of different shares within the investment portfolio in order to mitigate the downside risk on all of these shares because they are all in the same market sector and subject to the same risks, could be construed as operating a 'business'.

²⁴¹ For the sake of completeness, it should be noted that this gain on 'disposal' is paid 'early' through the daily variation margin payments received on a 'short' derivative position that is 'in the money'.

More importantly perhaps, even where a business is being conducted, this guideline necessitates consideration of the subjective element of whether (on the facts) the taxpayer has carried out that business with the requisite profit motive. Similarly, where a single transaction is involved, be it for an individual or a juristic person, it has been held to be more appropriate to simply consider whether there is a profit-making scheme.

The usefulness of this guideline as a separate determinative test is therefore questionable, since it in essence requires consideration of the same principal issues as 7.4.2 above.

7.5. Conclusion on arguments and proposed capital treatment

When one considers South African precedent to determine the income tax treatment of derivative instrument hedging strategies, no definitive answers emerge. The decisions have fallen on both sides of the revenue and capital divide. Gains have been found to be revenue in nature, but on the basis of the business conducted by the taxpayer. Gains have been found to be capital in nature, but in instances where the hedge was of the acquisition cost of an asset (as opposed to a hedge of the value of an asset already held). Gains realised to prevent a loss in value of an investment have been held to be capital in nature because no profit-making scheme was implemented, but no derivatives were used in this 'hedging' strategy. These decisions are therefore all distinguishable on the facts from the question at hand.

SARS puts forward the view that the sale of futures contracts should be taxed on revenue account even if used as a hedge against losses on underlying shares held as capital assets. The authority cited for this statement does not however support this conclusion, to the extent that the relevant courts did not actually make this finding.

In the opinion of the writer a compelling (and equitable) argument for the treatment of a derivatives hedge of a capital share investment can be made based on the analogy that the anticipated profit on the derivative hedge is intended to compensate for the underlying value which is lost, in the same way that insurance proceeds compensate for an insured loss. Where this loss is capital in nature, so is the compensation. It is however important to note that no direct tax precedent exists for this position, and commentators differ in their views in this regard.

An equally compelling argument may be made that the treatment of the derivative hedge should follow the nature of the underlying asset or transaction. Whilst case law can be pointed to in support of this theory, the cases cited are again potentially distinguishable in that they relate to the hedging of an acquisition cost for an asset, as opposed to the hedging of the value of an asset already held. While this approach would also appear to elicit support from commentators (and to align with the treatment in to the United Kingdom), it should again be noted that no direct tax precedent exists for this position either.

A taxpayer's ostensible subjective capital intention upon the acquisition of an asset (while being the most important factor in determining the nature of any receipt from its disposal) cannot be accepted as definitive. Similarly, circumstantial indicators of this intention – in the form of no derived return on the derivative instrument and the short holding period prior to its disposal – should not be seen to be decisive.

The most compelling argument as to why the gains realised on the disposal of the derivative, entered into as a hedge, should be classified as revenue in nature is based on the fact that the derivative is acquired with the intention to dispose of it at a 'profit', if the hedge has been correctly entered into. In other words, this is a scheme of profit-making.

However, to the extent that the taxpayer's purpose (reason) is to mitigate downside loss on the underlying equity investment, any profit could potentially be described as fortuitous and not something 'designedly sought for and worked for' and therefore capital in nature. Alternatively, it could be said that the taxpayer has more than one intention, and more than one purpose, in acquiring the derivative (i.e. a hedging intention for the purpose of mitigating loss, and a disposal intention for the purpose of realising a profit). With such a dual purpose, it is necessary that a 'real justification' for the acquisition and disposal of the derivative be found. It is submitted that the hedging purpose would meet this requirement, and that the taxpayer should not be said to have pursued a scheme of profit-making. Any resultant gains would be capital in nature. It is further submitted that referring to a taxpayer's *dominant, hedging purpose* in this manner in order to characterise the nature of the proceeds received would result in a more equitable application of the taxation laws, and that in the circumstances this is the preferred argument to be followed.

For the sake of completeness, none of the further common law guidelines reviewed appear to be of assistance in classifying the revenue or capital nature of a gain realised in the circumstances in question.

There are also, in addition to the above, compelling economic justifications for a proposed capital treatment of any such receipts and accruals, which are set out below.

7.6. Economic considerations motivating for capital treatment

Whilst it has been said for many years that '*there is no equity about tax*',²⁴² there are also compelling economic motivations for why the capital nature treatment proposed for gains realised on a derivatives hedge should be accepted as being correct.²⁴³

²⁴² Lord Cairns in *Partington v Attorney General* (1869) LR 4 HL 100.

²⁴³ As discussed above, there is economic merit in linking the tax treatment of the underlying capital investment and the hedging instrument. To do otherwise distorts the efficacy of the hedge.

Consider in this regard the following calculations in Table 1 below, for two different scenarios which are further explained hereafter:

Scenario 1: Sale of shares	
Disposal of shares @ R15,000	
Proceeds	R15,000
Base Cost	R5,000
Gain	R10,000
Disposal of shares @ R25,000	
Proceeds	R25,000
Base Cost	R10,000
Gain	R15,000
Scenario 2: Derivatives Hedge	
Futures contract entered into @ contract price of R15,000	
Proceeds	R5,000
Base Cost	R0
Gain	R5,000
Disposal of shares @ R25,000	
Proceeds	R25,000
Base Cost	R5,000
Gain	R20,000

Table 1: Comparison of capital gains derived from alternative strategies

In scenario 1, a taxpayer who acquired a share investment with an ostensible capital intention for a cost of R5 000, who anticipated a decrease in the market value of that investment after seeing growth to a market value of R15 000, decided to sell the shares accordingly in order to avoid losing their value accretion to date. The gain realised on this profit taking would likely be capital in nature. Moreover, if the same share investment had been held for more than three years the gain realised would be deemed to be capital in nature and all debate over the intention of the taxpayer would be removed.²⁴⁴

If that same taxpayer was to then in the future re-enter the market after the anticipated drop in the share price and purchase an equivalent quantity of those same shares at their new market value of R10 000,²⁴⁵ his CGT base cost for those shares would be R10 000 going forward.

At this point, the taxpayer’s position would be as follows:

²⁴⁴ Refer to section 9C of the Act, which provides that any amount (other than a dividend) received in respect of a ‘qualifying share’ (defined essentially as an equity share held for three or more years) shall be deemed to be capital in nature.

²⁴⁵ For present purposes it may be assumed that the taxpayer once again has an ostensible capital intention and that he can sufficiently prove that he has not begun trading in these stocks.

- He would have realised a capital gain of **R10 000** (R15 000 proceeds realised on the sale of the shares at their market value less the original base cost of R5 000).
- He would still hold the same quantity of shares in the company as he did previously, however with a new base cost of R10 000 going forward.

Contrast this with scenario 2 where the same taxpayer did not sell the shares in question due to, for example, illiquidity of the shares in the market, the costs involved in selling or simply because he believed in the ability of the share price to recover and did not therefore wish to disinvest from the stock long term, but instead entered into a derivatives position (e.g. a futures contract to sell the shares for their current share price of R15 000 at some point in the future) in order to hedge/protect the same value accretion in his underlying capital investment against the price drop which he anticipates will materialise. If he then simply closes out this position (without delivering the underlying shares to the counterparty) after the share price drops to R10 000 as anticipated, his position would be as follows:

- He would have realised a gain of **R5 000** in the form of the variation margin received on the futures contract (R5 000 proceeds realised less the original base cost of R0).
- He would still hold the same quantity of shares in the company as he did previously, however still with their *original* base cost of R5 000 going forward.

The taxpayer has therefore realised a smaller capital gain through the use of the derivatives hedge in scenario 2 (R5 000 as opposed to R10 000 on the sale of the shares in scenario 1), *but* has not received a step up in his base cost for the share investment which he holds (base cost remains the original R5 000, as opposed to having increased to R10 000 as in scenario 1).

If he was to therefore sell the shares several years later for their market value of R25 000 at that time, he would realise in scenario 1 a second capital gain of **R15 000** (R25 000 proceeds realised on the sale of the shares at their market value less the increased base cost of R10 000). In scenario 2 he would realise a larger capital gain of **R20 000** (R25 000 proceeds realised on the sale of the shares at their market value less the original base cost of R5 000).

The taxpayer would therefore realise capital gains of R10 000 and R15 000 respectively on the disposal of shares in scenario 1, whilst in scenario 2 there would be a R5 000 gain on the derivatives hedge and a subsequent R20 000 gain on the disposal of the shares. Importantly

however the total capital gains realised by the taxpayer would – in both scenarios – be the same (R25 000). This is an equitable result, for both the taxpayer and the Commissioner.

With this in mind, it would be palpably inequitable if the taxpayer in scenario 2 was to be taxed on the gain realised on the derivatives hedge on income account. Not only would this result in tax being paid at a higher rate, but as is seen above there is also no step up in base cost for the shares held in scenario 2 which would mean that the taxpayer would (upon an eventual sale of the shares in the future at R25 000) pay both income tax and capital gains tax on the same growth in value.

It is submitted that this inequality should not arise if one pursues the same purpose (protecting the growth to date in the value of the shares held), but achieves it in a different manner (through the use of a derivatives hedge, as opposed to simply selling the underlying shares).

In addition to the above, if the gains on the derivative were taxed on income account and if the price of the underlying share fell far enough that the taxpayer then took a further decision to dispose of the shares as well within the same year of assessment, any capital loss realised on the disposal of the shares could not be used to offset the revenue gain realised on the derivative.

If gains and losses realised on the derivative and the underlying shares respectively could not theoretically be offset against one another, it would make the hedge tax inefficient.²⁴⁶

The fact that the capital treatment of gains realised on the derivatives hedge creates an economically fair result in the circumstances should therefore be seen to further weigh in favour of any proposed capital treatment of such amounts for tax purposes.

²⁴⁶ Refer to the comments of Hutton to this effect (*op cit* note 86 at fn 16 on page 168).

CHAPTER 8 CONCLUDING REMARKS

8.1. Problem question addressed

This study set out to consider whether it is possible to hedge with a derivative on capital account, and for the gains realised on a derivatives hedge to be taxed as capital as opposed to revenue.

In order to address this question, the various arguments for the capital or revenue treatment of such receipts or accruals were considered against the background of a sale of futures contracts used as a hedge against losses on an underlying share investment held as a capital asset.

8.2. Conclusion on arguments

This study found that existing judicial precedent did not assist directly in answering the problem question (either positively or negatively), as it was distinguishable on the facts from the scenario at hand. The SARS argument which suggested that the problem question should be answered in the negative was however also refutable for lack of authority.

While compelling analogous insurance and underlying asset arguments could be found to answer the problem question positively, no direct tax precedent existed to support these either. Commentators' views also differed in this regard. It was found that the most compelling arguments for both a positive and a negative answer to the problem question are derived from common law first principles. Where emphasis is placed on the taxpayer's intention, the possibility exists that a scheme of profit-making could be said to exist which requires a negative answer to the problem question. It is submitted however that the more appropriate test is to emphasise the taxpayer's hedging purpose (or motive) over intention. Doing so allows for a positive answer to the problem question – the gains realised on a derivatives hedge of an underlying capital investment can and should be taxed on capital account.

8.3. Further proposed research

Areas for future research that could be considered would include the treatment of losses realised on the same derivatives hedges considered here, which should theoretically be treated in the same way – taxpayer's should not seek to have gains taxed on capital account whilst simultaneously trying to treat losses realised as revenue deductions. It could also be considered to include in such future research an analysis of the CGT treatment for the taxpayer on the ultimate disposal of the underlying share investment after having realised a loss on the hedge, to consider how this capital loss (potentially carried forward and offset

against the gain realised in a future year of assessment) economically plays out for both the taxpayer and the *fiscus*.

An investigation into the capital or revenue nature of gains or losses realised through the use of option contracts to hedge capital investments could also be considered, taking into account that options have legislative provisions in the Act which would need to be considered.

The use of index futures to hedge an underlying share portfolio, as opposed to Single Stock Futures hedging a particular share held, and a consideration of whether the same (or other) arguments for capital treatment could be made would be particularly useful. This could be expanded to differentiate between index futures used to hedge portfolios that comprise the same basket of equities, and the hedging of portfolios whose composition differs from that of the index used.

The extent to which the above arguments achieve the same, or differing, results when applied to derivatives hedges utilised by a collective investment scheme fund manager, as part of the manager's business, could also be considered.

Consideration could also be given to the results that would be obtained if the arguments put forward in this study, in particular those relating to common law first principles, were applied to determine the capital or revenue nature of gains or losses realised by speculators or investors in derivatives, including Single Stock Futures.

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