THE CHARACTERISATION FOR SOUTH AFRICAN TAXATION PURPOSES OF GAINS AND LOSSES ARISING FROM THE USE OF EQUITY FINANCIAL DERIVATIVE INSTRUMENTS

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DECLARATION

By submitting this research report electronically, I, Stephen Eugene Smith, declare that the entirety of the work contained therein is my own, original work, that I am the owner of the copyright thereof (unless to the extent explicitly otherwise stated) and that I have not previously in its entirety or in part submitted it for obtaining any qualification.

……Signed by candidate……..

S.E. Smith Date: 23 September 2020

ACKNOWLEDGEMENTS

When I decided upon this topic, I was convinced of the need for research to be done from a South African perspective. I had chaired a tax committee for the Association of Unit Trusts in South Africa during the period 2000/2001 and, as incoming chairperson, I had two significant agenda items to deal with: the challenge of income characterisation in these portfolios, which was being questioned by the South African Revenue Service (SARS), and the design of capital gains tax treatment for these portfolios, which would become effective in October 2001. Securing appropriate legal assistance with the former issue was challenging. I approached Professor Emslie, who agreed on a cooperative effort. By the time the matter was concluded and our arguments accepted, I asked him whether he would supervise my research on the topic of derivative characterisation. To verify the problem statement, I approached the now late Dr Jan de Villiers Graaff, who had been a member of the Tax Advisory Committee for South Africa.[1] He confirmed the uncertainty in the policy domain and was very helpful by providing me with copies of documents that set out the (at the time) latest thinking on the matter. All pointed to the lingering absence of domestic certainty and a need for further research on developments in foreign jurisdictions. More recently, as a consultant to the Association for Savings and Investment South Africa (ASISA), I had the experience of co-ordinating policy work between the industry and the National Treasury, the Financial Services Board (now the Financial Sector Conduct Authority or 'FSCA') and the South African Revenue Service (SARS) on the regulation of hedge funds in South Africa from 2009 to 2015. The many sessions on the subject of taxation and income characterisation not only confirmed and clarified the problem statement, but also confirmed its relevance. We were unable to agree on an approach

[1] Dr Graaff also served as a member of the Margo and Katz Commissions. While I will greatly miss the wonderful conversations we had from time to time on a variety of topics, this thesis does not reflect any of his views beyond those stated in these acknowledgements.

that satisfied all parties. No number of meetings seemed to cure the fact that fund managers unequivocally believed that their actions were always in the nature of investment; authorities, on their part, remained suspicious. Derivatives were only a small subset of this problem, but illustrated the point most acutely. In 2017, after meeting with the Davis Tax Committee (DTC) on behalf of the investment industry, I was invited by its Chairman to prepare a submission to the DTC. The submission relied exclusively on the research conducted for this thesis, which was done in my private time. The conclusions contained in the submission were cited in the Davis Tax Committee's *Corporate Income Tax Report*, dated March 2018, with support for the recommendation that a task team comprising the National Treasury, SARS, the FSCA and members of the financial sector be formed to investigate the matter further. I would like to thank ASISA for involving me in this work, which greatly contributed to my perspectives.

To assist with the verification of primary sources at the outset, I wrote to Professor Alvin Warren at Harvard University who confirmed the main works for the United States of America. In 2015 I visited Australia on business and contacted Professor Graeme Cooper of the University of Sydney. He was kind enough to send me a note summarising the relevant Australian Tax Office Rulings and confirmed my views on the limited jurisprudence on derivatives, while including two cases that should be considered.[2]

I would like to thank Professor Emslie for his patience over an extended period of research, interrupted by other academic priorities and public service that at times halted progress completely. His confidence and support have been humbling and the indulgence of the University of Cape Town much appreciated. Professor Emslie's guidance, and the reading material he gave me when I visited, always made for a rich experience. When I left his office, he would always press a book into my hand. Amongst them is *Law's Empire* by Ronald

[2] Email dated 29 July 2015.

Dworkin – I believe that I may have inadvertently stolen it! His exegesis of the law has reassured me that through clear thought and analysis my problem statement can be answered simply. It does not depend, as Dworkin put it, 'on special conventions or independent crusades'.[3] So this is what I have attempted: a simple and hopefully helpful conclusion framed within the existing rulings of our courts. I would also like to thank Professor Gutuza who agreed, during her sabatical, to assist with the finalisation of the thesis. I hope that I have done her kindness some justice.

I would like to thank my wife in particular. Sheena never let me forget that I had a task to complete and that it was worth doing. She always seemed pleased when I spent time on this endeavour at her expense.

I am indebted to the literature far more than any footnotes can acknowledge. In the process of shaping my thinking, I read far more than I can consciously acknowledge. So too, the discussions with South African policy makers and regulators helped me to appreciate the difficulties associated with a satisfactory outcome.

I would like to thank Jeanne Enslin and Ronel Gallie for their kind assistance with the initial editing suggestions and to Linda van de Vijver for her skilled observations as I prepared the final submission.

The errors that remain are entirely my own, as none will have seen the final copy.

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[3] R Dworkin *Law's Empire* (1986) 410–13.

PROBLEM STATEMENT

The use of financial derivative instruments in investment portfolios has outpaced the development of income tax legislation to differentiate their characterisation as either ordinary or capital income in South Africa. As capital income is taxed more leniently, this distinction has led to uncertainty in the application of the common law to diverse commercial conventions. This is especially applicable to derivative instruments, whose use has become commonplace in financial markets. Whether existing tax principles as determined by our courts can be applied in addressing the character of gains and losses on disposal is at issue. Can derivative instruments be regarded as capital assets in their own right and therefore be subject to ordinary determination?

I argue for equity derivatives (EDs) as a simplifying proxy, in line with Smalberger JA's determination in *CIR v Pick 'n Pay Employee Share Purchase Trust*[4] that 'transactions involving shares do not differ from transactions in respect of any other property and the capital or revenue nature of a receipt is determined in the same way whether one is dealing with land or shares'.

[4] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271 is regarded as a leading case on the subject.

METHODOLOGY

The research for this thesis comprises four broad sections: (1) background and context on financial derivatives and their use within managed portfolios; (2) international accounting treatment; (3) legislative, regulatory and case law overview for South Africa, the United States of America, the United Kingdom and Australia; and (4) an approach to these instruments that our courts and policy makers might apply in their analysis.

The research attempts, first, to contextualise derivatives. The general approach of the analysis is not dissimilar to the development of the definitions of income or capital gains tax[5] in South Africa.[6] Simplifying proxies are used to limit the many variables that might be encountered: only equity derivatives are considered within the context of regulated, managed investment portfolios. The object of the research is not to determine the characterisation of the instruments, but to enquire where the appropriate legal analysis should rightfully begin. The hypothesis has been stated above.

The critical issue is therefore whether these instruments can be treated as capital assets in their own right to qualify as property according to Smalberger JA's reasoning. To this end, the contractual nature of derivatives and the relationship of contract rights to notions of property and capital are considered within the framework of the ISDA Master Agreement for unlisted financial derivative instruments.

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[5] See SARS *Comprehensive Guide to Capital Gains Tax* Issue 7 (2018) 32: 'In designing the Eighth Schedule reference was made to the legislation of a number of countries most notably Australia and the United Kingdom and to a lesser extent Canada, the United States and Ireland amongst others. Experts from Australia, the United Kingdom and United States provided invaluable assistance. For a number of reasons no single country's CGT legislation could serve as a model for South Africa. Each country presented its own difficulties.'

[6] See *CIR v Goodrick* 1942 OPD 1, 12 SATC 279 at 304: 'When income tax was first levied in South Africa the definition of "income" was rather bald and sweeping, if taken according to its literal meaning, that the Legislature could not possibly have intended to use it in that sense. In ascertaining the meaning of the Legislature, therefore, our Courts invoked notions expressed in the English Acts to distinguish between moneys accruing upon the realization of capital assets and true income within the contemplation of the Legislature.'

A review of foreign legislation and case law attempts to identify the approach of legislators and courts in other common-law jurisdictions, given the lack of a policy framework and specific case law in South Africa applicable to financial derivative instruments. A comparative analysis is not attempted or intended. The research is concerned with how common-law jurisdictions have approached the distinction and whether interpretations by their courts align with Smalberger JA's determination in *CIR v Pick 'n Pay Employee Share Purchase Trust*[7] that 'transactions involving shares do not differ from transactions in respect of any other property', given that this is a leading case on the subject in South Africa.

Each jurisdiction is therefore reviewed and conclusions drawn. The assumption is that there can be no context distinct from the general concepts of law specific to derivatives. Continuity and coherency within a long tradition of case law on capital and revenue characterisation should be maintained. General case law on income characterisation is therefore included. The common-law jurisdictions of the USA, the UK and Australia were selected, because they share a similar general system of law.

As would be expected, the problem underlying the cases is universal, but the responses are not. The development of the law cannot, however, depend on a poll of decisions and codes adopted in foreign jurisdictions against a background of different rules and traditions. The law must be developed coherently, in accordance with principle, so as to serve, even-handedly, the ends of justice.[8] On the other hand, even within this limited grouping of jurisdictions sharing a similar colonial past, trying to bring systematic order to such varied contexts would seem to be of questionable value. Each jurisdiction is therefore reviewed separately and conclusions drawn in order to:

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[7] 1992 (4) SA 39 (A), 54 SATC 271.

[8] Per Lord Bingham in the House of Lords in 2002: *Fairchild v Glenhaven Funeral Services Ltd and Others*; *Fox v Spousal (Midlands) Ltd*; *Matthews v Associated Portland Cement Manufacturers (1978) Ltd and Others* [2002] UKHL 22 [34]. See Law Library of Congress *The Impact of Foreign Law on Domestic Judgments* (2010) 30.

1. provide perspective on what these jurisdictions have achieved in clarifying income characterisation for these instruments;
2. discover any helpful reasoning by the courts that will support or refute the findings of Smalberger JA in *CIR v Pick 'n Pay Employee Share Purchase Trust* as a leading case on the subject; and
3. make conclusions on tax policy development based on the above.

Three distinct policy approaches emerge: (1) a common-law approach, where the facts and circumstances are assessed for evidence of a 'scheme of profit-making' as indicative of a revenue motive; (2) an accounting policy approach, which is followed in the UK, Australia and, to some extent, South Africa; and (3) a highly codified system, as evidenced in the USA, which seeks to unite the common law and legislation.

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LIST OF ACRONYMS AND ABBREVIATIONS

AASB	Australian Accounting Standards Board
ASB	Accounting Standards Board
ASIC	Australian Securities and Investment Commission
ASISA	Association for Savings and Investment South Africa
ATO	Australian Tax Office
BIM	Business Income Manual
BIS	Bank for International Settlements
Brexit	Exit of the UK from the European Union
CCPs	Central Counterparties
CDOs	collateralised debt obligations
CDS	Credit Default Swaps
CEA	Commodity Exchange Act
CEC	Commission of the European Communities
CEO	chief executive officer
CFDs	Contracts for Difference
CFMA	Commodity Futures Modernization Act
CFTC	Commodity Futures Trading Commission
CG	capital gains
CGT	capital gains tax
CISCA	Collective Investment Schemes Control Act
CTA	Corporation Tax Act
DFIs	derivative financial instruments
DTC	Davis Tax Committee

DTI	Department of Trade and Industry
EBA	European Banking Authority
EC	European Commission
EDs	Equity Derivatives
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
ESVCLPs	early stage venture capital limited partnerships
EU	European Union
FCMs	futures commission merchants
FMB	Financial Markets Bill
FSA	Financial Services Act
FSB	Financial Services Board
FSMA	Financial Services and Markets Act
FSCA	Financial Sector Conduct Authority
FTSE	Financial Times Stock Exchange
GST	goods and services tax
HMRC	Her Majesty's Revenue and Customs
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICA	Investment Company Act
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
IOSCO	International Organisation of Securities Commission
IRC	Internal Revenue Code

IRS	Internal Revenue Service
ISDA	International Swap Dealers Association
ITA	Income Tax Act
ITAA	Income Tax Assessment Act
LBHI	Lehman Brothers Holdings Inc.
LBSF	Lehman Brothers Special Financing
LICs	listed investment companies
MBSs	mortgage-backed securities
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MIT	Management Investment Trust
MTF	Multilateral Trading Facility
NBC	National Bank of Commerce
OECD	Organisation for Economic Co-operation and Development
OEICs	Open Ended Investment Companies
OTC	over-the-counter
OTF	Organised Trading Facility
PSDs	Purely Speculative Derivatives
R&D	Research and Development
RIC	regulated investment company
SAA	South African Airways
SAFCOM	SAFEX Clearing Company
SAFEX	South African Futures Exchange
SAICA	South African Institute of Chartered Accountants
SAM	Solvency and Assessment Management Regulations

SARB	South African Reserve Bank
SARS	South African Reserve Service
SCR	Solvency Capital Requirement
SEC	Securities Exchange Commission
SFA	Securities and Futures Authority
SIFMA	Securities Industry and Financial Markets Association
SROs	self-regulatory organisations
TLAB	Taxation Laws Amendment Bill
TLRP	Tax Law Rewrite Project
TOFA	taxation of financial arrangements
TR	Trade Repositories
TRA	Tax Reform Act
UCITS	Undertakings for Collective Investments in Transferable Securities
UCT	University of Cape Town
UK	United Kingdom
US	United States
USA	United States of America
VCLPs	venture capital limited partnerships

CHAPTER 1

INTRODUCTION

1.1 CONTEXT

> Law is an interpretive concept … which unites jurisprudence and adjudication. It makes the content of law depend not on special conventions or independent crusades but on more refined and concrete interpretations of the same legal practice it has begun to interpret … Law's attitude is constructive: it aims, in the interpretive spirit, to lay principle over practice to show the best route to a better future, keeping the right faith with the past.[1]

The definition of 'gross income' in the Income Tax Act 58 of 1962 (the Act) excludes receipts or accruals of a capital nature, but includes capital gains and assessed losses on disposal in the Eighth Schedule of the Act. Receipts or accruals of a capital nature are not defined in the Act and have therefore been the subject of extensive litigation.

The definition of gross income includes 'the total amount in cash or otherwise, received by or accrued to or in favour of any person'. This amount includes 'not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal which has a money value'.[2]

Characterisation has depended on an examination of the facts of the case, such as the nature of the asset sold,[3] disposal in the ordinary course of business,[4] and a clearly observable

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[1] R Dworkin *Law's Empire* (1986) 410–13.
[2] See *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 52 SATC 9 at 363I–J in *CSARS v KWJ Investment* (142/2017) [2018] ZASCA 81 [24].
[3] *CIR v George Forest Timber Company* 1 SATC 20, 1924 AD 516; *COT v Booysen's Estates* 1918 AD 582.
[4] *Natal Estates Limited v CIR* 1975 (4) SA 177 (A), 37 SATC 193.

trade or business,[5] 'frequency'[6] or 'degree',[7] the nature of the asset,[8] the holding period of the asset,[9] the method of finance,[10] and the reason, method and circumstances of the transaction.[11]

Emslie, Davis, Hutton and Olivier[12] have summarised this body of case law, citing *CIR v Pick 'n Pay Employee Share Purchase Trust*[13] as a leading case on the matter. The paramount test is always the intention of the taxpayer.[14] The consistently applied test for distinguishing between capital and revenue receipts or accruals, confirmed in *CIR v Pick 'n Pay Employee Share Purchase Trust*, is the inquiry whether a taxpayer was engaged in a 'scheme of profit-making'.[15]

In a 1994 consultative document, the Tax Advisory Committee (SA) stated:

> [T]he question of the tax treatment of gains and losses on various transactions has yet to be resolved by our courts and this uncertainty, in particular in relation to the timing of the recognition of gains or losses, is hampering investment decisions by businessmen who seek certainty with regard to the tax consequences of any financial transactions which they may enter into.[16]

How jurisdictions approach this distinction can be found in two general legal traditions. Civil law may be defined as the legal tradition that has its origin in Roman law, as codified in the *Corpus Juris Civilis* of Justinian,[17] and as subsequently developed in Continental Europe

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[5] *ITC 1377* 45 SATC 221 and *Morrison v CIR* 1950 (2) SA 449 (A), 16 SATC 377.
[6] *Durban North Traders Ltd v CIR* 21 SATC 85, 1956 (4) SA 594 (A); *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283.
[7] *Natal Estates* (n 4).
[8] For example, Kruger Rands produce no income and have no other economic utility. See *ITC 1525* 54 SATC 209; *ITC 1526* 54 SATC 417; *ITC 1543* 54 SATC 446.
[9] *ITC 1343* 44 SATC 14.
[10] *ITC 595* 14 SATC 258; *ITC 1142* 32 SATC 237.
[11] *African Life Investment Corporation (Pty) Ltd v SIR* 1969 (4) SA 259 (A), 31 SATC 163; *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283, where the gains were both realised during strong markets.
[12] TS Emslie, DM Davis, SJ Hutton & L Olivier *Income Tax: Cases and Materials* (2001) 180.
[13] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[14] Ibid [85].
[15] Emslie et al (n 12) 180.
[16] Tax Advisory Committee (SA) *Consultative Document on the Tax Treatment of Financial Arrangements* (1994) 1.
[17] The *Corpus Juris Civilis* is a four-part compilation of Roman law prepared between 528 and 534 AD by a commission appointed by Emperor Justinian and headed by the jurist Tribonian. The *Corpus* includes the Code (a compilation of Roman imperial decrees issued prior to Justinian's time and still in force, arranged systematically according to subject matter); the *Digest* (or *Pandects*) (fragments of classical texts of Roman law by well-known Roman authors such as Ulpian and Paul, composed from the first to the fourth centuries AD,

and around the world. Civil law eventually divided into two streams: the codified Roman law (as seen in the French Civil Code of 1804 and its progeny and imitators – Continental Europe, Quebec and Louisiana being examples), and uncodified Roman law (as seen in Scotland and South Africa). Civil law is highly systematised and structured and relies on declarations of broad, general principles, often ignoring the details.[18]

Civil-law countries (eg France and Germany) typically treat all the income based on the nature of the entity so that a commercial company is viewed as generating business profits that will include capital gains. Common-law jurisdictions (the UK, the USA and Commonwealth nations) make this determination based on the nature of the income.

Common law is the legal tradition that evolved in England from the eleventh century onwards. Its principles appear for the most part in reported judgments, usually of the higher courts, in relation to specific fact situations arising in disputes that the courts have adjudicated. The common law is usually much more detailed than the civil law in its prescriptions. Common law is the foundation of private law, not only for England, Wales and Ireland, but also in 49 US states, nine Canadian provinces, and in most countries that first received that law as colonies of the British Empire and that, in many cases, have preserved it as independent states of the British Commonwealth.[19]

South Africa is regarded as having a mixed legal tradition, which includes Roman, Roman-Dutch and English legal influences, melded into a unified system.[20] In fact, as far back

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arranged in 50 books subdivided into tides); the *Institutes* (a coherent, explanatory text serving as an introduction to the *Digest*, based on a similar and earlier work by the jurist Gaius); and the *Novellae* (Novels) (a compilation of new imperial decrees issued by Justinian himself).

[18] W Tetley 'Mixed jurisdictions: Common law v civil law (codified and uncodified)' (2000) 60 *Louisiana Law Review* 683.

[19] Tetley (n 18) 684.

[20] Ibid 693.

as 1887. it was noted that 'we shall find references in the Law Reports to Roman, Dutch, English, American, Scotch, French, German and other authorities.'[21]

> Through colonization, the English common law was spread over North America, Australia and New Zealand, parts of Africa and Asia. In Europe, its influence has been limited to Wales, Ireland and, to a lesser extent, Scotland. After independence, the legal systems of the Latin American states were largely based on Roman law and French civil law. As from the twentieth century, this continent has seen a growing influence of the common law.[22]

The USA is a common-law jurisdiction, and has relied both on a statutory definition of capital assets and case law, and seems to have been no more successful in achieving certainty, as discussed in chapters 5 and 6. The UK and Australia, discussed in chapters 7 and 8 and 9 and 10 respectively, have turned to accounting standards to assist in the drafting of revised tax statutes and are facing problems of definition in the absence of appropriate and developed case law related to accounting standard concepts and language.

In the 2012 Explanatory Memorandum to the Taxation Laws Amendment Bill, the National Treasury states:

> In respect of financial instruments, the rules pertaining to income tax and financial accounting have completely diverged. This divergence has proven to be a challenge … From a SARS standpoint, the divergence between tax and accounting has become so great that accounting is often no longer a useful benchmark for assessing risk vis- à-vis the accuracy of taxable income.[23]

From a tax law perspective, the test to determine whether the gain or loss is capital or revenue is the 'scheme of profit-making' test.[24] The 'Basis for Conclusions' published under IFRS 9 for Hedge Accounting[25] states:

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[21] V Sampson 'Sources of Cape law' (1887) 4 *Cape Law Journal* 109 at 109–10. See F du Bois & D Visser 'The influence of foreign law in South Africa' (2003) 13 *Transnational Law and Contemporary Problems* 593.
[22] M van Hoecke *Methodology of Comparative Legal Research* (2015) 24.
[23] National Treasury 'Taxation Laws Amendment Bill Explanatory Memorandum' (2012) 57.
[24] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[25] IFRS Foundation, IFRS 9, Chapter 6, Hedge Accounting, Basis for Conclusions, 18. South Africa subscribes to accounting standards as determined by the IFRS Foundation and its standard setting body, the International Accounting Standards Board (IASB). IFRS 9, which became effective in January 2015 (replacing IAS 39 and 32), sets the standard for the recognition of financial instruments.

> The implementation guidance accompanying IAS 39 provided the rationale for not permitting derivatives to be designated hedged items. It stated that derivative instruments were always deemed to be held for trading and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.[26]

However, the 'Basis for Conclusions' goes on to state that 'this rationale is difficult to justify' as some purchased options have been allowed under hedging rules to qualify as items that may be the object of a hedge. The May 2012 IASB meeting agreed that accounting for macro hedging would be decoupled from IFRS 9. A separate standard will be issued for macro hedging. However, as far back as 1998, Southern stated that derivatives should be seen as assets or liabilities in their own right – a distinct departure from the traditional analysis and a defining point of departure for this research:

> The tax treatment of derivatives comes of age when it is established and accepted that the taxation of derivative financial instruments (DFIs) is not to be determined by reference to the tax treatment of the underlying instrument to which the derivative relates. Derivatives are to be treated as assets and liabilities in their own right with their own tax rules. This has the consequence that hedges will be de-recognised as hedges, in that they will be regarded as transactions in their own right, not as part of some larger transaction.[27]

The current lack of certainty is characterised by the following aspects:

1. our common-law tradition, which distinguishes between income types;
2. the absence of comprehensive legislation on derivatives in South Africa that codifies tax policy;
3. reliance on South African case law, in which there is little precedent on derivative income characterisation and often doubt as to how historic cases on character determination might be applied to these instruments;
4. the possibility of legal certainty being undermined by varied interpretations by our courts, as evidenced by the experience of other countries;[28]

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[26] Ibid. See page 18 para BC6.65.
[27] D Southern 'The taxation of derivatives' (1998) 4 *British Tax Review* 348–63.
[28] See the discussion of *Corn Prod Ref Co v Commissioner* 16 TC 395 (1951), 11 TCM (CCH) 721 (1952), supplemented by 20 TC 503 (1953), affirmed in part and review dismissed in part, 215 F.2d 513 (2d Cir. 1954), affirmed, 350 US 46 (1955) and *Arkansas Best Corp v Comm'r* 485 US 212 (1988) in chapter 6 on the USA.

5. the unfolding accounting treatment,[29] which classifies all derivatives as 'for profit or loss', other than when used as a hedge, yet is struggling with the limitations of its interpretation; and
6. an absence of recognition that derivative instruments might in themselves represent a capital asset (property, through the rights they confer), like the asset they reference.

These uncertainties make it difficult to predict outcomes and result in significant uncertainty in practice.[30] Smalberger JA, in *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* clearly made the point that the tests applied by our courts are laid down as guidelines only: 'There are a variety of tests for determining whether or not a particular receipt is one of a revenue or capital nature. They are laid down as guidelines only – there being no single infallible test of invariable application.'[31]

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[29] Prior to IAS 39 (effective 2001), derivatives were often not recognised in financial statements, as they required little or no initial investment. IAS 39 and IAS 32 (effective 2005) have since been the accounting standards applicable to financial instruments. IFRS 9 replaces IAS 39 and 32, effective 2015. IFRS 9 was developed to simplify the treatment of financial instruments and to move towards a more principles-based approach.

[30] See the discussion under section 1.1.1 below. In 2001 the Tax Committee of the then Association of Collective Investments had extensive engagements with SARS about gains made on the sale of listed shares. SARS expressed the concern that fund managers were actively trading portfolios rather than 'investing'. An opinion, styled as a Discussion Memorandum, 'Taxation of Equity Unit Trusts on Gains made on the sale of listed shares' was prepared by me and TS Emslie SC, dated 29 June 2001. The matter was successfully resolved. In 2006, I was called to a meeting on behalf of the Association of Collective Investments with the Financial Services Board to discuss how hedge funds might be included under the Collective Investment Schemes Control Act 45 of 2002 (CISCA), given the difficulties associated with the taxation of derivative instruments and what was generally seen as active management within the funds. Various options were discussed. The matter was not resolved and the regulatory initiative did not progress. Following the global financial crisis in 2008, the regulation of hedge funds was placed on the G20's agenda of reforms. South Africa, as a member of the G20, undertook a comprehensive and collaborative exercise with the investment industry to find a solution under CISCA. This culminated with the issuance of Board Notice 52 of 2015. The taxation of gains and losses associated with these portfolios was settled on the basis that portfolios would be subject to a facts and circumstances approach at the discretion of SARS, as for any other collective investment scheme portfolio (or any other similar determination not covered by specific provisions in the Income Tax Act). Given that SARS had never challenged a regulated CIS in court for active trading, I found this outcome unsatisfactory. In the absence of a simplifying regulatory provision, SARS was placed in an invidious position, investors were subjected to uncertainty and potential tax liability, and financial service providers were unfairly prejudiced as they have to provide assurance to clients about tax certainty. What was intended as an equitable outcome had in fact increased uncertainty.

[31] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 56.

1.1.1 Recent practical examples of attempts to improve certainty

After an initial submission in 2016 and meeting with the Davis Tax Committee on 31 October 2017 on behalf of the Association for Savings and Investment SA (ASISA), I prepared a submission for the Davis Tax Committee dated 30 November 2017, where research for this thesis informed a motivation for the establishment of a technical committee to develop an approach to the treatment of financial derivative instruments. The committee's response is cited in detail below in its report on the corporate income tax system.[32]

> The DTC considered the various elements of taxation within the financial sector in compliance with its terms of reference contained in the 2013 Budget Review (page 63). The aspects relating to financial services have been dealt with in various DTC reports including the BEPS report, and in particular Action 2 titled 'Neutralise the effects of hybrid mismatch arrangements' and Action 4 titled 'Limit base erosion via interest deductions and other financial payments' …
>
> Having said that, the below-mentioned submissions are worth mentioning based on the specificity of their contents. The Association for Savings and Investment South Africa (ASISA) made a submission that provides a comprehensive analysis of the current uncertainty within the South African market and international treatment of financial instruments from a capital versus revenue perspective, as well as a number of suggested ways available for handling this issue. ASISA concludes as follows:
>
> - There is no conceptual difference between buying a financial instrument (like a share) and entering a derivative contract that replicates ownership.
> - Derivatives are financial instruments in their own right and gains or losses therefrom might be capital or revenue.
> - Ordinary principles of interpretation should be applied, with due regard to what the parties contracted, within the context of their commercial agreement.
>
> The nature of derivative instruments is not defined by 'hedging'.
> - There is no conceptual difference between a long and a short position. Facts and circumstances associated with those positions determine their nature.
> - Multi-derivative or hybrid strategies should not be unbundled, but considered as unitary intent subject to ordinary principles.
> - Transactions within a portfolio should not be viewed in isolation of each other, but within the entirety of the investment mandate …

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[32] Davis Tax Committee *Report on the Efficiency of the Corporate Income Tax System* (2018) 92, 93.

> ASISA's recommendation is that a focus group between industry, the South African Revenue Service and National Treasury should be set up to reach some final views from a policy perspective. The DTC supports the formation of a focus group and has forwarded the ASISA and Mr Da Silva's submissions to the National Treasury for further consideration.

Following the issuance of the DTC report and an expectation that a technical work group would be established to consider a workable solution, the 2018 draft Taxation Laws Amendment Bill (TLAB), published for comment on 16 July 2018, included a surprise proposal that all gains and losses derived from the disposal of financial instruments within 12 months of their acquisition in Collective Investment Scheme (CIS) portfolios be deemed income of a revenue nature and therefore taxed at unit holder's marginal rates. This was a direct policy import from the USA, where such a rule exists across the tax system, as part of a two-tier capital tax rate regime. However, in this proposal it was to be applied selectively to CIS and the distinction was not to be a short- or long-term capital gains tax rate, but a CGT or ordinary marginal tax rate – i.e. a re-characterisation. The practice in South Africa since the inception of the CIS industry has been to treat all transactions as capital. These gains and losses were exempt from all income tax prior to the introduction of capital gains tax (CGT) in 2001. Since 2001, gains and losses have been included in unit holder's ordinary income at the CGT inclusion rate when units are redeemed. Accruals on capital account are deferred until redemption and then included in declared income by the taxpayer upon redemption.

Following the proposed 2018 TLAB amendment, all transactions in instruments held for less than 13 months would attract maximum marginal rates applicable to individual taxpayers (up to 45 per cent). This would affect not only share selection transactions, but also transactions generated to meet redemption requests, rebalancing, all derivative hedging, and portfolio optimising transactions. The Explanatory Memorandum accompanying the Bill motivated the reason for the policy change as follows:

> It has come to Government's attention that some CIS are in effect generating profits from the active

> frequent trading of shares and other financial instruments. These CIS argue that the profits are of a capital nature. They base this argument on the intention of long term investors in the CIS.
>
> The fact that the determination of capital or revenue distinction is not explicitly stated in the Act and reliance is based on facts and circumstances as well as the case law has led to different application of the law and this has resulted in an uneven playing field regarding the taxation of CIS.

The proposal was broadly objected to by the tax fraternity as inequitable. After having several meetings with the National Treasury and SARS, and an appearance before Parliament's Standing Committee on Finance, the proposal was withdrawn, pending further work that would be conducted in conjunction with financial institutions and other professional tax advisory firms. The situation remains unchanged as at the date of writing.

1.2 RESEARCH QUESTION

In the South African Institute of Chartered Accountants (SAICA) 'Report on the Tax Treatment of Futures and Options' dated 23 October 1992,[33] the association states that 'two main problems are encountered with the taxation of financial futures and options … The first problem relates to the capital/revenue distinction, i.e. can derivative instruments be regarded as capital assets?',[34] to which is added later, 'in their own right'.[35] Brincker by his own admission ventures a generalisation that 'speculation would be of a revenue nature and synthetic investments would be of a capital nature'.[36] The latter was a bold statement at the time, answering the SAICA question in the affirmative and in keeping with the findings of this research. The SAICA report goes on to state: 'The real issue therefore seems to be whether existing tax principles are capable of effectively addressing the capital/revenue

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[33] South African Institute of Chartered Accountants (SAICA) *Report on the Tax Treatment of Futures and Options* 5.
[34] Ibid.
[35] Ibid 22.
[36] TE Brincker *Taxation Principles of Interest and other Financing Transactions* Issue 4 (2011) W-6-2 and W-6-3.

distinction arising from these new financial instruments, or whether new rules need to be devised to cater for these new instruments.'[37]

One of the pragmatic policy approaches for addressing the characterisation of these instruments is to use accounting standards. This aligns financial reporting with the tax outcome and ensures that the two remain synchronised. Section 24JB of the Act is an example of this approach, where IFRS is referenced in tax legislation.

A review of the literature on financial derivatives indicates that both in Australia and the UK there is dissatisfaction with the consequences of a transliteration from accounting policy into tax law. The two disciplines of accounting and tax law serve different purposes, yet need to be understood together since they coexist in the commercial world. However, analysis demands that logic is not coloured by propositions that are inaccurately inferred. The departure point has to be a legal one.

What then is the correct legal departure point for assessing the tax character of financial derivative instruments? Is the often short duration of derivative contracts indicative of revenue character, according to the logic of *Barnato Holdings Ltd v SIR*[38] because it is presumed they are always 'bought for sale' or considered not to be of a capital nature? According to the SARS *Tax Guide for Share Owners*,[39] '[t]he 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*)).[40] The implication is that if the share type produces 'nil' dividends it is unlikely to be considered capital in nature, regardless of its purpose.

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[37] SAICA (n 33) 6.
[38] *Barnato Holdings Ltd v SIR* 1978 (2) SA 440 (A), 40 SATC 75.
[39] South African Revenue Service *Tax Guide for Share Owners* Issue 6 (2018) paras 3.3.3 and 3.4.6.
[40] Footnotes omitted. *Wisdom v Chamberlain* involved silver ingots held in a safe as a hedge, regarded by the court as a trading adventure. SARS states that '[t]he proceeds are more likely to be of a revenue nature when the type of share purchased does not produce dividends'. See South African Revenue Service *Tax Guide for Share Owners* Issue 6 (2018) at 3.4.6.

The question that thus arises is the following: Can these contracts, these financial derivative instruments, be considered to be assets in their own right and the income arising from them being characterised as capital or revenue, within established South African case law?

1.3 APPROACH OF THE THESIS

This thesis seeks to answer this question. It does so by applying two simplifying proxies to the determination of whether the income from derivative instruments is capital or revenue. First, it considers the use of derivative instruments in regulated investment portfolios only, where professional portfolio managers purport to be using the derivatives for investment and are subject to legislation and the regulation of their activities. Second, it tests the issue of characterisation against only one class of derivative, namely equity derivatives (EDs), as a means of limiting a complicated and almost limitless set of variables. These two simplifying proxies will enable an analysis unencumbered by the many contingencies that so easily divert logic. If this endeavour is successful, it fractures an overly generalised logic that these instruments are always 'bought for sale' (which is to define the tax nature through a generalised assumption based on intent or function which is the same for all taxpayers) or, as the accounting profession has held, 'for profit and loss – other than when used as a hedge', where it would seem that the exception proves the point.

This thesis does not address the use of financial derivatives within regulated investment portfolios per se. The thesis does not seek any special convention in thinking. It has to be agnostic to any special conventions that apply to the regulated savings system, which in most jurisdictions receives favourable policy treatment because saving serves a national purpose – increasing saving stocks that can be used for investment in the economy and diminishing dependency on the state. Regulated investment portfolios have been selected as a proxy for the legal analysis because the context provides a simplified and, in theory at least, a 'sanitised'

environment within which to consider the merits of what a departure point for the taxation of these instruments should be. These portfolios also demonstrate that an investment decision that was considered capital in nature and included in taxable income at the relevant inclusion rate (40 per cent for natural persons and 80 per cent for companies and trusts) could retrospectively be liable for tax at a much higher marginal tax rate (45 per cent) for individuals, given the distinction South Africa makes between the taxation of revenue and capital. This distinction represents a differential of 27 per cent for natural persons paying tax at the maximum marginal rate.

A logically reasoned policy or judicial outcome as to character determination should be based on the legal nature of these instruments, regardless of where and how they are used. This is the central objective of this research. What should be avoided is a definition based on pre-conceived opinions or public choice theory, that is 'legislation [that] may be little more than a series of "deals" between legislators and interest groups, having no definable public purpose, at all', rather than the more idealistic notion that 'unless the contrary unmistakably appears, that the legislature was made up of reasonable persons pursuing reasonable purposes reasonably'.[41]

> When I use a word, Humpty Dumpty said …, it means just what I choose it to mean – neither more nor less. The question is, said Alice, whether you can make words mean so many different things. The question is, said Humpty Dumpty, which is to be master – that's all.[42]

My approach has therefore been to choose other jurisdictions that have progressed further on the topic of derivative taxation. Three distinct policy approaches emerge: (1) a common-law approach, where the facts and circumstances are assessed for evidence of a 'scheme of

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[41] See M Livingston 'Practical reason, "purposivism", and the interpretation of tax statutes' (1996) 51 *Tax Law Review* 677.

[42] Lewis Carroll *Through the Looking Glass* ch VI at 238 (1946 ed). See WT Plumb 'The Federal Income Tax significance of corporate debt: A critical analysis and a proposal' (1972) 26 *Tax Law Review* 369.

profit-making' as indicative of a revenue motive; (2) an accounting policy approach, which is followed in the UK, Australia, and, to some extent, in South Africa; and (3) a highly codified system, as evidenced in the USA, which tries to unite features of the common law with legislation.

The USA has a long history of taxing capital gains and mainly using anti-avoidance measures to limit tax abuse through derivatives. Given the USA's common-law tradition and its leading role in the global financial system, its learnings are of great value. Codification and its limitations, demonstrated by the endless litigation in the US courts, must provide a forewarning for the selection of South African tax policy design. The UK and Australia have struggled with their embrace of accounting convention as a remedy for uniting commercial praxis with tax policy. Their common-law traditions make for sound comparisons with South Africa, given that our courts often follow the jurisprudence of their courts. The task of trying to extract lessons for derivative characterisation within the broader context of capital treatment within these jurisdictions that have similar legal systems does not allow for the consideration of civil-law jurisdictions, which might well provide further perspectives. As the research is mainly legal, and therefore reliant on a distinction in the way capital is taxed in common-law jurisdictions, this limitation seems satisfactory within the confines of a thesis.

The chapters that follow therefore consider: (1) relevant tax legislation; (2) accounting treatment; (3) general case law on capital treatment; and (4) leading case law specific to financial derivative instruments for each of the selected jurisdictions.

The first issue is therefore the relationship of the instrument with the underlying security, limited here to 'equity'. The second aspect is whether tax law should treat the derivative in the same manner as the tax of the underlying security (economic equivalence). A third issue is whether the differences between derivatives and the underlying shares reflect a substantively different subject that requires a different tax result. To this end, the contractual nature of

derivatives and the relation of contract rights to notions of property and capital are considered, as well as the courts' approach to the interpretation of these contracts. I submit a uniform method of construction and a simplification of the propositions that belong to the logic of character determination for these instruments. Using equity derivatives as the cornerstone, the totality of propositions is defined.

Insolvency case law in the UK related to the Lehman Brothers collapse following the global financial crisis in 2008/2009 guided this research to its conclusion – that the rights conferred through derivative contracts are property rights and that financial derivatives should therefore be treated as assets or liabilities in their own right and should not be defined with reference to any underlying asset or specified use, such as 'hedging'. It is therefore submitted that their treatment should accord with the leading judgment on the subject, *CIR v Pick 'n Pay Employee Share Purchase Trust*.[43]

The conclusions reached in this research will not spare the legal analyst from the obscurity of the borderline that distinguishes capital and revenue determination for any asset. This research merely presents an interpretative basis from which to begin. The conclusions, it is submitted, provide continuity with the developing literature and established South African case law, and suggest a starting point for policy formulation.

[43] 1992 (4) SA 39 (A), 54 SATC 271.

CHAPTER 2

A SHORT DEFINITIONAL INTRODUCTION AND EXPLANATION OF EQUITY DERIVATIVES AND THEIR USE IN INVESTMENT PORTFOLIOS

2.1 INTRODUCTION

> Claudius Ptolemy was the second-century astronomer who created a model of the heavens that predicted the positions of the sun, moon and planets, and was used for over 1,400 years. There was one problem with his universe, however: The earth was in the middle. How could a model that was simply wrong provide sufficient accuracy to be used by Western civilisation for over 14 centuries? The answer is: With a great deal of complexity. To explain and predict heliocentric planetary patterns in a geometric model, Ptolemy's planets travelled in a series of ellipses or epicycles around the earth. But this alone was insufficient. To correct further, Ptolemy had the planets move closer and then further away from the earth, and even slow down and reverse in their orbits. Our federal system for taxing financial instruments is truly Ptolemaic.[1]

This research topic presented a unique opportunity to study controversial and abstract subject matter. This requires a dispassionate consideration of the facts, but also an appreciation of the historic, socio-economic and legal contexts. At first I seemed to have little guidance upon which to proceed. This was especially true for South Africa as a jurisdiction. However, a wider reading soon revealed that things were not as new as they seemed, or as well defined or consistent as one might have hoped. Time proves to be an essential ingredient in the tradition of interpretation. It reminds us how society viewed matters through very different lenses not that long ago and that our own sense of correctness in the present could consequently also be partial. It is not possible to attempt a treatment of the contingency of law, other than to make the reader aware that such a consciousness needs to be present in a contextual reading of the

[1] David Miller, in his testimony to the Senate Finance Committee, described the US rules-based tax code on derivatives. See David Miller 'Toward an economic model for the taxation of derivatives and other financial instruments' (2013) 3 *Harvard Business Law Review* 108.

analysis that follows. It is essential to be sensitive and yet on guard in order to assign the correct measure of emphasis to sentiments that shape and influence a sense of social reality, interpretation and judgments within societies. As Phillips has explained:

> [L]egal history teaches us about the contingency of the law, about the fact that law is not a set of abstract ahistorical and universal principles, it does not exist in a vacuum. Rather, it is formed by, and exists within, human societies, and its forms and principles, and changes to them, are rationally connected to those particular societies. … I think it is useful, both to illustrate this point about contingency and to show how relatively new this idea is, to contrast the legal history we are familiar with today with the situation prior to the 1970s … As English legal historian, David Sugarman, has recently put it, prior to the 1970s English legal history in the twentieth century was narrow and parochial, 'preoccupied with the origins of legal doctrines and institutions, emphasizing continuity and de-emphasizing change and contingency'. Its subjects were limited to courts, judges and legal doctrine, its preoccupations were in the 'origins' of those subjects, its explanatory tools mostly internal to the legal system itself, and it emphasised continuity with the past ….[2]

2.2 SOCIETAL SENTIMENT

Derivatives are burdened by the notoriety of their users. A long list of spectacular crises includes losses in 1993 and 1994 by institutions such as the German company Metallgesellschaft,[3] the US companies Procter and Gamble[4] and Gibson Greetings,[5] and the British Barings Bank.[6] One of the USA's most prosperous municipalities, Orange County California, became bankrupt in 1994. In 1998, the hedge fund Long-Term Capital collapsed.[7] In 2003 and 2008, South African Airways (SAA) reported losses of R6 billion and R1 billion respectively, attributed to the use of derivatives in the hedging of currency and oil prices. The world has experienced the damaging effects of the financial crisis of 2008. The cataclysmic

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[2] J Phillips 'Why legal history matters' (2010) 41 *VUWLR* 293 at 295. He makes the case for why legal history matters for both lawyers and historians and argues for a continued contextual approach to the study of legal history.
[3] Losses through its US subsidiary as a result of oil derivatives requiring a $2 billion bailout.
[4] $157 million loss through interest rate swap agreements entered into with Bankers Trust.
[5] $23 million loss incurred by engaging in derivative transactions with Bankers Trust.
[6] $950 million in losses resulted in the collapse of the oldest British investment firm through the actions of its trader, Nicholas Leeson, in its Singapore office.
[7] For these examples, see Steven D Conlon & Vincent Aquilino *Principles of Financial Derivatives, US and International Taxation* (2000) A1.01[2] nn 2, 3, 4, 5, 6, 7.

failure of Lehman Brothers Holdings Inc triggered the crisis. The disappearance of insurers such as AIG,[8] Ambac, MBIA and others followed, enabled by derivatives that facilitated the build-up of systemic leverage. As Berd stated, '[i]n essence, the over-the-counter (OTC) market, instead of dispersing the counterparty risk of market participants, concentrated it in the hands of intermediaries and thus transformed it into pseudo-systemic risk.'[9]

The cost to societies is significant, from taxpayers who had to repair the chasm in the finances of the Orange County municipality to the estimated one million people who lost their jobs in South Africa after 2008. Second-round effects included the cost of further regulation and capital requirements within banks and insurers (Basel III[10] and Solvency II (in South Africa, the Solvency Assessment and Management framework or 'SAM')),[11] which again increase costs for users of the financial system. These events affect all aspects of public sentiment.

A comparative analogy is the development of societal sentiment and legal reasoning about something that is now regarded as settled within the understanding of finance – the concept of charging interest for the use of another's money. The great Roman-Dutch jurist Gerard Noodt (1647–1725) devoted much of his productive life to the study of interest as the 'life blood of finance'. His resulting treatise *De Foenore et Usuris Libri Tres* (*The Three Books on Interest-Bearing Loans and Interest*) contains the following remark in his preface:

> Yet strangely enough no other issue has to the same extent been subject to contradictory judgments of men. For interest was at one time held to be just and honourable, at another godless and disgraceful – let alone amongst the masses … but also amongst intelligent people of excellent reputation and highly

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[8] See AM Berd *Lessons from the Financial Crisis* (2010) xxvii: 'In some cases, such as AIG, with its "iron-clad" AAA ratings, there were no margins required whatsoever, making even a transaction earning a few basis points a winning trade, given virtually infinite leverage … The resulting margin calls appeared to be so severe precisely because any reasonable margin requirement is infinitely large when compared to zero, … (unless of course they have the internal discipline to set aside sufficient cash reserves and self-insure, like Warren Buffet's Berkshire Hathaway is used to doing).'

[9] Ibid xxvi.

[10] There have been three Basel Accords, referred to as Basel I (adopted in 1988), Basel II (2004) and Basel III (rules published in December 2010).

[11] The SAM regulations are intended to align the South African insurance industry with international standards.

> regarded dignity. And yet this unfavourable view was due not to interest itself but to the men who exploited interest-bearing loans and interest. What aggravated the misconception was the fact that those men who wanted to regulate by discipline the mores of other people with the intention of censuring worldly vices, sometimes – as usually happens – drew in the reins more tightly than occasion demanded, through ignorance of reasoning that controls human endeavours, the most that was achieved was that interest-bearing loans and interest were forbidden. And yet the most severe laws and punishments could not prevent the utilisation of money ….[12]

Aristotle expressed the following sentiment:

> But that [*usura*] which consists of the bartering of money is deservedly censured (since it is not consonant with nature, since in this case one person is hunting for profit from another); the whole system of moneylending is with very good reason hated by all, because profit is sought from the money itself and they do not acquire it for the purpose it was created; for it came into existence for the sake of the exchange, but *foenus*[13] increases and multiplies it; … an offspring of money. For that reason of all the means of seeking to acquire money, this is the one that is most seriously inconsistent with nature.[14]

2.2.1 Anecdotal examples of public sentiment about derivatives

Abbott LCJ, in his 1826 decision in *Bryan v Lewis,* expressed a similar difficulty with the nature of a derivative instrument. The plaintiff had sold a quantity of nutmegs to the defendant, to be delivered on 9 March. When delivery was tendered the defendant was unable to pay. Notwithstanding the fact that the plaintiff had expended money to purchase the nutmegs for delivery, Abbott LCJ held that the contract was unenforceable:

> I have always thought, and will continue to think, until I am told by the House of Lords that I am wrong, that if a man sells goods to be delivered on a future day, and neither has the goods at the time, nor has entered into any prior contract to buy them, nor has any reasonable expectation of receiving them by consignment, but means to go into the market and to buy the goods which he has contracted to deliver, he cannot maintain an action upon such a contract. Such a contract amounts, on the part of a vendor, to a wager on the price of a commodity, and is attended with the most mischievous consequence.[15]

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[12] G Noodt, SJ van Niekerk et al *The Three Books on Interest-Bearing Loans and Interest (Foenus et Usurae)* (2009) 3.
[13] '[W]henever something was owed in terms of an agreement, it was to be called *foenus*, but *usura* if it was delivered either according to that agreement or in accordance with judicial discretion'. Ibid 25.
[14] Ibid 27.
[15] *Ry & Moody* KB (1826) 386–7, quoted in EJ Swan *Building the Global Market: A 4000 Year History of Derivatives* (2000) 208 nn 58 and 59.

Even though it was pointed out to Abbott by counsel for the defendant that this would have a profound effect on the Royal Exchange, he was firm in his view. Ten years later, in *Wells v Porter*, this view of the law was called doubtful.[16] But this view was disapproved of only in 1839, and overruled in 1874.[17]

In a speech at the Worshipful Company of International Bankers dinner on 24 September 2008, the Archbishop of York criticised the use of equity derivatives in a short selling strategy[18] – a view not unlike that expressed by Abbott LCJ, 183 years earlier: 'To a bystander like me, those who made £190 million deliberately underselling the shares of HSBOS, in spite of its very strong capital base, and drove it into the bosom of Lloyds TSB Bank, are clearly bank robbers and asset strippers.'[19]

Yet, the economist and central banker Alan Greenspan, a proponent of free markets, would refer to derivatives as essential distributors of risk to those who could bear the risk (and therefore they were a public good):

> A market vehicle for transferring risk away … can be critical for economic stability … The buffering power of these instruments was vividly demonstrated between 1998 and 2001, when CDSs [Credit Default Swaps] were used to spread the risk of $1 trillion in loans to rapidly expanding telecommunications networks. Though a large proportion of these ventures defaulted in the tech bust, not a single major lending institution ran into trouble as a consequence.[20]

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[16] In examining the development of law applicable to speculative contracts, Swan (n 15) 78 and 79 provided a stark contrast to Abbott's decision from Roman law in the second century AD. In the second century AD, Sextus Pomponius wrote a 36-book commentary of the *jus civile* entitled *ad Sabinum*. In *Sabinus, Book 9*, he identified and distinguished between two kinds of valid contracts for future delivery. The first type, *vendito re speratae*, included contracts that promised for future delivery such things as future crops. The second, *vendito spei*, was essentially a sale of whatever proceeds a speculative venture returned. The important legal distinction between them was that the first kind was void if the goods failed to materialise (no crop), but the second was valid regardless of whether the venture yielded any proceeds or not. Pomponius wrote: 'Sometimes, indeed, there is held to be a sale even without a thing, as where what is bought is, as it were, a chance. This is the case with the purchase of a catch of birds or fish or of largesse showered down. The contract is valid even if nothing results, because it is a purchase of an expectancy and, in the case of largesse, if there is eviction from what is caught, no purchase proceedings will lie, because the parties are deemed to have contracted on that basis.'

[17] *Thacker v Hardy* 4 QBD 685 (1878), quoted in Swan (n 15) 208 n 64.

[18] When you borrow an asset to 'sell it short' in the expectation that its price will decline.

[19] E Parker *Equity Derivatives, Documenting and Understanding Equity Derivative Products* 7.

[20] A Greenspan *Alan Greenspan, The Age of Turbulence, Adventures in a New World* (2007) 371, 372.

These sentiments, much more broadly expressed in a full reading of his autobiography, were published in 2007 just before the financial crisis erupted, caused specifically by Credit Default Swaps (CDSs), which are a credit derivative. This time the world entered 'the Great Recession' as the crisis has been called. The financial crisis of 2008 demonstrated the powerful combination of leverage (or gearing) enabled by bank balance sheets coupled with the use of derivative instruments – a cost that ultimately came to be borne by society itself through job losses, higher public debt and increasing taxes. However, it was not the instruments themselves that caused the crisis, but the way in which they were used.

The 2011 Nobel Laureate in Economics, Joseph Stiglitz, described Alan Greenspan as the 'high priest' of an ideology that led to the crisis. He described Greenspan in this way not for his understanding of the function of financial derivatives, but because of his liberal approach to the regulation of financial markets. Like Noodt, Stiglitz pointed to failed morality, rather than financial instruments: 'When we tax the returns to speculation at much lower rates than the income of those who work hard for an income, not only do we encourage more young people to go into speculation, but we say, in effect, that as a society we value speculation more highly.'[21]

In 2002, the renowned investor Warren Buffet wrote a letter to shareholders in the 2002 Berkshire Hathaway Annual Report where he set out his view of derivatives: 'Indeed, at Berkshire, I sometimes engage in large-scale derivative transactions in order to facilitate certain investment strategies'. But then he issued a stern warning about the dangers of misuse:

> In fact, the reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit … When … I finish reading the long footnotes detailing the derivatives activities of major banks, the only thing we understand is that we don't understand how much risk the institution is running …. In our view … derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.[22]

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[21] JE Stiglitz *Freefall, Free Markets and the Sinking of the Global Economy* (2010) 278.
[22] Ibid 217.

An analysis by the US Staff of the Joint Committee on Taxation defined derivatives as 'a wager with respect to the change in price or yield of an underlier'.[23] The Companies and Securities Advisory Committee in Australia[24] opened their 1995 report with the following illustrative quote:

> Futures and commodity options trading is among humanity's more impenetrable concepts. It involves selling what one does not own and, as a rule, buying what one does not want. It is deeply shrouded in terminology that conceals its meaning. It operates in an arena where opinion is everything, where supply and demand are hard to distinguish from supposition and doctrine, and where inherent uncertainty has spawned an endless holy war between two religious-sounding antagonists, the 'fundamentalists' and the 'chartists', not to mention the new breed of computer-dependent faithful. Into this world comes the general public, eager to enjoy its riches and often unprepared to become its poor.[25]

And so with derivatives, not unlike interest, a tension springs from the concern that it is money serving itself, rather than its natural purpose. The tools of trade have themselves become the object of trade. This is referred to by some as an over 'financialisation' of economies, whereby financial services and their instruments exceed their social good; and where engineers, rather than designing and supervising the instruments of production, are bought at great price to mathematically construct derivative products for investment banks to on-sell to clients at rich margins. The topic could be debated endlessly. If the intent is purely speculative, the contracts introduce new risks for society. If they are used to hedge out existing risks, they net-off such specified risks between those that cannot bear them and a counterparty that is willing to bear that risk.

My intention, therefore, is to apply legal reasoning to validate established law amidst much contextual complexity in society.

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[23] Joint Committee on Taxation 'Present Law and Analysis Relating to the Tax Treatment of Derivatives, Scheduled for a Public Hearing before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on 5 March 2008' 2.

[24] The Companies and Securities Advisory Committee (the Advisory Committee) was established under Part 9 of the Australian Securities Commission Act 1989 (the ASC Act).

[25] PM Johnson & TL Hazen *Commodities Regulation* vol III 2 ed (1989) 155, cited in Companies and Securities Advisory, 1995, Law of Derivatives, International Comparison, at viii.

2.3 OVERVIEW OF THE MODERN LEGAL AND REGULATORY CONTEXT

There is a growing awareness that derivatives, although not referred to as such, have a much longer history than has been popularly thought. Kummer and Pauletto described their origins in Roman law as follows:

> Under Roman law, two types of forwards could be identified. The first was a promise for future delivery of goods at the delivery date and the second was a purchase of 'expectancy' as a Roman lawyer wrote in the second century AD. The legal difference between the two was that the first was void if the delivery of goods failed to materialise, but the second was valid even if the seller could not deliver on the promise. In this case, Roman law would enforce the intentions of the parties, even if they were speculative. Roman law had influence on derivatives trading and regulation for centuries, but its main contribution to the development of derivatives markets in Continental Europe, in the UK and later in the United States of America (USA) was the greatest barrier set by the Romans' own use of derivatives. In early Roman law, the transferability of the rights and obligations of contracts was not legally recognised. Assignment of contracts only became recognised by the end of the Empire.[26]

The concept of a 'sale of a promise' seems to be as old as trade itself, yet the physical non-delivery alternative as a means of honouring that promise, that is, by way of cash, resulted in these contracts, instruments or obligations being construed as the wagering of a bet on price movements. Even in relatively modern times, courts and regulators tried to rule against them as undesirable and unwanted. By way of introduction, I include historical context provided largely by Swan for two jurisdictions central to the development of financial markets: the UK and the USA. A review of current regulation is included for each individual jurisdiction when it is examined in this thesis.

2.3.1 Early developments in the United Kingdom

In 1845 the British Parliament introduced the Gaming Act, which sought to protect the public. The Act effectively 'took away all cognizance of wagers from the Courts of law'.[27] The

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[26] Paper presented to the European Free Trade Association, Seminar on Regulation of Derivatives Markets, Zurich, 3 May 2012, citing Swan (n 15) 75–84 and 284–6.
[27] Hansard, Parliamentary Debates (3rd series), vol 82 (4 July – 9 August 1845) 794, quoted in Swan (n 15) 211 n 85.

Financial Services and Markets Act 2000 contains a specific exclusion in section 412(1) which states that these instruments are 'void or unenforceable because of s. 18 of the Gaming Act 1845',[28] to avoid a contention that 'two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other … a sum of money.'[29]

The importance of this Act was not only its repressive effect on the development of the trading of derivatives in the UK and the USA, but also the fact that it led to the 'intent test',[30] which continues to play an important role in UK, US and South African law. The US Supreme Court endorsed the intent test in 1884 in *Irwin v Willar*.[31] Matthews J wrote for the majority as follows:

> A contract for the sale of goods to be delivered at a future day is valid … when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and, if under the guise of such a contract, the real intent be merely to speculate in the rise and fall of prices, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void.[32]

2.3.2 Early developments in the United States of America

Following the American Revolution, the individual states developed their own legislation, based on English law. In 1812, New York was the first state to regulate against the sale of securities that the seller did not own at the time. The short sale of natural resource commodities was, however, still enforceable. States such as Massachusetts, Missouri, Pennsylvania and Illinois followed with their own legislation.

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[28] Ibid.
[29] *Carlill v The Carbolic Smoke Ball Company* (1892) 2 QB 484 at 490, per Hawkins J.
[30] In *Grizewood v Blane* 11 CB 526 (20 November 1851) this test was explained and applied. See Swan (n 15) at 212, 213 and n 91.
[31] 110 US 499 (1884).
[32] *Irwin v Willar* 110 US 499 (1884) 508–9, quoted in Swan (n 15) at 239 n 85.

The 'intent test' applied in *Grizewood v Blane*[33] had its impact in the USA as well, with courts applying it and many states writing its principles into statute. The irony of this application, however, was that the *Grizewood* decision was based on the Gaming Act 1845 and not on the common law.[34]

In the late 1800s several states legislated against futures (most on the basis of non-delivery), including California (1879), Mississippi (1882), Tennessee, Arkansas, South Carolina (all in 1883), Texas (1885), Iowa (1886), Michigan (1887), Missouri (1889), Massachusetts (1890), North Dakota (1890), Louisiana (1898) and Ohio (1882). The legislation imposed fines or jail terms.[35]

In an 1896 report, strong interest was expressed in developments in Germany where similar sentiments against futures had resulted in repressive legislation:

> Germany, under the pressure of the Agrarian party, has undertaken what other nations have been desirous of doing, viz. to check speculation on the exchanges, not alone in stocks, but also in food products, principally grain. Whether this will be accomplished by the new law, remains to be seen, and it will certainly be very interesting for other nations to watch the experiment. Below are given the most salient features of the law:
>
> > No exchange can be established without the consent of the government, which, through a commissioner, will exercise a continued supervision over its actions and dealings.
> >
> > All dealings in futures or on term at the exchange are prohibited, unless the parties to the transaction are entered in the so-called exchange register.
> >
> > The 'term' business or dealing in futures in grain and mill products or stocks of mining and manufacturing establishments on the exchange is entirely forbidden.[36]

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[33] *Grizewood v Blane* (n 30) 584. Jervis CJ described the agreement as 'a colourable contract for the sale and purchase of railway shares, where neither party intended to deliver or to accept the shares, but merely to pay differences according to the rise and fall of the market … the transaction was clearly gambling, and a practice which clearly everyone must condemn.'

[34] Swan (n 15) 220.

[35] Ibid 239, 240.

[36] US Consular Reports, vol. LII, November 1896, quoted in JF Boyle *Speculation and the Chicago Board of Trade* (1920) 182–7.

The enactment of legislation in this vein continued into the twentieth century, based on general suspicion fuelled by incidents such as the 'Panic of 1907'.[37] Pressure for federal regulation resulted in various examinations of the futures market.

In 1905, the Supreme Court case of *US Board of Trade of Chicago v Christie Grain & Stock Co*[38] set aside the intent test, turning to a 'serious business purpose' as a means of distinguishing between gambling and real business, thereby enunciating a legitimate form of futures trading.

2.3.3 The introduction of federal regulation

By 1916, the US Congress had enacted the Cotton Futures Act, followed by the unsuccessful Futures Trading Act of 1921.[39] The Grain Futures Act of 1922[40] and the Commodity Exchange Act (CEA) of 1936 followed. The CEA was the result of President Franklin Roosevelt's call for greater regulation after the market collapse of 1929.

Continuing concerns about laxity in the self-regulatory system, with allegations about puts and calls (derivative option instruments) being sold for non-exchange traded commodities, undue price loading on the part of sellers, and credit risk because sellers were not covering their own positions led to the formation of the Commodity Futures Trading Commission (CFTC) in 1974. Regulation became a product of the Commodity Futures Trading Commission Act. However as the SEC realised the extent to which derivatives were becoming a part of its market, rivalry developed, with more than one jurisdictional encroachment by the SEC being taken to court.[41]

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[37] Farmers caught in extended credit hoped to repay from future crops. However, sagging prices caused panic. Many farmers and those politicians who supported them believed that prices were driven artificially low by futures traders. This notion of course ignored the fact that commodity speculation is a zero sum game. See Swan (n 15) 244 n 104.
[38] 198 US 236 (1905).
[39] Unsuccessful because the monetary tax it imposed (aimed at options contracts) was held to be unconstitutional by the US Supreme Court in *Hill v Wallace* 259 US 44 (1922).
[40] Which omitted the monetary tax.
[41] Swan (n 15) 260, 261.

In 1992, Congress enacted the Futures Trading Practices Act, intended principally to allow the CFTC to exempt from regulation certain transactions that had to be freed from regulation for internationally competitive reasons. However, more complexity has resulted.

Following the financial crisis of 2008, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was passed by Congress in July 2010. The Act confers expansive new authority for non-security-based derivatives on the CFTC, and authority for security-based derivatives on the SEC.[42] Under the Trump administration there have been calls for change. A US Treasury report[43] dated October 2017 expressed the following sentiment:

> More than seven years after Dodd-Frank's enactment, it is important to reexamine these rules, both individually and in concert, guided by free-market principles and with an eye toward maximizing economic growth consistent with taxpayer protection.[44]

2.3.4 United Kingdom regulatory development after World War 2

The period between the two World Wars saw the developing of concern about 'share-pushing', which involved unbridled selling and persuasion by salesmen. As a result, the Bodkin Committee (established in 1937)[45] recommended the registration of dealers in shares. The Prevention of Frauds (Investment) Act of 1939 was passed. The implementation of the Act was delayed by World War 2, and was consolidated into the Prevention of Frauds Act of 1958.[46] The Act remained until 1986 as the principal statutory regulation of the futures and investment industry.

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[42] 'Explanatory Memorandum: Annexure C, An Examination of the South African OTC Derivatives Markets to Recommend Measures for Strengthening their Regulatory Oversight' (2010) 34. This report was commissioned by the Financial Services Board of South Africa, in response to a call by the G20 for certain measures to be implemented in the OTC derivatives markets of member countries.
[43] US Department of the Treasury 'A Financial System That Creates Economic Opportunities, Capital Markets' Report to President Donald J. Trump (2017).
[44] Ibid 5.
[45] Swan (n 15) 226.
[46] LCB Gower 'Big bang and city regulation' (1988) 51(1) *Modern Law Review* 1–22; Swan (n 15) 227 n 21.

However, concern over the lack of regulation to undergird investor confidence resulted in the appointment in 1981 of Professor Gower by the Secretary of State for Trade to survey the industry and to make recommendations for legislation. In 1984, the Governor of the Bank of England appointed an advisory group (called the 'Ten Wise Men') in response to Professor Gower's recommendations to look into self-regulatory organisations (SROs). These developments culminated in the publication of a White Paper, *Financial Services in the United Kingdom: A New Framework for Investor Protection*,[47] emanating from an accord between the Bank of England and the Department of Trade and Industry (DTI). The principles were then incorporated in the Financial Services Act (FSA) of 1986:

1. Excessive regulation was not desirable as it imposed unnecessary monitoring and enforcement costs and impeded new product and service design.
2. The best available standards in terms of self-regulation therefore had to be developed.
3. Regulation was not an antidote for risk, but rather necessary to see that risk taking was fairly rewarded in terms of profit and that the scope for losses resulting from fraud and the concealment of risk were minimised.
4. Regulation would therefore offer more comprehensive protection against fraud and negligence, facilitate fair competition and innovation, and allow the details of the industry to be run by those familiar with it, with minimum state intervention.

Swan attributes the enshrinement of these principles to the successful growth of future trade in the UK. Factors such as a stable government, a history of international futures trading, a good judicial system, language and convenient time zone placement are all secondary to a liberal approach. 'Other advantages such as political power, vast production of natural

[47] 1985 Cmnd 9432.

resources, or large consumption of commodities cannot compete with liberal regulatory policy in attracting healthy international futures markets.'[48]

No major revisions were made to the regulatory policy until the Financial Services and Markets Bill was introduced in 1998.[49] The enactment of the Financial Services and Markets Act 2000 introduced a new regulatory regime under the supervision of the Financial Services Authority, focusing on market risk, investor education, and the avoidance of abuse and money laundering. Effective from 1 December 2001, the Act created a new mega-regulator, the FSA,[50] which amalgamated a number of authorities.

Following the financial crisis of 2008, at the request of the European Commission (EC), a report was published on 25 February 2009 by a high-level group chaired by Jacques de Larosière. The report concluded that 'the supervisory framework of the financial sector of the Union needed to be strengthened to reduce the risk and severity of future financial crises and recommended reforms'. This included 'the structure of supervision of that sector, including the creation of a European System of Financial Supervisors, comprising three European supervisory authorities, one each for the banking, the insurance and occupational pensions and the securities and markets sectors, and the creation of a European Systemic Risk Council'.[51]

The 2012 European Market Infrastructure Regulation (EMIR) imposes requirements on firms entering into any form of derivatives. In the UK, the Financial Services and Markets Act 2000 now includes 2013 regulations governing OTC derivatives, Central Counterparties (CCPs) and Trade Repositories (TRs).[52]

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[48] Swan (n 15) 234.
[49] T Herrington 'Amendments to the Financial Services Act' (February 1990) *International Business Lawyer* 78–80 at 78; Swan (n 15) 232 n 53.
[50] The FSA is a body corporate governed by its chair and governing body, capable of being removed by the Treasury: FSMA 2000, Sched 1, para 2. See A Hudson *The Law on Financial Derivatives* (2002) 514 n 7.
[51] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.
[52] Financial Services and Markets Act 2000 (Over-the-Counter Derivatives, Central Counterparties and Trade Repositories) (No. 1 & 2) Regulations 2013.

2.4 INTRODUCTION TO EQUITY DERIVATIVES

This thesis is unable to attempt a full explanation of derivatives, other than within the narrow confines of the stated topic. Two simplifying proxies have been applied in an attempt to limit almost limitless variables. These are the following:

1. Only equity financial derivative instruments were considered.
2. The context was limited to investment portfolios licensed as such by domestic regulators, and managed by professional managers on behalf of third party investors. On the part of the manager and the investor it was assumed that legitimate investment objectives exist because of adherence to regulation.

2.5 ANECDOTAL EXAMPLES OF DEFINITION

By way of introduction, a few definitional examples from various quarters are offered next.

The first 'legal' or judicial use of the term 'derivative' was made in *American Stock Exchange v Commodity Futures Trading Commission*,[53] a 1982 New York Federal Court case. Judge Weinfeld wrote:

> When exercised, options on physicals lead to the delivery of the physical commodity itself; thus they are 'first derivative' instruments but one step removed from the underlying commodity. Options on futures are 'second derivative' instruments which give rise only to delivery of a futures contract, a contractual undertaking which can be transferred to third parties to buy or sell a fixed amount and grade of a certain commodity on some specified date. The term is first found in a reported English decision in October 1995.[54]

The Securities Investment Board in the UK simply defined a derivative as 'a future, option or contract for differences'.[55] The Securities and Futures Authority (SFA) and the Self-Regulatory Organisation (SRO) also applied this definition.

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[53] 528 F.Supp. 1145 (USDC SDNY 1982).
[54] *Bankers Trust International PLC v PT Dharmala Sakti Sejahtera et al* Queen's Bench Division (Commercial Court) (Transcript), 19 October 1995. See Swan (n 15) 6.
[55] *SIB Rulebook* vol 1 ch 3: 'The Financial Services Core Glossary' (1992) 2. See Swan (n 15) 11 n 55.

The Bank of England, after enquiring into the Barings Group, issued a report[56] on 18 July 1995 in which a derivative was defined as 'a contract or instrument that changes in value depending on the price movements in another instrument or index, e.g. future, option.' The Financial Law Panel in the UK formulated the following definition of derivatives:

> At its widest, a 'derivative' can be taken to mean any obligation which is identified by reference to another obligation. Thus, an option to buy an equity is a derivative of an equity, which is itself a chose in action. For present purposes, we think this definition is too wide to be helpful. Accordingly, we use the term to mean a chose in action under which sums will be, or may in specified circumstances become, payable between one party and another. The amount or amounts payable will often, but not always, vary according to a formula or other objective external factors.[57]

Tolley's Taxation of Corporate Debt, Foreign Exchange and Derivative Contracts defined derivatives as being '"derived from" something outside themselves but then take on a life of their own and become financial assets with distinct characteristics. Their nature is defined as "the sale of a promise".'[58] Swan defined derivatives as '[a] sale of a promise to provide an agreed asset: (1) at an agreed price, and (2) at an agreed future time, which may be settled by choosing from agreed alternatives.'[59]

Swan extended his analysis further by explaining that promises can be exchanged (a swap), or a right to enter into a contract can be sold (an option). 'An option confers no more than a contractual right to acquire property on payment of a consideration.'[60] An option is neither an irrevocable offer nor a conditional contract but an *asset in its own right*:

> An offer is not strictly speaking either an offer or a conditional contract. It does not have all the incidents of the standard forms of either of these concepts. To that extent it is a relationship *sui generis.* But there are ways in which it resembles each of them. Each analogy is, in the proper context, a valid

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[56] Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings (1995). See Swan (n 15) 11 n 57.
[57] Financial Law Panel *Transactions in Derivatives Legal Obligations of Banks to Customers: A Discussion Paper* (May 1995) 9. See Swan (n 15) 12 n 59.
[58] D Southern & PricewaterhouseCoopers *Tolley's Taxation of Corporate Debt, Foreign Exchange and Derivative Contracts* (2001) 317, 318.
[59] Swan (n 15) 17.
[60] *Vandervell v IRC* 43 TC 519 at 559.

> way of characterising the situation created by an option' (*Spiro v Glencrown Properties Ltd* (1991) All ER, per Hoffmann J at 606).[61]

Hull commented on the last 30 years as follows:

> Derivatives are added to bond issues, used in executive compensation plans, embedded in capital investment opportunities … We have now reached the stage where anyone who works in finance needs to understand how derivatives work, how they are used, and how they are priced.[62]

He defined derivatives as–

> a financial instrument whose value depends on (or derives from) the values of other, more basic, underlying variables. Very often the variables underlying derivatives are the prices of traded assets … However, derivatives can be dependent on almost any variable, from the price of hogs to the amount of snow falling at a certain ski resort.[63]

Buffet, as practitioner and critic, provided a practical explanation of the instruments:

> [T]he word covers an extraordinarily wide range of financial contracts. Essentially, these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices, or currency values … Derivative contracts are of varying duration (running sometimes to 20 or more years), and their value is often tied to several variables. Unless derivative contracts are collateralised or guaranteed, their ultimate value depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses – often huge in amount – in their current earnings statements without so much as a penny changing hands … The range of derivatives contracts is limited only by the imagination of man.[64]

Lynch appropriately captures the status quo as follows:

> A derivative is invariably described in words to the following effect: 'a financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity', or 'a financial instrument whose value depends on (or derives from) the value of other, more basic, underlying variables.' This is the definition that is almost always used in legal scholarship and in policy discussions. But for legal and policy analysis purposes, this definition is

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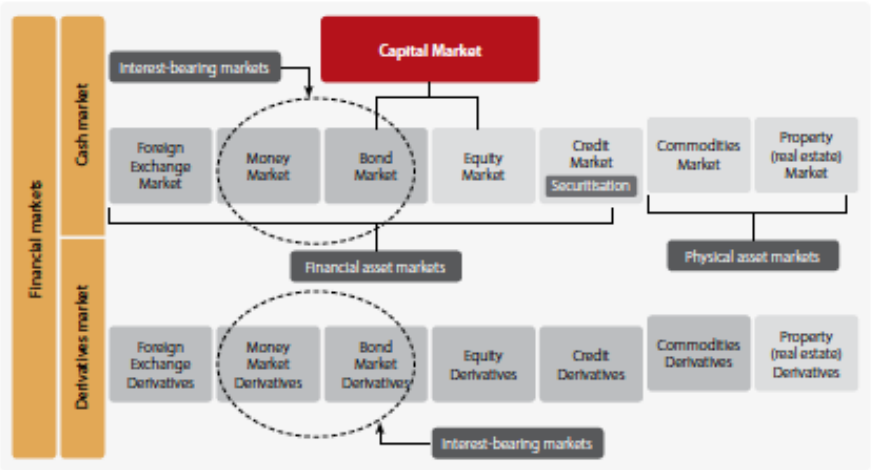
[61] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 18.
[62] J Hull *Options, Futures, and other Derivatives* (2009) 1.
[63] Ibid.
[64] CJ Loomis *Tap Dancing to Work, Warren Buffet on Practically Everything, 1966-2012* (2012) 217.

> inadequate—it is imprecise, incomplete, and fails to capture the nature and scope of modern derivative transactions.[65]

In chapter 11 I propose a definition to improve on the legal understanding of these instruments, based on the literature reviewed.

2.6 THE MARKET AND THE SOUTH AFRICAN MARKET INFRASTRUCTURE

Figure 2.1 provides a useful depiction of South African financial markets both with respect to asset classes and the cash and derivative markets. As can be observed, the derivatives market mirrors the physical cash market. The cash market comprises financial assets such as bonds and equity, while the physical asset market comprises assets such as property, metals, food or crude oil. This research focuses specifically on equity derivatives.



Source: Goodspeed (2017)

Figure 2.1: Financial market infrastructure South Africa[66]

The relative size of South Africa's equity market as at November 2019, according to the World Federation of Exchanges statistics, is illustrated in Table 2.1:

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[65] TE Lynch 'Derivatives: A twenty-first century understanding' (2011) 43 *Loyola University Chicago Law Journal* 1–50 at 10–11.

[66] National Treasury, South African Reserve Bank & the Financial Sector Conduct Authority *Financial Markets Review Final Report* (2019) 22.

Table 2.1: Relative size of the South African equity market[67]

Instruments	Measure	South Africa	World	SA % World
Spot transactions	Daily average turnover in USD billion	27	1987	1.4%
Outright forwards		7	999	0.7%
Foreign exchange swaps		30	3202	0.9%
Currency swaps		1	108	0.9%
Options		7	297	2.4%
Total		**72**	**6595**	**1.1%**

Source: BIS Triennial Survey. 2019, accessed at https://www.bis.org/statistics/rpfx19_fx_annex.pdf

Trade in derivatives can be conducted either via a formal derivatives exchange (exchange traded) or between counterparties off-market (over-the-counter), via what today are largely standardised contract terms. As mentioned, significant regulatory efforts since the 2008 financial crisis[68] have been directed at bringing OTC derivatives within the formal clearing and settlement systems of regulated markets. According to the World Federation of Exchanges' Annual Statistics Guide (December 2018), the relative size of the exchange-traded derivatives market as South Africa is as follows:

[67] Ibid 34.
[68] At the Pittsburgh Summit in September 2009, G20 leaders called for the implementation of a number of key measures to reform the financial markets.

Table 2.2: Relative size of South Africa's exchange-traded derivatives market[69]

Instruments	Measure	South Africa	World	SA % World
Stock options	Volume in millions	8	4452	0.2%
Single stock futures		9	1453	0.6%
Stock index options		5	4349	0.1%
Stock index futures		18	3379	0.5%
Short-term interest rate futures		11	1754	0.6%
Long-term interest rate futures		1	1950	0.1%
Currency options		32	1156	2.8%
Currency futures		42	2520	1.7%
Commodity futures		3	5640	0.1%
Other options*		1	182	0.5%
Other futures*		133	236	56.4%
*Index volatility options and futures and dividend options and futures				

Source: WFE Annual statistics Guide 2018

Bekale, Botha and Vermeulen explained the regulation and derivative market infrastructure in South Africa as follows:

> In the wake of the financial crisis, the Financial Markets Bill (FMB) of 2012 was adopted in South Africa to replace the Securities Services Act (2004) to adhere to the G-20's new commitment for the standardisation of OTC derivatives, the clearing of these instruments through CCPs, and the reporting of all derivatives contracts to trade repositories … . The FMB prescribes the regulation and supervision of derivatives market institutions, and also emphasises the relationship of these institutions with their respective members in order to reduce systemic risk, ensure markets that are fair, efficient and transparent, and also to protect investors … . Moreover, new derivatives rules govern South Africa's derivatives trading in agreement with the guidelines of the International Organisation of Securities Commission (IOSCO). These require the derivatives market to have prefunded resources from, altogether, the clearing members of SAFEX Clearing Company (SAFCOM) and the Johannesburg Stock Exchange (as the host of the South African Futures Exchange, SAFEX) on behalf of SAFCOM, which provides capital in addition to the collateral posted by market participants, and thus serves as a way for better counterparty risk management in the derivatives market … .[70]

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[69] National Treasury et al (n 66) 35.

[70] AN Bekale, E Botha & J Vermeulen 'Institutionalisation of Derivatives Trading and Economic Growth: Evidence from South Africa' Economic Research Southern Africa, Paper 505 (2015) 6 (references omitted). While derivatives used to be settled via SAFCOM, they are now settled via JSE Clear, as illustrated in figure 2.2.

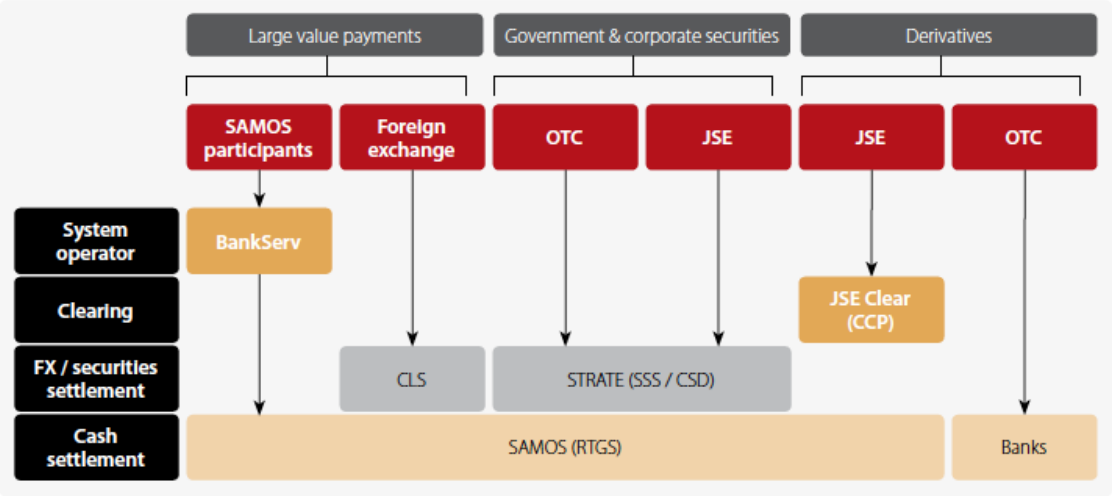

Figure 2.2: South African financial market infrastructure transaction flows[71]

2.7 DERIVATIVE BUILDING BLOCKS

> The absence of a statutory definition appears to be a pernicious legacy of a bygone era of federal taxation … when the rustic simplicity of the label … was sufficient.[72]

Forwards and options are the building blocks upon which all derivatives are constructed. An understanding of these two derivative types enables an analysis of all other derivative constructs. As Hudson explained, '[t]he option is the basic technique which underpins all other derivatives in the mathematics of finance theory. A forward is generally thought of as a series of options, and a swap is typically priced and structured as a series of forwards.'[73]

However, as Hudson pointed out, for a lawyer an option and forward are essentially different concepts. An option grants a *right* to its holder and a forward creates an *obligation*.

Forwards and options can be traded bilaterally off exchange (over-the-counter contract or 'OTC') or through an exchange (with the exchange providing a guarantee that the contract

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[71] National Treasury et al (n 66) 36.
[72] *Kurzner v United States*, 413 F.2d 97 at 99 (5th Cir. 1969), referring to the word 'corporation', in Plumb (n 42) at n 4.
[73] Hudson (n 50) 5-55.

will be honoured). A forward contract (OTC) and a future (listed on an exchange) refer to the same derivative type. Options can be OTC or listed.

2.7.1 Options

An option can be entered into in two converse formats: the option, secured by the payment of a premium, secures the right for the holder to *buy* the underlying asset by a certain date for a certain price, known as a *call option*. Likewise, an option can confer a right on a holder to *sell* the underlying asset, known as a *put option*. As Hull explained, 'the price in the contract is known as the *exercise price* or *strike price* and the date in the contract is known as the *expiration date* or *maturity*.'[74] Conlon and Aquilino paraphrased the usual language used for these instruments by stating that an option contract is 'identical to a forward contract except that delivery and payment of the purchase price occur at the discretion of the holder or purchaser of the option. The party who is obligated to perform if the holder exercises the option is the *writer* of the option'.[75] Unlike a forward contract, which is used to secure a lock-in price, an option presents an elective right at the risk of losing a premium if the option is not utilised. In this sense, the option can be used as an insurance policy against a price movement, at the price of a premium payment.

2.7.2 Forward contracts

Hull described a forward contract as an agreement to buy or sell an asset at a certain future time for a certain price.[76] The concept can be compared to a spot contract, which is an agreement to buy or sell an asset today. 'One of the parties to a forward contract assumes a long position and agrees to buy the underlying asset on a certain specified future date for a specified price. The other party assumes a short position and agrees to sell the asset on the same date for the same

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[74] JC Hull *Options, Futures, and other Derivatives* (2009) 6.
[75] Conlon & Aquilino (n 7) A1.02[2][b] at A1-13.
[76] Hull (n 74) 3.

price'.[77] As Conlon and Aquilino described, in the language of the market, a commitment to sell a particular commodity at a given price is *going short* and a commitment to purchase at a particular price is *going long.*[78] A short sale can be achieved by either owning or borrowing a security (from a pension fund) as cover for delivery against the contract. It is possible to sell a security without owning it or borrowing the asset contracted for (assuming full financial risk of honouring that contract with any market movements of the asset), but *naked shorting* is not permitted in South Africa. Conlon and Aquilino explained the matter as follows:

> If X enters into a short sale but does not actually own the asset subject to the short sale, the short sale exposes X to market risk if the price of ABC stock rises, since X will ultimately have to purchase ABC stock and deliver it to Y (that is, cover its short position) on the delivery date at the price called for in the forward contract to effectively pay for the stock it borrowed in executing the short sale. X will profit from its short sale if the market price of the stock declines, since it will be able to cover its short position by purchasing the ABC stock at a lower price. Likewise, X will suffer a loss if the market value of the stock increases, because X will be required to pay a higher price for its ABC stock to cover its short position.[79]

As mentioned above, the legal perspective of a forward is somewhat different from how the market conceives these instruments. In financial theory, a forward is conceived of as two synthetic options containing a right to buy or sell at an identified price in the future. As Hudson put it, '[t]he forward is a promise to supply'.[80] With an option there is no such obligation.

2.8 EQUITY DERIVATIVES

The focus of this research is equity derivatives or derivatives that reference equity or share values, whether they are individual companies or a composite index. As discussed previously, exposure could be via forwards or options.

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[77] Ibid 4.
[78] Conlon & Aquilino (n 7) A1.02[2][a] at A1-13.
[79] Ibid A1.02[2][a] at A1-13.
[80] Hudson (n 50) 5-92.

Equity derivatives are forward contracts (or futures, if listed) or options that reference the equity asset class. The distinction between debt and equity is a vast subject and has nothing to do with derivatives per se. However, the permeability of the boundary between debt and equity has presented fertile ground for derivative instruments used in tax planning. Equity is risk capital entirely subject to the gains and losses of the corporate venture. Corporations issue stock to shareholders, who receive dividends out of distributed earnings and may experience gains or losses on the capital value of the stock over time, driven by the company's performance and a rating of what its prospects are, given its internal abilities, and the geography and markets in which it operates. Different types or classes of stock may include different rights. Debt, on the other hand, is an unqualified promise to pay a defined sum on a specified date at an agreed interest rate. The value of that debt (appreciation or depreciation) arises from changes in prevailing interest rates and the creditworthiness of the borrower. In the case of equity derivatives, the derivative instrument may reference underlying metrics that are derived from a number of equity sources. These underlying equity metrics can typically be accessed via OTC derivatives (a swap, an option or a forward), exchange traded derivatives (a future, an option or a listed structured product) or structured products involving equity derivatives (certificates, notes, units in a fund or warrants).

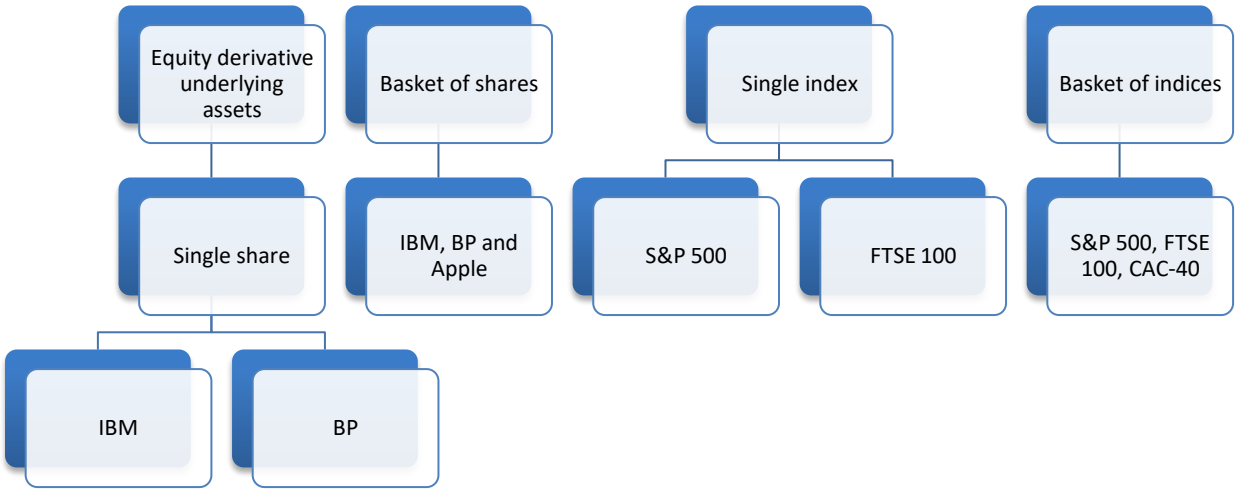

Figure 2.3: Possible underlying equity references[81]

Divergent views on the relevance of applying existing principles of interpretation to equity derivatives include the following:

1. No cash flows emanate from these instruments (such as dividends, interest or rental).
2. The often short duration of the intrinsic instruments undermines the concept of an asset that could qualify for a long-term intention associated with an investment intention.
3. The short-term contractual tenor implies that they are bought for sale and therefore utilised in a scheme of profit-making.
4. The cash settlement of these instruments results in no physical asset ownership and is therefore synonymous with either a speculative motive or a change of intention.
5. Leverage (economic amplification) is inherent in the instruments, which suggests a speculative motive.

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[81] E Parker *Equity Derivatives, Documenting and Understanding Equity Derivative Products* (2009) 21.

6. The ability exists to create a 'short position' or sale, thereby creating negative economic exposure to an asset not owned ('naked short'), which is not permitted in South Africa.

Concern therefore exists that any one or a combination of these might obscure any capital characterisation when used in an investment portfolio as a means to an end (see options below) or as an end in themselves (see synthetics below).

2.8.1 Equity options

The holder of an option acquires a 'right'. EB Broomberg and Des Kruger, commenting on the tax effect of option moneys, pointed out that such a right could be in the nature of capital or income. An option may be seen as a step towards acquiring an asset. If the asset is in the nature of capital in the hands of the taxpayer, the option is capital. If, however, it is trading stock, it is revenue:

> It is supposed to be a basic principle of tax law that any money received in respect of an asset, without that asset changing hands, is to be regarded as income … However, the rule may not be an infallible test for income. Thus, where a taxpayer granted a right to prospect over her farm, and also granted the prospector an option to purchase the mineral rights, and the taxpayer received certain sums in consideration for the grant of these rights, all the courts, after a careful analysis of the nature and effect of the contract, have held that there was one conjoint and indivisible consideration – and this consideration was not for the grant of a lease, nor of a usufruct, but in respect of a contract *sui generis.* The reasoning then went as follows: Any proceeds received for the sale of the land and mineral rights themselves would represent receipts of a capital nature in the hands of this particular taxpayer. The grant of an option is merely a step, possibly an essential step, in the process of realizing an asset such as mineral rights. Accordingly, payments received in respect of such an option will in such a case also be of a capital nature. This line of reasoning was expressly approved of by the Appellate Division in *SIR v Struben Minerals.* The door is still open for draftsmen to use this principle. It does follow, of course, that if the asset itself is trading stock in the hands of the taxpayer, then any option moneys received by the taxpayer in respect of that asset would represent income in his hands …'.[82]

2.8.2 Equity forwards and futures

An investor may wish to use forwards (unlisted) or futures (listed) rather than buying physical equity for many reasons. They are useful where a portfolio manager wishes to increase or

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[82] E Broomberg & D Kruger *Tax Strategy* 3 ed (1998) 24–5.

decrease financial exposure to an asset, and where there are liquidity, cash-flow, market or other reasons to defer the actual purchase of the stock. This would include the availability of tightly held stock, the efficiency of capital exposure by outlaying only a margin, and the costs associated with physical ownership. An investor may wish to gain general exposure to the market, but cannot physically construct such exposure quickly or might have insufficient capital to achieve that. An all share futures contract would achieve general exposure to the market. Despite these benefits, investors might be concerned about the risk that, notwithstanding an equivalent holding term of these derivatives, gains and losses might fall to be taxed as revenue on realisation.

2.9 MIXING AND MATCHING: FINANCIAL EQUIVALENCE

The legal analysis of a derivative product is not necessarily the same as its commercial or mathematical structure.[83] Warren demonstrated through simple mathematics how combinations of the basic derivative building blocks could be used to achieve economic equivalence.[84] If one appreciates that the ability to lock in a future price and delivery can be contractually achieved through a forward contract and that options provide a right but not an obligation to do the same, then the economic attributes of these two instruments can be combined to produce any variety of outcomes.

The theory of put/call parity expresses this relationship as follows:

$S + P_k = Z_k + C_k$

Where: S = value of the stock
Z = value of the riskless zero-coupon bond
C = value of the call
P = value of the put
k = a particular strike price or maturity value of bond

Assuming:
1) efficient markets for the stock, bonds and options;
2) stock pays no dividends and the bond is a zero-coupon bond;

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[83] Hudson (n 50) 5-02.
[84] See AC Warren Jr 'Commentary: Financial contract innovation and income tax policy' (1993) 107 *Harvard Law Review* 460–92.

3) there is no credit risk;
4) options are European-style options with identical exercise dates.[85]

The above equation is nothing other than an expression of equivalent risk and opportunity.

As Warren so aptly pointed out, this relationship intuitively makes sense.[86] An investor who holds both a share and a 'put' at a strike price of *k* (indicated by the subscript) will at the date of exercise have assets worth S but no less than k, because he will exercise the put if S is less than *k* (expressed as $S + P_k$). Likewise, an investor who holds a zero-coupon bond that will pay *k* upon maturity and a call option with a strike price of *k* is guaranteed the value of *k* as the zero provides the minimum he would receive and the call option would be exercised if its value exceeded *k*. Thus, if the call was written on the stock S, equivalence would be achieved. This relationship is possible because of instrument values that are derived in relationship to another asset.

It is therefore possible to construct a 'synthetic' share 'S' by expressing the equation as follows: $S = Z_k + C_k - P_k$

Or, for that matter, it is possible to express any other variable in terms of the others.

It must of course be borne in mind that the result is an economic equivalence and does not amount in legal terms to a share. It is a combination of instruments that provides the holder with the financial equivalent of holding the share and is made possible precisely because of derived values.

For example, using the concept of put–call parity, a firm can acquire equity interests in another firm through at least five different transactions: (1) directly purchasing shares; (2) engaging in an equity swap; (3) executing an equity-linked note; (4) purchasing a call, selling

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[85] Ibid.
[86] Ibid.

a put (or entering a forward contract); and (5) buying a prepaid forward on equity. All five of these roughly equivalent transactions achieve similar ownership objectives, yet all are subject to disparate tax treatments.[87]

It is relevant at this juncture to mention the taxation dilemma that this presents: an actual share is subject to taxation on a realisations basis in most jurisdictions and a zero coupon bond may be subject to taxation on a yield-to-maturity basis (S24J). In order to resolve this taxation dilemma, tax authorities would have to define the synthetic in the same manner as the real instrument (the share), which of course it is not, and neither is it in the interests of the authorities to do so, as the taxable nature of what is sought would be subject to manipulation so as to achieve the desired result. Alternatively, bonds and shares would have to be taxed in identical fashion, to remove the distinction between the taxation of interest-bearing versus equity instruments. This flies in the face of long-accepted practice, which distinguishes between loan and equity finance, the latter affording title and a different risk set.

The difficulty associated with the taxation of instruments therefore is that income tax has relied on distinctions that can be undermined by financial innovation. When discerning the character of income, the so-called 'objective' tests recognise the nature of income associated with bonds and equities, namely interest and dividends. Their tax treatment is a matter of fact and clearly established; no subjective assessment is involved.

Financial derivatives, which are utilised in portfolio management, defy easy definition precisely because of their ability to take on the economic nature of an established instrument such as a bond or equity, without in law actually qualifying as such an instrument. In a 2011

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[87] MP Donohoe *Financial Derivatives in Corporate Tax Avoidance* (PhD dissertation, University of Florida, 2011), describing the discontinuity of the US tax code. See A Nesvetailova 'Tax evasion and avoidance through financial engineering: The state of play in Europe' Coffers EU Horizon 2020 Project (2018) 32.

report to the US Joint Committee on Taxation, this attribute of derivatives was summarised as follows:

> These five basic instruments [equity, debt, options, forward contracts and swaps] can be combined in various ways to replicate the economic returns of any underlying asset … This ability to combine basic instruments and to create new instruments represents financial innovation that might lower the cost of capital … or might mitigate the risk of new projects … [it] also creates great difficulties in the taxation of financial instruments.[88]

Various methodologies have been suggested for dealing with these complexities, including: '(1) transactional analysis, which aggregates or disaggregates new transactions to conform them to existing legal categories, (2) taxation of changes in market value, rather than realization events, (3) taxation based on an assumed formula, and (4) anti-avoidance administrative approaches'.[89] This research adopts a legal perspective that touches on approach (1) above.

2.10 WHY USE DERIVATIVES IN AN INVESTMENT PORTFOLIO?

The general consensus in the literature is that a taxpayer might enter into a derivative contract for two reasons: to *earn income* or to *manage risk*.[90]

While income could be of either a capital or revenue nature, those taxpayers wishing to manage risk need to ensure that their well-meaning motives are not vulnerable to challenge, forcing them into a position of having, for example, hedging income categorised as revenue when it should be capital or *vice versa*. This is precisely what happened in *Federal National Mortgage Association v Commissioner*[91] in the USA, despite clear procedures by its Asset and Liability Committee, proper minutes, and public disclosure as to intent. With a mortgage book

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[88] Joint Committee on Taxation, Congress of the United States *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (2011) 5.
[89] See AC Warren Jr 'US income taxation of new financial products' (2004) 88 *Journal of Public Economics* 899.
[90] See Hudson (n 50) 2-20.
[91] *Federal National Mortgage Association v Commissioner* 100 TC 541 (1993).

of $95 billion, the enormity of the implications is clear. Other authors have categorised the nature of derivative transactions as falling within four broad groupings, namely *speculation*, *hedging*, *asset liability management* and *arbitrage*.[92] More pertinent to the investment industry, the distinction may be made according to three purposes: *speculation, investment* or *hedging*.[93]

2.10.1 Speculation

The common perception in the derivatives market is that derivatives are deployed for straightforward speculative purposes.[94] This is unsurprising, as the cost of entering a derivative contract for identical economic exposure is far less than purchasing or holding a physical equity. The large number of cases following *Hazell v Hammersmith & Fulham*[95] (200 writs issued) dealing with void swap contracts entered into by municipal authorities in the UK arose because local authorities had assumed commercial intentions to improve their debt exposure (interest rate swaps) while generating some additional income for the municipalities. Lord Templeman's view on the matter was that the authorities were engaging in 'no other interest than seeking to profit from interest rate fluctuations'.[96] Lynch cites a powerful example of how, in 2007, John Paulson earned over $3 billion in a single year and his hedge fund, Paulson & Co, earned $15 billion betting through a set of synthetic collateral debt obligations, referencing credit default swaps, which in turn referenced a set of sub-prime mortgages that the US housing market would falter.[97]

Speculation is probably the least contentious issue as it is accepted in tax law that transactions concluded in 'pursuance of a scheme of profit-making' will be revenue in nature.[98]

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[92] See Hudson (n 50) 2-11.
[93] S Hutton 'The taxation of derivatives in South Africa' (1998) 47 *The Taxpayer* 165.
[94] *Hazell v Hammersmith & Fulham* LBC (1991) 1 All ER 545 at 549, per Lord Templeman.
[95] Ibid.
[96] See generally Hudson (n 50) 2-12.
[97] TE Lynch 'Gambling by another name? The challenge of purely speculative derivatives' Indiana University Maurer School of Law Legal Studies Research Paper Series (2012) 3. See also TE Brincker *Taxation Principles of Interest and other Financing Transactions* Issue 4 (2011) W-6-2.
[98] See *Overseas Trust Corporation Ltd v CIR* 1926 AD 442, 2 SATC 71.

Establishing whether there is indeed a scheme of profit-making is often subject to the test of 'intention'. What is more pernicious in implied logic is that the instrument itself, because of its design, is speculative. Perceived intention due to majority use within markets and prominent financial failures can influence how courts frame derivative market function and use.[99] This struggle is evident in *Morgan Grenfell v Welwyn and Hatfield DC*,[100] where Hobhouse J asserted that interest rate swaps were 'at least potentially a speculative character deriving from the fact that the obligations of [the parties] are to be ascertained by reference to a fluctuating market rate which may be higher or lower than the fixed rate at any time.'[101]

2.10.2 Hedging

South Africa does not recognise hedging in the Income Tax Act. Even though hedging is not necessarily recognised in South African legislation, both the accounting and legal professions seem to appreciate the view that, of the categories of use, transactions concluded to ameliorate or offset risk should follow the income characteristics of the object of the hedge.

It is thought that a hedging transaction is most like an insurance contract. In determining the character of the income of the hedge, the South African courts are most likely to follow the kind of reasoning first formulated in the English case of *Burmah Steam Ship Co Ltd v IRC*,[102] enquiring as to whether the proceeds fill a hole in the taxpayer's profits (revenue) or income-producing structure (capital).

In *ITC 594*,[103] the President of the Court said:

> It seems to be clear from the decided cases both in the Special Court and on the English decisions that where an amount is received in substitution for an amount which might have been received had it not

[99] See Hudson (n 50) 33 where Hudson also alluded to the dangers of perception, as contended in this thesis.
[100] *Morgan Grenfell v Welwyn and Hatfield* DC (1995) 1 All ER 1.
[101] Ibid 7. See Hudson (n 50) 34.
[102] *Burmah Steam Ship Co Ltd v IRC* (1930) 16 TC 67 (Court of Sessions), 1931 SC 156, cited in Hutton (n 93) 166.
[103] 14 SATC 249.

> been for the intervention of the occurrence insured against, then the amount is coloured by, so to speak, or assumes the character of the accrual for which it is substituted.[104]

Brincker similarly supports the view that the hedge should derive its character from the underlying asset, provided that both were acquired with a capital motive.[105] Here, however, practical difficulties arise in the burden of proof required to show intent. When residual risk associated with a hedge produces profit, it is very difficult to convince SARS that intention to profit was not also present. This has been observed in practice, where it is very difficult, despite good record keeping, to defend a characterisation as capital, especially where there might be a string of hedging transactions over a few years in a portfolio that mostly produced net gains. In *ITC 340*, the taxpayer had a separate profit motive.

One should thus be careful to use the judgement in *ITC 340* to conclude that, as the forward exchange contracts were concluded to hedge the revenue cost of acquiring the taxpayer's trading stock, the proceeds from the contracts were of a revenue nature.[106] On the particular facts it was also found that the taxpayer had a separate purpose of making a profit.[107]

Premised on the 'floodgates' argument, it is unlikely that derivative contracts could be regarded in themselves as insurance contracts. There is no intention to provide straightforward insurance. Hutton stated as follows:

> [A] taxpayer would generally have to show a match in the nature, extent and duration of the two transactions as well as the likely effectiveness of the hedge … for instance, by showing a high degree of correlation between changes in the value of the hedge and opposite changes in the value of the underlying position.[108]

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[104] Ibid.
[105] See the discussion of the relevance of *ITC 340* (1935) and *ITC 1498* (1989) in J Maule *The Income Tax Nature of Derivatives Hedges* (2018) 63 and 64.
[106] Hutton (n 93) 168.
[107] See Brincker (n 97) W-7.
[108] Hutton (n 93) 169.

In *Kleinwort Benson v Birmingham CC*[109] the Court of Appeal held that the hedge against a swap exposure entered into by the plaintiff bank with a local authority had to be de-coupled from the swap. The plaintiff had argued for passing on a loss generated by the hedge. In the wake of the House of Lords decision in *Hazell v Hammersmith and Fulham LBC*[110] it was evident that the swap was void, and the plaintiff had an open exposure on the 'hedge'. The Court of Appeal held that the hedging agreement was not part of the main agreement and that, notwithstanding the fact that the bank had argued that it had further swap transactions tied to the hedge with other parties, the loss could not be passed on to the local authority.[111] Hudson contrasted this decision with an apparent willingness in *Scotland*[112] to recognise market practice that both parties would have hedged their transactions and that the loss associated with the cost of funding and closing-out a hedge should be taken into account.[113] In *Australia and New Zealand Banking Group v Societe Generale*,[114] the inclusion of the loss on the hedge was disregarded because the International Swaps and Derivatives Association (ISDA) master agreement stated recognition of loss on early termination was not related to the reason for loss realisation triggered by an official prohibition on payments in the Russian markets.[115]

Maule's observation that, based on existing case law, 'no definitive tax precedent exists for adopting a capital position in respect of a derivative hedge' and 'similarly, there is no precedent for what is required to be shown in order to discharge the burden of proof' seems correct.[116]

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[109] *Kleinwort Benson v Birmingham CC* [1996] 4 All ER 733.
[110] *Hazell v Hammersmith and Fulham LBC* [1992] 2 AC 1.
[111] See Hudson (n 50) 5-151, 153.
[112] *Bank of Scotland v Dunedin Property Investment Co Ltd (No 1)* 1998 SC 657.
[113] Hudson (n 50) 5-150.
[114] *Australia and New Zealand Banking Group v Societe Generale* [2000] 1 All ER (Comm) 682 CA.
[115] Hudson (n 50) 5-149.
[116] Maule (n 105) 64.

2.10.3 Derivatives as an instrument of risk mitigation at the macro and portfolio management level

There is growing official recognition of the role of derivatives in risk management. Were hedging done only through the use of physical assets, for example, bonds to manage interest rate risk, a major drawback would be encountered, given the shortage of available and liquid bonds with the correct maturities to match the moving pattern of cash flows, which would in turn result in a lot of trading. Derivatives therefore provide a more efficient and cost-effective means of implementing hedging, rather than trading in physical assets. Two general approaches are used: (1) duration matching, where the hedge matches the sensitivity of the assets and liabilities to interest rate movements; and (2) cash flow matching, where interest rates and sensitivity are matched for assets and liabilities.

In an equity context, a portfolio manager may hedge out downside from equity exposures viewed as overvalued, by executing what is referred to as a long–short strategy. A ‘long’ position is taken on equity investments across the general market. An index could be used. At the same time a ‘short’ position could be taken for single shares using a contract for difference or an index future. Both positions are taken with a long-term view, but the short derivative positions normally have a duration of less than 12 months for the sake of cost efficiency, and reset.

While there may be a conservative (eg risk mitigation or prudential) purpose at the time of implementation, the hedge, due to incorrect assumptions at the time of its design, may partially fail in its purpose due to market movements, thereby rendering the hedge itself a ‘risk-bearing’ instrument. This performance (or basis) risk is difficult if not impossible to eliminate, but may also be willingly entertained because of the cost of a more perfect hedge, the conceptual inaccuracy of designing a ‘macro’ hedge of a broad portfolio exposure.

It may be asked how a derivative can in effect reduce risk when the popular view is that a derivative is a risky instrument. Through the markets, however, these instruments enable the shifting of risk to those who are amenable to bearing it. Why is this so? Speculators are willing to assume risk in the hope of making exceptional profit. The derivatives market therefore allows risks to be shifted and apportioned. In this sense they function at the macro level as hedges, assuming that risk concentration is prudentially managed. The fact that a trader, bank or prime broker might irresponsibly assume too much risk does not imply that the derivative market by definition creates risk.[117] Efficient distribution of risks, by unbundling the risks and the gains or losses associated with those risks, provides a stabilisation of total profits in the world economy.[118]

A central hindrance to effective regulation preceding the financial crisis was surely the lack of consensus or absence of a common view on how the financial system functions or fails to function to achieve the equilibrium necessary for the effective distribution of risk. Those in favour of 'light touch' regulation held that it was self-correcting over time (market rationality). Gallegati *et al*[119] suggested that the interconnected world is both a safer and more dangerous place in which to live. The same system that disperses risk efficiently in normal markets transmits negative shocks in a way that can amplify its effect through the system. Conceived of as a system of financial nodes, risk can be transmitted in two ways:

1. It can be entirely or partially transferred from one node to its neighbours in its original quantity, reducing as it is diffused (risk sharing).
2. It can be multiplied in transmission to other nodes (contagion).

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[117] See United Nations *Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its seventh meeting* (1997) 76.
[118] Ibid.
[119] M Gallegati, B Greenwald, MT Richiardi & JE Stiglitz *The Asymmetric Effect of Diffusion Processes: Risk Sharing and Contagion* (2008).

In the former, under normal propagation, the mechanism results in a 'reversion to the mean'; in the latter, the mechanism results in a 'convergence to the bottom'. This is especially prevalent where all nodes are homogeneous and assets positively correlated; diversification simply provides a stronger conductor for transmission of the shock and co-movement in asset prices. In this context, contagion is an inevitable by-product of diversification. Battiston et al stated that the larger the number of connected neighbours, the smaller the risk of an individual collapse, but the higher the systemic risk:

> Risk sharing by itself would lead systemic risk to zero as the connectivity increases. Distress propagation and the bankruptcy cascade effect, together with trend reinforcement – i.e. the fact that individual financial fragility feeds back on itself – may amplify the effect of the initial shock and lead to a full-fledged systemic crises ….[120]

Where hedging is not recognised, asymmetric taxation of the hedge and its underlying asset may result, leading to distortions. This may simply be explained by decomposing the return of a transaction into a risk free component (R_u) and a risk adjusted component (Δ_u), so that total return (T_u) can be expressed as $R_u + \Delta_u = T_u$.[121] As will be explained in more detail below, a taxpayer wishing to hedge away risk needs to acquire a hedge that ideally could be represented as $-\Delta_h$. This would mean that the risk has been entirely offset and the return from the asset or portfolio is risk free, expressed $R_u + \Delta_u - \Delta_h = R_u$. The after-tax position may be somewhat different, however, if $\text{Return}_{\text{After Tax}} \neq R_u$ * [1-Effective Tax Rate], especially if $\text{Return}_{\text{After Tax}} < R_u$ * [1-Effective Tax Rate]. In this instance the hedge has lost the taxpayer money by being tax-ineffective.[122] Such tax asymmetries may result from various factors, such as split hedges, timing or character mismatches.[123] Facilitation of the productive use of

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[120] S Battiston, DD Gatti, M Gallegati, BCN Greenwald & JE Stiglitz 'Liaisons dangereuses: Increasing connectivity, risk sharing and systemic risk' (2012) 36(8) *Journal of Economic Dynamics and Control* 1121–41.
[121] See CT Plambeck, HD Rosenbloom & DM Ring *General Report* International Fiscal Association (1995) 675.
[122] Ibid.
[123] Ibid.

derivatives through legislation amounts to 'allowing gains or losses from derivatives held as hedges to be co-ordinated, both in character and in time, with income and loss from the transaction being hedged.'[124]

In *Robert Foss Kennedy v Dresdner Kleinwort Wasserstein*,[125] a practical up-to-date explanation was given of how exposure to risk is assumed for the sake of achieving gain through price inefficiency and yet is hedged to limit downside. This brief extract from the Honourable Justice Langley's rendition of what was explained in evidence provides an appropriate example of the fact that a hedge itself is not necessarily a benign instrument: 'Some trades might, in effect, hedge each other. The risk in the aggregate position would be hedged daily by spot trades … risk management itself provides an opportunity *for profit and a risk of loss*.'[126]

Hedging in a portfolio might therefore be imperfect for several reasons and may happen at portfolio level (macro) or instrument level (micro). Because of the imperfect nature of hedging strategies, which might in themselves be a result of limited instruments or price considerations, they may result in profits or losses. This adds complexity to discerning the character of the resulting income. Southern stated the following:

> The tax treatment of derivatives comes of age when it is established and accepted that the taxation of DFIs is not to be determined by reference to the tax treatment of the underlying instrument to which the derivative relates. Derivatives are to be treated as assets and liabilities in their own right with their own tax rules. This has the consequence that hedges will be de-recognised as hedges, in that they will be regarded as transactions in their own right, not as part of some larger transaction. This in turn entails that there is no inherent likelihood that hedges which work pre-tax will work post-tax.[127]

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[124] See United Nations *Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its seventh meeting* (1998) 75.
[125] *Robert Foss Kennedy v Dresdner Kleinwort Wasserstein* High Court of Justice, Queen's Bench Division, Commercial Court Case No 2002 Folio 1186.
[126] At [27]. Emphasis my own.
[127] D Southern 'The taxation of derivatives' (1998) 4 *British Tax Review* 348–63.

It is clear that characterising income based on the presence of a 'hedge' is fraught with practical difficulties. This leads one to the third motive, more readily accepted today than when Southern published his article 20 years ago.

2.10.4 Investing

As the market for derivatives has developed, it has become increasingly accepted that derivatives can facilitate efficient portfolio management[128] and can become integrated in the investment strategy.

> Long-term investment strategies might be put in place by organizing a range of options to acquire specific assets at a variety of prices so that the purchaser is able to acquire the underlying asset whenever its market value is greater than the price identified in the option ....[129]

'Investing' implies utilising the instruments themselves as 'fixed' capital assets.[130] When Brincker suggests that 'synthetics would be of a capital nature',[131] he is referring to derivatives constructed using the put–call parity theorem as described in section 2.8 above, where the economic equivalent of a share ($S = Z_k + C_k - P_k$) is held in the place of a share as it provides identical economic exposure.

The riskier the asset, the more difficult it becomes to hold the asset on a '*for keeps*' or '*for better or worse*' basis.[132] This tends to mitigate against an investment intention and makes the burden of proof for the taxpayer that much more onerous. For example, it is much easier to acquire a plot of land with a speculative motive, sell it a few years later, and justify it as an investment, than it is to purchase a much riskier asset such as a share, with an investment motive, be prudentially obliged to sell it because the fundamentals change, and then justify that

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[128] This is a colloquial term, even used by regulators, which lacks technical definition. It is intended to imply that derivatives are used to optimise a portfolio strategy, such as using futures to gain exposure to a share, while the physical share is being acquired in the market. This might be necessary as the shares do not trade often.
[129] Hudson (n 50) 2-17.
[130] As opposed to floating capital.
[131] Brincker (n 97) W-6-3.
[132] *CIR v Barnato Holdings Ltd* 1978 (2) SA 440 (A).

it was not speculation. This is a problem associated with the nature of the asset. Furthermore, the volatility of the market wherein the asset is acquired directly affects the basis on which the investment can be made. With derivative instruments, increased market volatility requires a far more vigilant and agile approach. But, to take the step in logic that this alone is evidence of 'a gain made by an operation of business'[133] is too great. In *CIR v Middelman*[134] the view was taken that a taxpayer following an active investment policy to maintain the yield on a portfolio of securities does not necessarily imply that there is trading in securities. In *CIR v Guardian Assurance Co SA Ltd,*[135] authority from *CIR v Richmond Estates*[136] was quoted, wherein reference was made to *LHC Corporation of SA (Pty) Ltd v CIR*,[137] that 'continuous monitoring … by LIBAM in the performance of its steward mandate … did not serve to convert what had been compiled as a capital base … into a pool of floating capital'. Furthermore, it is a well-established principle[138] that realisation of a capital asset does not constitute a change of intention; nor does realisation to best advantage render the proceeds of revenue income. The Chairman of the International Accounting Standards Board made the following insightful remarks on 9 April 2013:

> Finally, I would like to stress that even long-term investors cannot afford to ignore short-term fluctuations, if only because you never know how short the short-term will be …
>
> It is estimated that an airplane flying from London to New York will only spend 10% of the time pointing in the right direction. The direction of the plane is not determined by the pilot alone, but also by external factors such a wind, speed and direction.
>
> The pilot needs to make continuous short-term corrections in order to achieve the long-term goal – to arrive safely in New York. Business is no different. The renowned Swedish long-term investor, Boerje Ekholm, recently said that while his company always has a long-term objective, 'we'll be

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[133] In *Overseas Trust Corporation Ltd v CIR* 1926 AD 441 the Chief Justice stated the following at 453: 'Where an asset is realized at a profit as a mere change of investment there is no difference in character between the amount of enhancement and the balance of the proceeds. But where the profit is, in the words of an eminent Scottish judge, "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".'
[134] *CIR v Middelman* 1991 (1) SA 200 (C).
[135] *CIR v Guardian Assurance Co SA Ltd* 1991 (3) SA 1 (A).
[136] *CIR v Richmond Estates* 1956 (1) SA 602 (A).
[137] *LHC Corporation of SA (Pty) Ltd v CIR* 1950 (4) SA 640 (A).
[138] *CIR v Stott* 1928 AD 252, 3 SATC 253; *CIR v Paul* 1956 (3) SA 335 (A), 21 SATC 1.

> terriers in the short term on how you run the business'. He stressed that in reaching your long-term objective, you have to evaluate every day. If you do not adjust your business in time, the risk of a much larger correction further down the line grows exponentially.
>
> So, beware of people who tell you that they only care about the long term and who do not want to be bothered by market values.[139]

2.11 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION CONTRACTS

Standardisation of documentation for derivatives[140] is widely practised through the International Swaps and Derivatives Association (ISDA).[141] Most of these documents are based on the UK and US legal systems. Civil-code jurisdictions such as France and Germany have sought to develop their own contracts informed by their own commercial codes.[142]

The ISDA model contract is an attempt at standardisation to bring certainty and order to the markets for OTC derivatives traded 'off-market'. The 'Master Agreement' and all the Confirmations form a single agreement between the parties.[143] This allows a netting across transactions within the umbrella agreement. There are three tiers of derivatives documentation:

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[139] H Hoogervorst, at http://www.ifrs.org/-Alerts/Conference/Pages/HH-speech-April-2013.aspx (accessed 28 April 2013): 'Accounting and long term investment – "Buy and hold" should not mean "buy and hope"'.

[140] The standard documentation is designed to be used to document many different categories of OTC derivatives transactions such as interest rate swaps, currency swaps, credit default swaps, commodity swaps, equity swaps, caps, collars and floors, currency options, foreign exchange transactions and options of various types.

[141] ISDA is a not-for-profit corporation incorporated in the State of New York in 1985. It reportedly has over 820 member institutions.

[142] A Hudson 'Dealing with derivatives' 23 (undated). Available at http://www.alastairhudson.com/financelaw/derivativeslawcourse.pdf (accessed 28 April 2014).

[143] See *Lomas v JFB Firth Rixson Inc* (2010) EWHC 3372 [118] (Longmore LJ), where this is affirmed by the Appeal Court (Lord Justices Longmore, Patten and Tomlinson presiding):

> We also agree with Mr Kimmins and Mr Zacaroli that Flaux J's approach is inconsistent with the 'Single Agreement' provision in Section 1(c) of the Master Agreement. That provides:-
> '*Single Agreement*' All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this 'Agreement'), and the parties would not otherwise enter into any Transactions. The effect of Section 1(c) is that the parties are agreeing that the obligations contained in 'all Transactions … entered into' are not to be treated as separate and distinct, but are made subject to the contractual framework constituted by the Master Agreement, including when an Early Termination Date occurs.

the *confirmation* recording each individual transaction; the *master agreement* that sets out the general terms; and the *credit support* document that provides for collateral or guarantees.[144]

The ISDA Master Agreement has evolved through three editions in 1987, 1992 and 2002. The 2002 version closely resembles the 1992 version and they are often used interchangeably.[145] On 19 September 2018, ISDA published the ISDA Benchmarks Supplement, which allows adhering entities to amend the contractual triggers and fallbacks of OTC derivatives documentation that references interest rate, FX, equity and commodities benchmarks, under current ISDA definitions incorporated into transactions using ISDA derivatives documentation. This follows concerns associated with the exit of the UK from the EU:

> The contractual continuity issue arises because, after Brexit, UK and EU-27 regulated firms will no longer benefit from the single market passport which currently allows them to engage in regulated activities in the EU-27 and the UK respectively without the need for an additional local licence. This raises issues for certain longer-dated OTC derivative contracts, which were entered before Brexit, when the entity held the relevant passport, but where the contract continues beyond Brexit. In such cases, some so-called 'lifecycle events' that arise during the life of the contract may be regarded as constituting regulated activities in the jurisdiction where the client or counterparty is located, thus triggering the application of local licensing requirements if the firm retains those contracts after Brexit.[146]

The commercial convenience of combining all agreements under a master document for the purpose of economic consolidation does not necessarily hold in law, with insolvency and tax law being cases in point. Hudson noted that the House of Lords has permitted set-off where there are mutual debts owed, but not between multiple parties.[147] In tax law, the artificiality becomes problematic. For example, in *Inland Revenue Commissioners v Scottish Provident*

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[144] See Hudson (n 50) 6-01.
[145] Ibid 6-96.
[146] ISDA *Contractual Continuity in OTC Derivatives Challenges with Transfers* (2018) 4.
[147] See Hudson (n 50) 115.

Institution,[148] which is discussed later, the options and the collateral agreement were held to be separate.

In *Lomas*, Mr Justice Briggs described this contract as 'probably the most important standard market agreement used in the financial world'. Hudson estimated that the ISDA architecture is standard for 90 per cent of all OTC transactions.[149]

In the case of equity derivatives, the contract typically references a share. The 2011 ISDA Equity Derivatives Definitions defines a share with reference to a referring derivative contract:

> 2.5.4 'Share' means a financial instrument issued by a company that is in legal form a share, a stock or a unit in the equity capital of that company and, in relation to an ED Transaction and/or ED Leg, means:
>
> (i) any Share Specified as an ED Leg Reference Underlier;
>
> (ii) in relation to a Basket or Index that is an ED Leg Underlier, any Share that is a Basket Component of that Basket or an Index Component of that Index, as the case may be; and
>
> (iii) in relation to a Derivatives Contract, any Derivatives Contract Underlier that is a Share.

At this point, no branch or coherent body of law relating to derivatives exists. As Hudson put it, there is no law of derivatives, but rather the law on derivatives. 'However, there are concepts, cobbled together from other legal disciplines which form a complete set which could be called "the law affecting derivative products".'[150]

> So, the law of finance is created out of those central concepts of the substantive law: including contract law, property law, criminal law, tort law, equity and private international law which are relevant to derivative transactions but which operate across the entirety of our law beyond financial markets.[151]

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[148] *Inland Revenue Commissioners v Scottish Provident Institution* (2003) STC 1035. Also see Hudson (n 50) 116.

[149] Hudson (n 50) 106 and 150, based on Briggs J's acceptance of ISDA's estimate of usage in *Lomas v JFB Firth Rixson Inc* (2010) EWHC 3372 (ch); (2011) 2 BCLC 120. From a commercial perspective ISDA architecture has the following practical functions:

1. Frames all the documentation under one umbrella for the purposes of standardisation and netting;
2. Individual transactions are documented by a 'confirmation';
3. The Master Agreement can be altered via a 'schedule' and alterations or enhancements to credit terms are set out in 'credit support documents';
4. It specifies governing law, jurisdiction for remedy and termination etc.

[150] Hudson (n 50) 6-03.

[151] Ibid 1-48.

2.12 CONCLUSION

Chapter 2 alone could easily comprise a thesis. I have therefore attempted to simply introduce the essential building blocks from which all derivatives are constructed. If options and forward contracts can be combined in various ways to replicate the economic returns of any underlying asset, then the analysis must firstly assess the most basic building blocks of these financial instruments. To simplify further, only one asset class, equity, is considered in this research. A distinction is drawn between speculation, hedging and investing, all of which lack finite definition. Although hedging is an essential component of investing (protecting against downside risk), it is distinct from accepting a derivative as an asset in its own right. Furthermore, the key distinction between speculating and investing within the financial system is that, at a macro level, it is speculators who have the risk appetite to sit on the other side of trades when portfolio managers want to minimise risk. In this manner, risk is apportioned to wherever it can be accommodated. However, when a manager is tempted to assume speculative positions to increase returns, the portfolio management function moves into a sphere of operation that is out of character. There are therefore two sides to a transaction, which might be quite dissimilar in nature. This research is concerned with one defined leg of the transaction only.

On 14 September 2018, the Financial Sector Conduct Authority (FSCA) issued a warning to managers of collective investment schemes following a concern about excessive trading in portfolios:

> The Financial Sector Conduct Authority ('the Authority') would like to reiterate the principles which CIS Managers have to adhere to in the administration of a collective investment scheme and more specifically section 2(1) of the Collective Investment Schemes Control Act, No 45 of 2002, which stipulates that: 'A manager must administer a collective investment scheme honestly and fairly, with skill, care and diligence and in the interest of investors and the collective investment scheme industry.' … Any CIS Manager engaged in the above-mentioned … is hereby reminded that the Authority views

such practices as not being in the interests of investors and the industry and regards such a CIS Manager as not acting with due honesty.[152]

[152] FSCA *Possible Tax Avoidance Schemes in Collective Investment Schemes Industry* (2018).

CHAPTER 3

INTERNATIONAL ACCOUNTING TREATMENT

3.1 INTRODUCTION

As has been stated above, this thesis includes three approaches to tax policy on financial derivatives: (1) a common-law approach; (2) an accounting policy approach; and (3) a highly codified system, as used in the USA. This chapter is devoted to a basic outline of the accounting treatment of financial derivatives. Accounting cannot be divorced from the subject matter as our own Act now references IFRS in section 24JB for 'covered persons'. The policy reasons are not hard to find: In the 2012 Explanatory Memorandum to the Taxation Laws Amendment Bill, the National Treasury makes the following statement:

> In respect of financial instruments, the rules pertaining to income tax and financial accounting have completely diverged. This divergence has proven to be a challenge … From a SARS standpoint, the divergence between tax and accounting has become so great that accounting is often no longer a useful benchmark for assessing risk vis- à-vis the accuracy of taxable income.[1]

In resolving the above, the National Treasury has looked to accounting standards as a pragmatic basis for resolving some uncertainties and narrowing the gap between the two treatments. Section 24JB is a legislative innovation that circumvents dealing with income characterisation according to common-law principles by deeming a certain category of taxpayers (principally, banks)[2] as subject to ordinary treatment because it matches the business model. On the other hand, the section excludes 'all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income'[3] under IFRS 9 for certain financial assets such as a share, an

[1] National Treasury *Taxation Laws Amendment Bill Explanatory Memorandum* (2012) 57.
[2] Section 24JB(1).
[3] Section 24JB(2).

endowment policy, an interest in a collective investment scheme, a trust, a non-trading partnership, or a domestic or foreign dividend earned by a covered person. This category of 'amounts' that falls within the excluded perimeter of income defined by section 24JB is the subject of this research, using collective investment schemes as the proxy.

South Africa subscribes to the accounting standards as determined by the IFRS Foundation and its standard setting body, the IASB. IFRS 9, which became effective in January 2015 (replacing IAS 39 and 32), sets the standard for the recognition of financial instruments and is discussed below.

Box 4.1: Extract from the 2012 Taxation Laws Amendment Bill Explanatory Memorandum[4]

> In general, income tax systems impose tax on a realisation basis when calculating gain or loss in respect of asset values … However, in recent years, a growing trend exists toward notional realisation in respect of liquid financial instruments (e.g. listed and over-the-counter shares, bonds and derivatives) … Legislation exists that provides for mark-to-market taxation in respect of certain financial instruments (e.g. debt, interest-rate swaps and certain options); otherwise, the overall income tax system remains on a realisation basis.
>
> In respect of financial instruments, the rules pertaining to income tax and financial accounting have completely diverged. This divergence has proven to be a challenge for both taxpayers and SARS alike. From a taxpayer compliance standpoint, the resultant divergence has proven costly in terms of systems for financial institutions. The sheer volume of financial transactions for large financial institutions requires expensive systems that require constant adjustment. Tax deviations are often then accounted for manually, thereby being prone to inaccuracies. From a SARS standpoint, the divergence between tax and accounting has become so great that accounting is often no longer a useful benchmark for assessing risk vis-à-vis the accuracy of taxable income.
>
> Admittedly, current law contains a specific rule that allows taxpayers to utilise annual mark-to-market fair value methodology. However, this election in favour of annual fair value methodology is incomplete because this election only caters for specific instruments (e.g. debt), thereby leaving equity and other instruments under the realisation principle.

[4] National Treasury *Taxation Laws Amendment Bill Explanatory Memorandum* (2012) 56–8.

3.2 GENERAL ACCOUNTING TREATMENT OF DERIVATIVES

Prior to IAS 39, derivatives were often not recognised in financial statements, as they required little or no initial investment. IAS 39 (effective 2001) and IAS 32 (effective 2005) have since been the accounting standards applicable to financial instruments. The instruments are divided into four main categories:

a) fair value through profit and loss, which has two sub-categories:
    i) held for trading (derivatives are always categorised as held for trading unless accounted for as hedges); and
    ii) voluntary designation;
b) held to maturity assets;
c) loans and receivables;
d) available-for-sale assets.

IFRS 9 replaces IAS 39 and IAS 32, with effect from 2015. IFRS 9 was developed to simplify the treatment of financial instruments and move towards a more principles-based approach. IFRS 9 requires income from financial instruments to be recognised based on the business model in use by the accounting entity and the nature of the cash flows. The distinction made is between assets held to collect a contractual income stream (debt) and those held to collect fair value proceeds that are realised to produce an income stream.

Paragraph 4.2(a) of IFRS 9 states:

> A financial asset shall be measured at amortised cost if both of the following conditions are met:
>
> (a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
>
> (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

The exception to the above is the use of a hedge or an equity instrument held as an investment. Paragraph 5.4.4 specifically requires the accounting entity to make an (irrevocable) election concerning the nature of the asset at initial recognition.

Paragraph 4.4.1 provides that:

> A gain or loss on a financial asset that is measured at fair value and is *not part of a hedging relationship* (see paragraphs 89–102 of IAS 39) shall be recognised in profit or loss *unless* the financial asset is an *investment in an equity instrument* and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.4.4.

Paragraph 5.4.4 states that '[a]t initial recognition, an entity may make an *irrevocable election* to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this IFRS that *is not held for trading*.'[5]

It is noteworthy that IFRS 9 (which retains this definition from IAS 39) defines 'held for trading' as a financial asset or financial liability that:

> (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
> (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
> (c) *is a derivative* (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).[6]

Therefore, derivatives as an instrument class are always regarded as being associated with a trading motive, other than when used as a hedge. This precludes derivatives from being considered for categorisation under paragraph 4.1 relative to the 'business model' of the entity. The 'business model' concept has as its objective whether instruments are held to maturity to collect their income stream (contractual interest or dividends), rather than realisations from fair value. However, this is not determined on an instrument-by-instrument basis, but at a portfolio level. It is acknowledged that not all instruments might comply with an investment mandate

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[5] Emphasis my own.
[6] See IFRS 9, Appendix A. Emphasis my own.

through to maturity, for example, due to a credit deterioration and re-rating. However, if the number of sales is more than infrequent, then the investment fund should assess whether such sales are consistent with the business model objective. The standard provides no bright-line measure of an acceptable frequency. The application guidance in Appendix B of the standard explains the principles as follows:

1. The business model is a matter of fact, identified by the way the business is managed and performance evaluated (e.g. if fair value is used in determining fees, it speaks to an ordinary revenue motive).[7]
2. This determination is not driven by a single factor, but includes:
    a. How performance is reported;
    b. How managers are compensated; and
    c. The frequency, timing and volume of sales planned and made historically.[8]

This logic, however, is not extended to derivatives, implying that these instruments cannot be recognised as investment assets in their own right within a portfolio. This places great emphasis on the definition of 'hedging', as it is the only means by which derivative use would not be recognised through profit and loss.

IFRS 9 defines a derivative as:

> A financial instrument or other contract within the scope of this IFRS (see paragraph 2.1) with all three of the following characteristics:
>
> (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
>
> (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
>
> (c) It is settled at a future date.[9]

[7] Paragraph B4.1.2A.
[8] Paragraph B4.1.3.
[9] This is the same definition that is used in the South African Income Tax Act.

Leverage is regarded as indicative of non-standard cash flow characteristics by paragraph 4.1.9. The guidance note states: 'More than insignificant leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest'.[10] Here, economic characteristics are used as the determinant.

3.3 HEDGE ACCOUNTING

3.3.1 Instrument-based hedging

The 'Basis for Conclusions' published under IFRS 9 for Hedge Accounting[11] states:

> The implementation guidance accompanying IAS 39 provided the rationale for not permitting derivatives to be designated hedged items. It stated that *derivative instruments were always deemed to be held for trading* and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.[12]

However, the 'Basis for Conclusions' goes on to state that 'this rationale is difficult to justify' as some purchased options have been allowed under hedging rules to qualify as items that may be the object of a hedge.

Notwithstanding this revision, however, the general hedge accounting regime under IFRS 9 is prescriptive. The qualifying criteria in paragraph 6.4 of IFRS 9 provide the following:

1. The hedging relationship must consist of both eligible hedging instruments and eligible hedged items.
2. There must be a formal designation and documentation of the hedging relationship, which includes the entity's risk management objective and strategy for undertaking the hedge.
3. There must be compliance with the following hedge effectiveness requirements:
    a. There is an economic relationship between the hedged item and the hedging instrument;
    b. The effect of credit risk does not dominate the value changes that result from that relationship;
    c. Quantitative restrictions on the hedge ratio, so that the actual hedged item and its hedging instrument bear quantitative resemblance to the ratio and that no imbalances exist which subvert the desired accounting outcome.

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[10] Examples given include stand-alone options, forwards and swap contracts.
[11] IFRS Foundation 'IFRS 9, Chapter 6: Hedge Accounting' 18.
[12] Emphasis my own.

The standard recognises three types of hedging relationships:

1. fair value hedges – a hedge of the exposure to changes in fair value (market movement);
2. cash flow hedges – a hedge against variability in cash flows;
3. hedge of a net investment in a foreign operation (defined in IAS 21).

It seems that these categories and their boundaries in IFRS 9 are accounting attempts to keep the representation of intent (the risk management objective) aligned with economic execution, due to the ease with which derivative positions may be stated as hedges that are imperfect, but actually represent attempts at profit- or loss-making.

In summary, it can be said that IFRS 9 distinguishes derivatives by the nature of the asset, unless it is used for hedging (purpose).

3.3.2 Dynamic hedging

The inability of the IAS 39 standard to frame a portfolio approach to dynamic hedging or risk management through simple modification within IFRS 9 resulted in the standard being issued, with this section to be published at a later date.[13] In April 2014, the IASB and IFRS issued a discussion paper, stating the following:

> Risk management is complex and developing an accounting approach to reflect the underlying economics of such activities that is operationally feasible and that provides information that is useful to users of financial statements has been challenging. The IASB originally sought to better reflect risk

[13] IFRS Foundation (n 11) 6–7: 'The IASB began its deliberations on the Accounting for Macro Hedging project in September 2010. The drivers for initiating the project were the difficulties associated with applying existing hedge accounting requirements to a dynamically managed portfolio with continuous or frequent changes in the risk positions that are being hedged.1 In effect, open portfolios are forced into closed portfolios for hedge accounting purposes. These constraints make it difficult to reflect dynamic risk management in financial statements. In addition, the existing portfolio hedge accounting requirements in IAS 39 Financial Instruments: Recognition and Measurement are limited to interest rate risk only. For these reasons, the IASB decided to consider a new accounting model for dynamic risk management … In May 2012 the IASB tentatively decided to develop a DP as the initial due process step. The IASB noted that the development of an accounting model for dynamic risk management was not a modification to hedge accounting requirements but that it would instead be a fundamental change in how risk management is considered for the purposes of financial reporting. Given the complexities involved, the DP allows the IASB to seek feedback on a broader range of alternatives and variations. The IASB also realised that the development of a new accounting model for dynamic risk management would take time. This conflicted with the timeline for IFRS 9 Financial Instruments. Consequently, in May 2012 the IASB separated the two projects, allowing it to finalise IFRS 9 while progressing with the accounting for dynamic risk management as a separate project.'

> management in the accounting by amending IAS 39 Financial Instrument: Recognition and Measurement to incorporate fair value hedge accounting for a portfolio hedge of interest rate risk. However, the scope of that amendment was limited to interest rate risk and banks have found those particular hedge accounting requirements difficult to apply in practice. This is because banks' risk management of interest rate risk is usually performed dynamically, and is based on open portfolios to accommodate the constant changes in risk exposures faced by the bank.[14]

The paper comprises 115 pages and is almost exclusively focused on interest rate risk as understood within a banking enterprise. Even though the paper admits this and the public consultation process seeks application to other industries, the quick resolution of something as broad and complex as a general accounting standard will take time. The reasons given for the review of hedge accounting are relevant to the analysis for this study, rather than the discussion paper's proposed valuation solution. This is especially relevant when reviewing the UK and Australia, where accounting standards have been used as an approach to rewriting tax statutes. Some of the inadequacy or artificiality of the IAS 39 fair value approach is the following:

- Hedge accounting uses an instrument approach, whereas in practice risk management is conducted on a portfolio basis on net open risk positions, rather than gross exposures.
- The need for such one-to-one designation between the hedged item and the hedging instrument in effect forces an open portfolio scenario into a series of closed portfolios with an artificial short life.
- The accounting standards designate what are considered eligible hedged items, rather than business reality.
- Recognition and measurement approaches are designed for the hedging of static exposures, which does not reflect practice. In other words, the static model of

[14] IASB and IFRS Foundation *Discussion Paper DP/2014/1: Accounting for Dynamic Risk Management: A Portfolio Re-evaluation Approach to Macro Hedging* (2014) 5.

> hedging would be relevant if no new exposures were added or cancelled or removed.[15]

3.4 SUMMARY

Box 4.1 above expresses the National Treasury's concern with the divergence between accounting and taxation.

> In respect of financial instruments, the rules pertaining to income tax and financial accounting have completely diverged. This divergence has proven to be a challenge for both taxpayers and SARS alike … From a SARS standpoint, the divergence between tax and accounting has become so great that accounting is often no longer a useful benchmark for assessing risk vis-à-vis the accuracy of taxable income.[16]

Income classification does not have the same significance in accounting that it has in taxation. Accounting focuses particularly on the final result of an enterprise and does not pay the same attention to the nature of income. Accounting does not focus much on individuals, whereas tax laws cannot avoid them. Mark-to-market methodologies may work for a bank, but do not work well for individuals due to the liquidity constraints of individuals. Section 24JB is a helpful route towards certainty if its assumptions hold for excluded taxpayers in section 24JB(1)*(d)* and financial assets in section 24JB(2)*(a)*. However, within these categories of excluded taxpayer entities and financial assets, uncertainty still prevails.

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[15] Ibid 10–13.
[16] National Treasury *Taxation Laws Amendment Bill Explanatory Memorandum* (2012) 56–8.

CHAPTER 4

SOUTH AFRICA: REGULATION AND CASE LAW

4.1 INTRODUCTION

> Modern day financial transactions are changing rapidly and are becoming increasingly sophisticated and complex as new financial arrangements are developed … On the other hand the general principles of our present tax law were developed prior to the introduction of many of these instruments and it is therefore becoming increasingly difficult to deal with the tax consequences of a number of these financial instruments under our current tax laws.[1]

The Tax Advisory Committee's 1994 report considered the need for a means to include derivative instruments in tax legislation, but ultimately deferred the matter, pending further research.[2] A comprehensive framework for financial arrangements, as was proposed, has not as yet been developed for South Africa.[3] The committee largely supported Australian policy concepts, but proposed the following on the subject of income character for financial arrangements: 'Australia proposes that all gains and losses will be on revenue account, whereas the Committee is in favour of applying normal tax principles.'[4]

This research confirms this approach many years later. An examination of US, UK and Australia tax policy for this thesis revealed that the USA has largely been dissatisfied with its complex rule-based system and is striving to move towards a mark-to-market system for all gains and losses. Australia and the UK have opted to follow an accounting approach and have since been trying to refine legislation to this effect. In 2012, the SA Taxation Laws Amendment Act introduced section 24JB, applicable to JSE-licensed stockbrokers and banks, which also

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[1] Tax Advisory Committee (SA) *Consultative Document on the Tax Treatment of Financial Arrangements* (1994) 1.
[2] Relayed to me by the late Dr De Villiers Graaff, who was a member of the committee. He suggested that the USA, the UK and Australia should be researched for guidelines.
[3] Tax Advisory Committee (SA) (n 1) 2.
[4] Ibid.

follows accounting standards, with the definitions of ‘derivative’, ‘financial instrument’, ‘financial assets’ and ‘financial liabilities’ being referenced in the statute to IFRS 9.

Section 24JB(2) specifically excludes shares not held for trading, an endowment policy, and an interest in a collective investment scheme. No specific provision exists for determining the tax character of financial derivative instruments within regulated investment portfolios, in keeping with the Act’s silence on characterisation in general. Beyond the remit of section 24JB, the situation is therefore largely unchanged since the Tax Advisory Committee made its remarks in 1994.

This uncertainty is particularly relevant to investment portfolios (collective investment schemes and insurance portfolios), even when professionally regulated and managed.

Despite the fact that portfolios are regulated by the Financial Sector Conduct Authority and have approved investment mandates with limited investment powers under statute and regulation, the Commissioner can determine that a transaction within that portfolio during a year of assessment has in fact not been one of investment, but one of profit-making. However, the onus of proving that an amount is capital or revenue rests on the taxpayer under section 102 of the Tax Administration Act. For example, even though section 24JB specifically excludes derivative transactions in collective investment schemes in terms of its deeming provision, this does not imply that there is any certainty associated with this class of instrument. As was stated at the beginning of this thesis, the concern here is not with any specific type of portfolio such as collective investment schemes or life portfolios, and the point is simply made to illustrate that uncertainty continues to prevail. There is no comprehensive legislative framework for character determination, a lack of clarity within existing case law, and many strong, but not necessarily substantiated, views among the authorities. The SARS *Tax Guide for Share*

Owners[5] does not provide clarity either. This is not the fault of any particular party, but simply a reflection of the difficulties associated with resolving fundamental points of principle with respect to these instruments, as evidenced in the varied approaches of other jurisdictions. This research therefore attempts to clarify a single point, based on existing case law on income character determination, which will hopefully strengthen certainty. What follows assumes that the reader has knowledge of the extensive case law on character determination in SA and does not attempt to re-examine this case law as part of the thesis.

4.2 REGULATORY FRAMEWORK APPLICABLE TO THE SAVINGS INDUSTRY

The South African savings and investments industry manages three pools of savings:[6]

1. collective investment schemes (R2,448 billion);
2. retirement funds (R3,607 billion); and
3. life insurance portfolios (R1,922 billion)

In addition to the above, the asset management industry also manages small pools of assets on behalf of short-term insurers and medical schemes.

In South Africa, policy pertaining to the third-party investment of public money is set by the National Treasury. The regulations that frame that policy and the enforcement thereof are the functions of the Financial Sector Conduct Authority (the FSCA, previously the Financial Services Board (FSB)) and the Prudential Authority (PA), under the auspices of the South African Reserve Bank (SARB).

Following the financial crisis of 2008, the government published a policy reform paper in 2011, entitled *A Safer Financial Sector to Serve South Africa Better*. In February 2013, a

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[5] SARS *Tax Guide for Share Owners* Issue 7 (2020).
[6] These figures are drawn from the most recently available data in the SARB QB (December 2019), ASISA statistics (June and September 2019) and FSCA (2018) reports.

detailed follow-up document was published, entitled *Implementing a Twin Peaks Model of Financial Regulation in South Africa.*[7] In December 2013, the Financial Sector Regulation Bill was published to give effect to Twin Peaks.[8] The Financial Sector Regulation Act came into effect on 1 April 2018. On 11 December 2018, the FSCA published the draft Conduct of Financial Institutions (COFI) Bill, which deals with the conduct of financial institutions and the treatment of customers. A second draft is awaited. Figure 4.1 provides a useful overview of how the financial services industry is categorised by legislative instrument and regulating authority.

	Deposit Taking (BANKS)	**LT & ST Insurance** (INSURANCE FIRMS)	**Financial services/ Advisory**	**Retirement savings** (PENSION FUNDS)	**Credit Ratings Agencies** (CRAs)	**Pooled investments** (CIS)	**FMIs**	**Medical Schemes**
Sectoral law	Banks Act	Long-term / Short Term Insurance Acts	Financial Advisory and Intermediary Services Act	Pension Funds Act	Credit Rating Services Act	Collective Investment Schemes Control Act	Financial Markets Act	Medical Schemes Act
Designated Licensing Authority	**PA**	**PA**	**FSCA**	**FSCA** (subject to s.231)	**FSCA**	**FSCA** (subject to s.231)	**FSCA**	**CMS** (subject to s.231)
Setting and supervision of standards	***PA and FSCA, for respective standards***							
Enforcement of sectoral law	***Primarily Designated Financial Sector Regulator***							

Figure 4.1: Overview of the FSR Bill regulatory framework[9]

[7] See National Treasury *Response and Explanatory Document Accompanying the Second Draft of the Financial Sector Regulation Bill* (2014) 8. 'Many countries have chosen a Twin Peaks approach, including Australia, Belgium, the Netherlands, New Zealand and the United Kingdom. However, each has implemented their own unique version of the model. For example, the UK's Prudential Regulatory Authority operates as a subsidiary of the Bank of England and is responsible only for the prudential regulation of systemic institutions like banks, insurers and some asset managers, while the Financial Conduct Authority is responsible for market conduct supervision, both credit and all other financial institutions, and some prudential supervision. The Australian Prudential Regulatory Authority is completely separate from the Reserve Bank of Australia. In Belgium and the Netherlands, account has to be taken of the role of the European Union and the European Central Bank, hence the domestic central bank is responsible for prudential oversight, but not for monetary policy.'

[8] See, generally, National Treasury (n 7).

[9] National Treasury 'Stakeholder consultation workshop: Second draft of the Financial Sector Regulation Bill Jan–Feb 2015', slide 14. 'PA' refers to 'Prudential Authority'; 'FSCA' refers to 'Financial Sector Conduct Authority'; and 'CMS' refers to 'Council for Medical Schemes'.

4.3 REGULATED SAVINGS VEHICLES

4.3.1 Retirement funds

Retirement funds are not subject to tax in the fund and are therefore not affected by income characterisation. This also applies to the use of financial derivative instruments. Section 36(1) of the Pension Funds Act of 1956, as effected by regulation 28, empowers the Minister of Finance to stipulate prudential limits for retirement funds. This includes investment in regulation 28-compliant collective investment schemes.

4.3.2 Long-term insurance

The long-term insurance industry is regulated by the Long-term Insurance Act 52 of 1998 (LTIA). The LTIA came into effect on 1 July 2018, with a two-year transitional period.

The insurance business model is by its nature pre-funded by premiums and has long-term liabilities that need to be matched (or hedged) on the balance sheet. Section 34 of the LTIA prohibits speculative or geared positions. Regulation therefore imposes strict prudential requirements on insurers to ensure that these corporations can honour promises made to policy holders. Instruments such as derivatives may be used only for mitigating risk or efficient portfolio management.[10] What this encompasses under the new solvency requirements developed by the FSCA has been extensively examined in the calculation of the Solvency Capital Requirement (SCR),[11] as derivative exposure may be allowed only in respect of assets in excess of the assets required to meet the short- or long-term insurer's liabilities under their respective policies.

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[10] Section 34(2) of the LTIA.
[11] FSCA 'Solvency Assessment and Management: Pillar 1' – Sub Committee, Capital Requirements Task Group Discussion Document 75 (v3), Treatment of risk-mitigation techniques in the SCR.

4.3.3 Collective investment schemes

Collective investment schemes are regulated by the Collective Investment Schemes Control Act 45 of 2002 (CISCA). Section 46 of CISCA empowers the registrar to determine investment powers for these portfolios:

> (1) The registrar may, after consultation with the advisory committee, determine the manner in which and the limits and conditions subject to which securities or classes of securities may be included in a portfolio of a collective investment scheme in securities.
> (2) The registrar may, after consultation with the advisory committee, determine different manners, limits and conditions for different securities or classes of securities or different portfolios of a collective investment scheme in securities.

The FSCA Board Notices 90 and 52 specify in detail the investment powers of CIS portfolios. These include qualifying securities and instruments, conditions and limits of inclusion.

4.4 APPROACH OF THE SOUTH AFRICAN COURTS TO INCOME CHARACTER DETERMINATION

Unfortunately, our courts provide little specific guidance on the characterisation of derivative transactions. The SARS *Tax Guide for Share Owners*[12] cites one domestic case, *ITC 1756*[13] and an English decision, dated 1969, in *Wisdom v Chamberlain (Inspector of Taxes)*[14] to support a view that '[t]he proceeds are more likely to be of a revenue nature when the type of share purchased does not produce dividends'.[15] The former case resulted in the court not considering the character of a futures contract once it had established that the transaction fell outside of the tax year under consideration. The latter case considered a commodity transaction

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[12] SARS *Tax Guide for Share Owners* Issue 7 (2020).
[13] *ITC 1756* (1997) 65 SATC 375 (C). Other cases such as *ITC 43* (1925) 2 SATC 115 involving grain futures, *ITC 340* (1935) involving a forward exchange contract, and *ITC 1498* (1989) also involving a foreign exchange contract are not relevant to the equity derivatives being considered here. However, *ITC 1498* supports the concept of hedging with a derivative on capital account.
[14] *Wisdom v Chamberlain (Inspector of Taxes)* (1969) 1 All ER 332 (CA).
[15] SARS (n 12) 6.

in silver. The SARS *Guide* states: '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)*.'[16]

Futures contracts, which can be used to acquire an economic exposure to an asset when the physical asset is not readily available, could be of an equity nature. The *Guide*, however, declares all futures contracts as likely to be on revenue account as they do not produce an income, namely dividends. The purpose, such as hedging, is of no effect.

Our courts have confirmed that, while not universally valid, the test consistently applied when determining income character is whether a scheme is one of profit-making. Smalberger JA confirmed in *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust*[17] that '[t]he appropriate test in a matter such as the present is a well-established one. The receipts accruing … will be revenue if they constitute a "gain made by an operation of business in carrying out a scheme for profit-making."' As Van der Merwe AJA (as he then was) explained more recently,[18] '[t]hat expression refers to the use of the taxpayer's resources and skills to generate profits, usually, but not always, of an ongoing nature.'[19]

CIR v Pick 'n Pay concerned a share purchase trust established in 1977 by Pick 'n Pay Stores Ltd for the benefit of its employees. The scheme was administered by the financial director of the Pick 'n Pay group and overseen by a board of trustees. For the years of assessment 1982 to 1984, the trust made the following profits and losses:[20]

1982 R28,006

1983 R31,699

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[16] Ibid.
[17] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) 54, SATC 271; TS Emslie & DM Davis *Income Tax: Cases and Materials* (2011) 306.
[18] *Commissioner for the South African Revenue Service v Capstone 556 (Pty) Ltd* (20844/2015) [2016] ZASCA 2 at 24.
[19] Ibid 26.
[20] *CIR v Pick 'n Pay Employee Share Purchase Trust* (n 17) 56.

1984 R39,782

1985 (R70,619)

The Commissioner appealed against a decision of the Cape Income Tax Special Court that the above amounts were of a capital nature. On appeal, the court held that the amounts were capital in nature.[21] Given the dissenting opinion of Nicholas AJA that the amounts constituted floating capital, Smalberger JA (with Goldstone JA and Howie AJA concurring) stated that the transactions in shares should be viewed no differently from transactions 'in respect of any other property': 'Transactions involving shares do not differ from transactions in respect of any other property and the capital or revenue nature of a receipt is determined in the same way whether one is dealing with land or shares.'[22]

As the facts of the case were not in dispute, the determination, given the above statement, had to be inferred from the facts. While acknowledging the 'variety of tests' enunciated by our courts, Smalberger referred to them as 'guidelines only' and not of 'invariable application'.[23] The appropriate test in these circumstances is whether the receipts constitute 'a gain made by an operation of business in carrying out a scheme for profit-making'.[24] The facts of the case and 'sound commercial and good sense'[25] pointed to character of a capital nature for the following reasons:[26]

1. A distinction is drawn between the conducting of a business that involves a series or pattern of transactions and a scheme that may more appropriately refer to a single transaction.
2. However, how the receipts that flow from that business are characterised depends on the objectives and dominant purpose of the business. In this case, the trust operated as a conduit

[21] Ibid.
[22] Ibid.
[23] Ibid.
[24] Ibid.
[25] Quoting Friedman J in *ITC 1450* 51 SATC 70 at 76.
[26] *CIR v Pick 'n Pay Employee Share Purchase Trust* (n 17) 56.

for employees to acquire shares under the rules of the scheme. 'There was no intention on the part of the trust to conduct a business in shares'[27] as a dealer in shares would do, by buying and selling to make a profit. The trust, by contrast, was executed according to the obligations and constraints placed upon the trustees. This did not include the making of profits from shares bought and sold in meeting those obligations. From a commercial viewpoint, this had no comparable likeness to a dealer in shares.

3. Profits or losses from transacting in the shares were therefore purely an incidental by-product of the main business of the trust and 'contemplation [of profit] is not to be confused with intention'.[28] 'The sole purpose of acquiring, holding and selling the shares was to place them in the hands of eligible employees'.[29]
4. Furthermore, 'the manner in which the Trust held and dealt with the shares makes that conclusion [that they were floating capital] untenable'.[30] 'Where no trade is conducted there cannot be floating capital'.[31]

In *CIR v Stott*,[32] Wessels JA stated that '[t]o convert what was an ordinary investment into a profit-making business, there had to be proof of some special acts which show that the taxpayer had embarked on a scheme of profit-making.'[33] What that proof comprises may include any number of circumstantial facts. In *John Bell & Co (Pty) Ltd v Secretary for Inland Revenue*,[34] Wessels JA referred to '[s]omething more [being] required in order to

[27] Ibid.
[28] Ibid.
[29] Ibid.
[30] Ibid.
[31] Ibid.
[32] *CIR v Stott* 1928 AD 252, 3 SATC 253.
[33] Ibid 264; Emslie & Davis (n 17) 190.
[34] *John Bell & Co (Pty) Ltd v Secretary for Inland Revenue* 1976 (4) SA 415 (A), 38 SATC 87.

metamorphose the character of the asset and so render its proceeds gross income.'[35] A mere change of intention to dispose of an asset held as capital was not enough.

In *CIR v Nussbaum*,[36] 'frequency' was seen as indicative of a scheme of profit-making. Nussbaum was a teacher by profession and had inherited a share portfolio in 1946. He had managed it himself over the years, adding to it as he had surplus funds. At the end of the 1984 tax year, he held shares in 150 companies. He had in the previous three tax years concluded 47, 75 and 61 sales and 120, 159 and 118 purchases of shares, which is almost one transaction every business day.[37] The Commissioner sought to tax the proceeds on the basis that he was employing his shares as stock-in-trade. The taxpayer's appeal to a full bench of the Cape Provincial Division succeeded, with the court accepting his contention that his efforts were directed at maximising dividend income and that the manner in which he had done so did not detract from the fact that he was an investor and not engaging in speculation. The Appellate Division, however, found in favour of the Commissioner. Howie JA held as follows:[38]

1. Although not conclusive, the scale and frequency of the taxpayer's share transactions were of major importance.
2. By keeping a constant watch over his portfolio and 'farming' it assiduously, the taxpayer had manifested a secondary purpose of dealing in shares for a profit, notwithstanding that his primary purpose had been to maximise dividend income.
3. Looking beyond his *ipse dixit* to all the facts of the case, the taxpayer's profit-making activities could not be regarded as being merely incidental to his investment activities.
4. The taxpayer had not discharged the onus of showing that he was not engaged in a scheme of profit-making as a secondary activity.
5. The profits made during the years in question were therefore taxable.
6. The appeal was allowed with costs.[39]

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[35] Ibid 429. Wessels JA provided an example of the taxpayer already trading in similar assets or then and there starting a business or a scheme of profit-making.
[36] *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283; Emslie & Davis (n 17) 213.
[37] Emslie & Davis (n 17) 213.
[38] Ibid.
[39] Ibid 212.

In *CIR v Richmond Estates (Pty) Ltd*,[40] Centlivres CJ stated, quoting the sixth edition of *Gunns Commonwealth Income Tax*,[41] 'it is as difficult to make the change [from revenue to capital] for taxation purposes as it is for a rope to pass through the eye of a needle'. In *ITC 1547*[42] this in fact happened after land that was held as trading stock by the taxpayer was expropriated. The taxpayer contended for a change in original intention, but failed to discharge the onus of proof to the satisfaction of the court. With regard to *SIR v Rile Investments (Pty) Ltd*,[43] Clegg stated as follows:

> *Rile* establishes that it is possible for a taxpayer to change its intention in relation to a particular asset not once but twice (or more) … Another interesting facet of *Rile*'s judgment is that it casts further light on the 'something more' necessary to metamorphose the nature of an asset held by the taxpayer. [44]

Corbett JA divided the holding period of the asset into three phases, corresponding with changes in shareholding in *Rile*. Without exploring the complexity of the facts, it is enough to state that, in the second period, the learned judge held that the intentions were mixed, or of a dualistic nature, but by the third phase when Nedbank became a shareholder in Rile, 'it [Rile] no longer had a dual intention but intended to pursue only the object of developing the property as a permanent investment'. Corbett JA, in his judgment, pointed to the need for a court to have objective evidence to substantiate such a finding, stating that 'there was sufficient evidence of more than a mere change of intention to justify the finding of the court *a quo*'. The taxpayer had to show to the satisfaction of the court that he meant to cease trading in the asset and to hold the asset on a long-term basis on capital account.

In *COT v Levy*,[45] the court held that, where mixed intentions exist, the dominant intention should be used in deciding intention:

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[40] *CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A).
[41] Ibid 653.
[42] 55 SATC 19.
[43] *SIR v Rile Investments (Pty) Ltd* 40 SATC 135, 1978 (3) SA 732 (A).
[44] DJM Clegg *Tax Law through the Cases* (1991) 111.
[45] *COT v Levy* 1952 (2) SA 413 (A), 18 SATC 127.

> Where the purposes of an individual taxpayer are mixed, the only course, on principle as well as for practical reasons, is to seek and give effect to the dominant factor operating to induce him to effect the purchase … [U]nless one were to hold, what the legislature could not have intended, that the taxpayer must exclude the slightest contemplation of a profitable resale of the property, it seems to me that the only test to apply is that of the main or dominant purpose.[46]

The same test was applied in *CIR v Paul*.[47] Although the case involved an individual, it was pointed out in *Levy*'s case[48] that the test may be slightly different in the case of a trading company versus an individual, according to *CIR v Leydenberg Platinum*.[49]

When deciding whether there were mixed intentions, a distinction may be made between a main purpose and a dominant purpose. As Steyn CJ said in *African Life Investment Corporation (Pty) Ltd v SIR*:[50] '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'.[51]

How this might apply to individuals is clearly illustrated in *CIR v Nussbaum*.[52] The court contrasted the case with *CIR v Pick 'n Pay Employee Share Purchase Trust,*[53] where the profits were merely incidental. In *Nussbaum,*[54] the court held that Nussbaum had 'farmed' his large portfolio.[55]

In *CIR v Guardian Assurance Company (SA) Ltd,*[56] the Commissioner sought to tax the profits from the sales of shares in a share portfolio according to his policy to treat short-term insurers as 'all-in companies', that is, that all its investments were trading stock. The company

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[46] Clegg (n 44) 122.
[47] *CIR v Paul* 1956 (3) SA 335 (A), 21 SATC 1.
[48] *COT v Levy* (n 45) 420.
[49] *CIR v Leydenberg Platinum Ltd* 1929 AD 137, 4 SATC 8 at 145; Emslie & Davis (n 17) 203.
[50] *African Life Investment Corporation (Pty) Ltd v SIR* 1969 (4) SA 259 (A), 31 SATC 163.
[51] Ibid 269.
[52] *CIR v Nussbaum* (n 36).
[53] *CIR v Pick 'n Pay Employee Share Purchase Trust* (n 17).
[54] *CIR v Nussbaum* (n 36).
[55] Ibid 1166.
[56] *CIR v Guardian Assurance Company (SA) Ltd* 1991 (3) SA 1 (A).

contended that the insurance business and the investment portfolio were run as separate entities within the company. The court accepted the evidence and held that the proceeds constituted receipts of a capital nature.

In *CIR v Middelman*,[57] the taxpayer sold his quoted shares to maximise his long-term investment income. The sale of the shares was held to be incidental to his main objective and not taxable. In *ITC 1509*,[58] the court held that it would be quite incorrect to generally classify a taxpayer as a dealer in shares and to adopt the approach that a taxpayer operating as a share dealer would always be considered a share dealer. The court expressed the view that it is necessary to look at the purpose for which the taxpayer acquired each particular counter and the circumstances under which he came to sell that particular counter.

In *ITC 1185*,[59] Miller J stated the following with regard to determining a taxpayer's intention at the time of acquiring a property:

> [T]he i*pse dixit* of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. 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. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions.

As Miller J stated, the distinction can be drawn into question in 'the course of conduct' of the taxpayer. No conduct can be universally interpreted and therefore the onus of proving the relative merits of transactions in different circumstances is vexed with complexity. In this respect, the length of a holding period is itself an inferior test. In *Natal Estates*,[60] farmland that had been held for 50 years was nevertheless taxed on revenue account because it had been

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[57] *CIR v Middelman* 1991 (1) SA 200 (C).
[58] *ITC 1509* 54 SATC 18.
[59] (1972) 35 SATC 122 (N) 123–4. See SARS *Comprehensive Guide to Capital Gains Tax* Issue 7 (2018) 17.
[60] *Natal Estates Limited v CIR* 1975 (4) SA 177 (A), 37 SATC 193.

converted into trading stock, while in *ITC 1185*[61] the proceeds from the sale of property held for a mere seven months were taxed as capital because of an intervening economic circumstance. In finding that the profit was of a capital nature, Miller J stated the following:[62]

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

In *ITC 862,*[63] the period was 50 years. In *CSARS v Capstone,*[64] the holding period was 22 months (June 2002 to April 2004). On appeal, the court had to decide the nature of a single transaction. The case had been decided in the Commissioner's favour in the Tax Court, Cape Town, and overturned before a full bench of the Western Cape Division on appeal to the High Court. The Supreme Court of Appeal then gave the Commissioner special leave to appeal against the High Court's decision. The case involved the rescue of Profurn, a company listed on the JSE, which had by 2001 run into serious financial difficulty. It owed FirstRand Bank over R900 million and somewhere in the region of R70 to R90 million to Steinhoff. The head of FirstRand Corporate, Dr Theunie Lategan, approached Mr Claus Daun, a wealthy businessman and shareholder in Profurn and Steinhoff, to inject capital into Profurn to reduce its debt to a more sustainable R300 million. Mr Daun agreed, on condition that Mr David Sussman of JD Group Limited (JDG) managed Profurn to turn it around. The resulting transaction involved Profurn converting R600 million in debt to equity through a rights offer, which was underwritten by FirstRand. A merger thereafter between Profurn and JDG resulted in an exchange of Profurn shares for JDG shares. The JDG shares were sold to special purpose vehicles (SPVs). Mr Daun used a German private holding company controlled by him to inject

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[61] *ITC 1185* (1974) 35 SATC 122.
[62] Ibid 128. See Emslie & Davis (n 17) 195.
[63] *ITC 862* 22 SATC 301.
[64] *CSARS v Capstone 556 (Pty) Ltd* 2016 (4) SA 341 (SCA), 78 SATC 231.

R300 million into the structure. Preference shares were issued for R200 million and the remaining R100 million was funded by way of a loan from FirstRand.

The inquiry concerned the share sale by the taxpayer, Capstone, of approximately 17.5 million shares in JDG, through which it made a profit of almost R400 million. Van der Merwe AJA cited the well-known view of the courts that there is no 'halfway house'.[65] 'It follows that Capstone could only discharge the onus by showing, on a balance of probabilities, that the proceeds were capital … on the particular facts of each case, for which there is no single infallible test.'[66]

He quoted Innes CJ[67] in Overseas Trust Corporation Ltd v Commissioner for Inland Revenue:[68] 'Where an asset is realised at a profit as a mere change of investment there is no difference in character between the amount of enhancement and the balance of proceeds.'

Citing Hefer AP[69] in *Samril Investments (Pty) Ltd v Commissioner*,[70] Van der Merwe AJA noted that profit-making is also an element of capital accumulation. 'Thus the mere intention to profit is not conclusive. There must be "an operation of business in carrying out a scheme for profit making" for a receipt to be income.'[71] Acknowledging that the distinction may be a fine one, a number of factors were set out that need to be assessed, apart from the intention of the taxpayer: 'it is therefore essential to consider the "business activities in which the taxpayer is ordinarily engaged"; the period for which the asset is held ("the longer that period the more likely it is that the disposal is a realisation of capital rather than a receipt of

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[65] Ibid para 22, citing *Cowe v Commissioner for Inland Revenue* 1930 AD 122 at 129.
[66] Ibid.
[67] Ibid para 23.
[68] *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 452–3.
[69] *CIR v Capstone* (n 64) para 26.
[70] *Samril Investments (Pty) Ltd v Commissioner, South African Revenue Service* [2003] ZASCA 118, 2003 (1) SA 658 (SCA) [2].
[71] *CIR v Capstone* (n 64) para 26.

income"; the nature of the risk undertaken which is either directed at building up a capital asset or generating revenue and profit.'[72]

Of particular interest is the reference to McCreath J on behalf of the full bench in *Commissioner for Inland Revenue v General Motors SA (Pty) Ltd*:[73]

> Finally, I consider that the correct approach in a matter of this nature is not that of a narrow legalistic nature. What has to be considered is the commercial operation as such and the character of the expenditure arising therefrom. This is perhaps but another way of expressing the concept that it is the substance and reality of the original loan transaction that is the decisive factor.

Further, the court references the remarks of Lord Hoffmann[74] in *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd*:[75]

> The innovation in the *Ramsay* case was to give the statutory concepts … a commercial meaning. The new principle of the construction was a recognition that the statutory language was intended to refer to commercial concepts … the court was required to take a view of the facts which transcended the juristic individuality of the various parts of a preplanned series of transactions.

Therefore, 'the transaction must be considered in its entirety from a commercial perspective and not be broken into component parts or subjected to narrow legalistic scrutiny.'[76]

4.5 SUMMARY

The discussion of the cases above makes it clear that certainty is lacking. The SARS tax guide relies on the construct and nature of financial derivatives as proof of a revenue nature because derivatives do not produce dividends. If the nature of the instrument is by definition seen to be that of revenue, then there can be no 'special act', according to *CIR v Stott*, or metamorphisis, according to *John Bell & Co (Pty) Ltd v Secretary for Inland Revenue*, to convert its tax nature

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[72] Ibid para 32.
[73] Ibid para 34.
[74] Ibid.
[75] *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] 1 All ER 865 [32].
[76] *CIR v Capstone* (n 64) para 34.

to capital – it is intrinsic. The nature of these contracts is discussed in chapters 8 and 11, with reference to leading decisions, involving rights under derivative contracts, which followed the bankruptcy of Lehman Brothers. *CIR v Nussbaum*, on the other hand, is heavily weighted towards 'frequency' as a determinant of income character. Financial derivatives can be of a very long duration, but their pricing becomes increasingly expensive the longer the period, due to unquantifiable risks. They can also be used as a step towards acquiring the physical asset or may be traded vigorously at a lower cost than the physical. All these circumstances provide an appearance that is analagous to *Nussbaum*. An analysis in chapter 11 therefore contrasts *Nussbaum* and *CIR v Pick 'n Pay Employee Share Purchase Trust*, as the court chose to do in *Nussbaum*, but substituting derivatives for shares.

CHAPTER 5

UNITED STATES OF AMERICA: LEGISLATIVE AND REGULATORY OUTLINE FOR FINANCIAL DERIVATIVE INSTRUMENTS

5.1 INTRODUCTION

> The USA leads the culture of derivatives regulation. The USA is still seen as the source of that sort of capitalism which gave rise to financial derivatives, just as the US dollar remains the world's safe haven currency in spite of its causative role in the global economic pandemonium of 2008–2009 …[1]

Of the jurisdictions under consideration, the USA has the most developed tax code on derivatives. The US Treasury quantifies its derivative market at $200 trillion (notional), which is seven times its equity market.[2] The USA is therefore relevant internationally as a capital market and to South Africa in that it has a common-law tradition and has developed legislation in an attempt to unify statute and common law. This seems tempting as a policy direction for South Africa. However, the game of catch-up with the market has by consequence led to a complexity of code unequalled by any of the other jurisdictions considered in this thesis. In 2011, the Government Accountability Office (GAO) in the USA released an analysis of the use of financial instruments for tax avoidance by the business sector. The GAO established that these instruments are the main means deployed by multinationals to avoid tax compliance.[3] Work done on behalf of the EU cites a set of literature that has evolved recently in the USA, focusing on the role of financial derivatives in tax planning by financial and non-financial corporations. 'Of this, the work of Michael Donohoe stands apart.'[4] Donohoe sought to empirically quantify the use of derivatives by US corporations in reducing tax liabilities and

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[1] A Hudson *The Law on Financial Derivatives* 6 ed (2018) 2-15.
[2] US Department of the Treasury *A Financial System that Creates Opportunities, Capital Markets* (2017) 5.
[3] US Government Accountability Office *Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse* (2011).
[4] A Nesvetailova, A Guter-Sandu & R Palan *Tax Evasion and Avoidance through Financial Engineering: Implications for Policy* (2018) 10 [references omitted].

demonstrates that, despite the extensive anti-avoidance tax code, significant fiscal leakage occurs:

> Donohoe conducted a series of studies of US corporations showing that many of those investigated attained reductions in current taxes and cash taxes paid in the four years subsequent to deployment of derivatives. He established that these benefits increase with the magnitude of derivatives employed; they result mainly from tax deferral opportunities, and are not driven by effective hedging of economic risks. Further, Donohoe and colleagues estimate that Special Purpose Entities (SPEs) facilitate over $330 billion of incremental cash tax savings, or roughly 6% of total U.S. federal corporate income tax collections during 1997-2016. In his later work, he estimated the corporate tax savings from financial derivatives amounts to between 3.6 and 4.4 percentage point reduction in three-year current and cash effective tax rates (ETRs). The decline in cash ETR equates to $10.69 million in tax savings for average firm and $4.0 billion for the entire sample of 375 new derivatives users. Of these amounts, $8.75 million and $3.3 billion, respectively, are incremental to tax savings that theory suggests are a byproduct of risk management.[5]

From a regulatory perspective, the USA and Europe have been the two principal drivers of change following the 2008 financial crisis. The Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) has been the key instrument for regulatory change in the USA. This includes a new framework for the regulation of swaps and derivative markets, risk retention for securitised products, mandating the clearing of certain derivatives through central counterparties, and the designation of systemically important financial market utilities. Within the banking sector, the Volker Rule prohibits banks from doing proprietary trading on their balance sheets (principally derivative trading) and thereby risking solvency.

The US Investment Company Act of 1940 (the ICA) is the principal statute regulating investment companies in the USA. The US Investment Advisers Act of 1940 (the Advisers Act) regulates registration, reporting and operations of external fund managers to portfolios. The US Securities and Exchange Commission (the SEC) is the primary regulator of investment companies and asset managers in the USA.[6]

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[5] Ibid 7 [references omitted].
[6] See generally P Dickson *The Asset Management Review* (2012) 450–1.

5.2 TAX WITHIN THE REGULATED INVESTMENT FRAMEWORK

The asset management industry in the USA is typically divided into two segments: those that offer access to a public pool of assets (anyone can participate), and those that offer access to private pools (by agreement). The former comprise principally unitised schemes (mutual funds or unit trusts) and the latter comprise hedge and private equity funds and real estate funds available to investors of some means and experience.

The legislative vehicles for public pools and private pools of professionally managed money typically seek to achieve tax neutrality so as to distribute income and capital gains and losses to the investors without incurring tax within the entity. Publicly accessible vehicles have to be registered with the SEC as a regulated investment company (RIC). Distributions from an RIC are generally taxed as ordinary income if dividends are accruing to US citizens. Long-term and short-term capital gains are taxed at reduced rates (21 per cent) if retained in the fund. If they are distributed, short-term gains are taxed at the maximum marginal rate (37 per cent).[7] Foreign investors are subject to a 30 per cent withholding tax on dividends from an RIC. Disposal of shares in a RIC will be treated as capital 'to the extent the payment is treated as payment in exchange for the stock' and, conversely, as ordinary if 'essentially equivalent to a dividend'.[8] In the same fashion, private investment pools are normally held in partnerships where the conduit nature of these arrangements enables tax neutrality at the entity level. 'The source and character of partnership items is generally determined at the entity level.'[9]

Bergman *et al* summarised income character determination within the investment industry as follows:

> Investing is not considered to be a 'trade or business', regardless of the extent, continuity, variety and regularity of the investment activity. An overseas investor is not considered to be engaged in a trade or

[7] Bloomberg Law *Portfolio 740-3rd Taxation of Regulated Investment Companies and their Shareholders* (2020).
[8] Ibid 461.
[9] Ibid 462.

> business by investing in a fund that trades in stock, securities and commodities (although lending and other activities undertaken by a fund may give rise to a trade or business).[10]

5.3 TAX LEGISLATIVE FRAMEWORK FOR DERIVATIVES

On 18 May 2016, Senator Ron Wyden introduced a discussion document to standardise and simplify the legislative treatment of derivatives and move towards a broad mark-to-market policy regime. On 2 May 2017, this was followed with the Modernisation of Derivatives Act of 2017, as a Bill to Congress. He described the existing law on the treatment of derivatives as follows:

> There are no general principles governing the taxation of derivative contracts in the United States, but instead a complex set of tax rules and regulations that evolved in piecemeal fashion over time. The existing rules provide differential treatment based on many factors, including: character of tax attribute (ordinary vs. capital), timing of recognition (short-term versus long-term), type of derivative instrument (option, future, forward, or swap, and whether over-the-counter or exchange-traded), disposition of the contract (terminated, exercised, or lapsed), type of settlement (cash vs. physical delivery), intended use of the instrument (investment vs. business hedge), nature of the taxpayer (dealer, trader, or investor; corporation or individual), source of the transaction (U.S. or foreign), and whether the counterparty is a U.S. or foreign person. In addition, taxpayers must consider numerous anti-abuse rules (e.g., straddle and wash sales rules) when they engage in certain derivative transactions. Moreover, these tax rules prescribe federal tax treatment of derivative instruments without regard to their treatment under accounting rules.[11]

The USA has the most intricate legislative framework for derivative instruments amongst those surveyed. What can be described as a rules-based system has increasingly tried to cater for more and more permutations in the use and design of these instruments. While it is not possible for this analysis to consider every legislative contour, it is also not possible to appreciate the rationale of the courts without understanding the structure of the tax statute. Most of the derivative provisions seem to be motivated by anti-avoidance. Attempts by drafters

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[10] See Bloomberg Law (n 7) 463. The description of the regulatory environment is principally informed by this publication at 450–64.
[11] R Wyden *Modernisation of Tax Act of 2017, Section-by-Section* (2017).

to be more specific in response to rulings by the courts have resulted in an ever-tightening legislative noose that, by virtue of its specificity, then spawns exceptions not previously envisaged. The legislation therefore uses specific targeted provisions that override the general treatment. These specific provisions provide categorical taxing solutions for specific *users*, *uses* and *products* (instruments). The tax treatment is affected by whether the taxpayer is an end-user, a trader or a dealer, and whether the transaction is part of a specific derivative strategy such as a hedge, a straddle or a conversion transaction. In general, gains follow the nature of the underlying asset and those of an ordinary nature are included in ordinary income and are taxed at the marginal rate within each tax cycle. Different treatment may apply to cash-settled as opposed to physically settled derivatives. The treatment of losses is determined by the legal nature of the taxpayer (corporate or individual). Capital gains and losses may receive different treatment. Gains may be taxed at a lower rate (20 per cent) and losses in excess of gains for the tax cycle may be limited. Box 5.1 below lists both the general and special provisions. Section 5.4 then provides a brief description of each before the interpretative challenges in chapter 6 are addressed.

Box 5.1: Outline of legislative provisions

General provisions	
Section	**Purpose**
1221	General rules for determining capital gains and losses
1222	General rule applicable as to whether gain short-term or long-term
1223	Basic rules for holding period
1234	Basic rules concerning character of gain or loss of options
1234A	Special rules for determining capital gains or losses for options
1234B	Special rules for determining capital gains or losses for futures
Specific provisions	
Section	**Purpose**
475	Dealer mark-to-market rules (user defined)
988	Foreign currency hedging rules (defined by use)
1092 and 263 (g)	Straddle rules (defined by use)
1221	Business hedging regulations (defined by use)
1233	Short sale rules (defined by use)
1256	Mark-to-market rules
1258	Conversion rules
1259	Constructive sale rules
1260	Constructive ownership rules

Treasury Reg. sec. 1.1275-6 Debt hedging rules

5.4 BRIEF DESCRIPTION OF GENERAL PROVISIONS[12]

5.4.1 Section 1221 – General rules for determining capital gains and losses

The term 'capital asset' is defined in legislation in the USA by the exclusion of what 'capital' does not include amongst property held by the taxpayer.

5.4.2 Section 1222 – General rule applicable as to whether gain is short-term or long-term

The USA distinguishes between short- and long-term capital gains. 'Short-term' capital gains recognise the fact that a holding period is not always a defining quality in the characterisation of income. Section 1222 defines such a gain as being triggered by a sale or exchange of a capital asset held for not more than one year in the computation of gross income.

5.4.3 Section 1223 – Basic rules for holding period

As the holding period set down in section 1222 has a determining function in the characterisation of a gain or loss, section 1223 defines the basis for calculating the holding period.[13]

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[12] Coming to grips with the complexity of the US legislation and case law was no easy task. To validate sources I wrote to Professor Alvin Warren at Harvard University at the start of my research to verify the main works on the topic. Conlon and Aquilino's treatise was then mostly used to inform the original contents of this chapter. Given the date of Conlon and Aquilino's work I needed to ensure that the summary remained accurate. This chapter has therefore been cross-referenced to the report prepared by the Joint Committee on Taxation, entitled *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11) 2 December 2011. The report was requested following the financial crisis on federal tax rules relating to the taxation of financial instruments. The many journal articles are cited and require no further mention. Verification was repeated in 2018 by cross-referencing this chapter to a very helpful document sent to me by the Investment Company Institute in the USA. The Congress of the US Joint Committee on Taxation prepared an analysis for Senator Ron Wyden dated 18 May 2016, wherein the existing law was analysed as part of a comparative analysis to the discussion document and Bill that he was preparing for introduction to Congress to modernise derivative taxation. While the ICI's assistance was in response to a request from me given challenges the investment industry was facing following a proposal in the draft 2018 Taxation Laws Amendment Bill, I am nonetheless grateful that it has also been helpful for this research. I have also accessed a 2017 version that was prepared for Senator Wyden to match the Bill that followed the discussion document.

[13] See also Treasury Regulation section 1.1223-1(a).

5.4.4 Section 1234 – Basic rules concerning character of gain or loss

Section 1234 sets out the basic rules concerning income character for options. The deduction of capital losses incurred by companies is limited to the extent of capital gains and, for other taxpayers, a cap on the excess of capital gains that can be set off against ordinary income in any year applies.

The characterisation of the term of the gain or loss as either short- or long-term may be affected by the provisions of the *straddle* or *wash sale* rules.[14]

Section 1234 also prescribes when premiums are taken into account. For federal income tax purposes, two fundamental principles underscore the taxation of option premiums:

1. Premiums paid by a holder are capitalisable, not deductible, either immediately or over time.
2. Premiums received are not immediately treated as income to the writer.[15] Ordinary income arises if the option is not exercised. If the option is with respect to 'property' that includes shares, securities and commodities futures, the gain or loss is a short-term capital gain or loss.[16]

5.4.5 Section 1234A – Special rules for determining capital gains and losses

The character of options follows the nature of the underlying asset.[17] If the option is cash-settled, then the nature will be determined by the holding period, which needs to be more than a year for the option to qualify as a long-term capital gain.[18] If the option purchaser exercises

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[14] Steven D Conlon & Vincent Aquilino *Principles of Financial Derivatives, US and International Taxation* (2000) B1.05, B1-33.
[15] Rev. Rul. 71-521, 1971-2 CB 313, cited in Conlon & Aquilino (n 14) B1.05[4][c].
[16] Section 1234(b) and 1234(b)(2)(B).
[17] Section 1234(a)(1).
[18] Rev. Rul. 88-31, 1988-1 C.B. 302; Joint Committee on Taxation *Description of the Modernization of Derivatives Tax Act of 2016* 2.

a physically settled option, the holding period will be calculated from the date of exercise for the referenced or underlying property.[19]

5.4.6 Section 1234B – Special rules for determining capital gains and losses (futures contracts)

Section 1234B references the character of the futures contract to the nature of the asset to which it refers as follows:

> Gain or loss attributable to the sale, exchange, or termination of a securities futures contract shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by the taxpayer).[20]

It also deems the gain or loss from the *sale* or exchange of a capital asset as short-term, other than in certain circumstances.

5.5 BRIEF DESCRIPTION OF SPECIFIC PROVISIONS

5.5.1 Section 475 – Dealers in securities

Enacted in 1993, section 475 sets out the rules applicable to dealers in securities (taxpayers who are engaged in selling securities to third parties). Section 475 represents a departure from realisations-based taxation, recognising gains and losses on the last day of the tax year, based on fair market value. Prior to the introduction of this provision, dealers were permitted to value inventory in securities at (1) cost; (2) the lower of cost or market; or (3) fair market value (mark-to-market). However, the ability of dealers to avoid the recognition of gains while recognising unrealised losses in terms of this approach resulted in the design of the section 475 rules. The character of gains and losses under section 475 is ordinary.[21] As is self-evident, almost all transactions would have, on at least one side, a taxpayer subject to section 475.

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[19] Section 1223(5).
[20] 26 USCS 1234B(a)(1).
[21] Section 475(c)(3).

5.5.2 Section 988 – Foreign currency hedging rules[22]

Section 988 is an exemption to the mark-to-market rules applicable under section 1256, although excluding regulated futures contracts or non-equity options. Section 988 recognises the need for hedges against foreign currency fluctuations as prudent business practice. Its ambit therefore includes hedges relative to property held or to be held or borrowings and obligations. The condition, however, is that with all business hedges the transaction has to be properly identified as such by the taxpayer. A 'qualified fund' is entitled to use this provision.

5.5.3 Sections 1092 and 263(g) – Straddles[23]

The provisions in these co-joined sections are anti-abuse rules directed at the use of straddles. Typically, the buyer of a straddle believes that the price of an underlying asset will be volatile, but may not have any particular view on the directions of movement of the price. Offsetting positions are therefore purchased, using a call and put option on the same asset with identical maturity and strike prices.[24] A taxpayer's holding period on a position does not run while a straddle is in force for that position. The character of the position preceding a straddle remains intact during the term of the straddle.[25]

This section is directed at preventing the ability of users of this strategy to transform short-term capital gains into long-term capital gains while not bearing the economic risks associated with holding the underlying asset for the long term.

This section, which is complex in design, serves therefore to restrict taxpayers' timing of loss recognition and, consequently, the holding period of an asset, so as to prevent the creation of artificial tax losses and the translation of short-term gains into long-term gains.

This approach is encapsulated in the legislation as follows:

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[22] Conlon & Aquilino (n 14) B1.06[4][d].
[23] Ibid B3.03.
[24] A Inglis-Taylor *Dictionary of Derivatives* (1995) 111.
[25] Treasury Regulation section 1.1092(b)-2T(a)(1). See Joint Committee on Taxation (n 18) 12.

> Any loss with respect to one or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognised gain (if any) with respect to [one] or more positions which were offsetting positions with respect to [one] or more positions from which the loss arose.[26]

Section 263(g) requires the capitalisation of interest and carrying charges and therefore prevents a taxpayer from deducting these against ordinary income on an ongoing basis during the period of the straddle.

5.5.4 Section 1221 – Business hedging[27]

> Whether derivatives that are used to hedge business risks were capital or ordinary items, and how they should be accounted for, was a matter of case law[28] and administrative guidance until Treasury regulations were published in 1993 and 1994. These regulations governed the timing and character of hedging transactions under sections 1221 and 446 respectively. In 1999, Congress amended section 1221 to include business hedging transactions as exceptions to the definition of capital asset, and in 2002 final Treasury regulations were published under the new legislation. Regulations under section 446 governing the timing of hedging transactions were not changed.[29]

Hedging is used to insure against an adverse change in the price of an asset held or to be acquired.[30] Section 1221(b)(2) defines a hedging transaction as one entered into in the normal course of the taxpayer's trade, primarily to manage risk of price changes or currency fluctuations. The section does not define 'primarily to manage risk', relying instead on a facts and circumstances determination.[31] Those that fall within this definition are afforded ordinary treatment. Hedging of capital assets is not covered by the definition of a business hedge.

The relevance from a legislative perspective for these regulations is a recognition of the economic distortion that results when a hedge has ordinary income as its one component and

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[26] IRC 1092(a)(1) in Conlon & Aquilino (n 14) B3.03[3][a].
[27] Conlon & Aquino (n 14) B3.04.
[28] *Corn Prods Ref Co v Commissioner* 350 US 46 (1955); *Arkansas Best Corp v Commissioner* 485 US 2 at 12 (1988); *Federal National Mortgage Ass'n v Commissioner* JOO TC 541 (1993). See Joint Committee on Taxation (n 18) 14.
[29] Joint Committee on Taxation (n 18) 14.
[30] Inglis-Taylor (n 24) 65.
[31] Treasury Regulation section 1.1221-2(c)(4)(i). See Joint Committee on Taxation (n 18) 14.

the loss from the offsetting position is capital, resulting in an economic solution that is ineffective from a tax perspective, as capital losses cannot be used to offset income gains. Whereas taxpayers may seek to avoid the anti-abuse provisions of the straddle and wash sale rules, these rules are beneficial and the difficulty is often overcoming a narrow application on the part of the Internal Revenue Service (IRS).[32]

5.5.5 Section 1233 – Short sales

Where an asset is sold for delivery at a later date, it is referred to as a short sale. Subject to possible section 1259 application, a taxpayer entering into a short sale does not recognise a gain or loss until the property is delivered to close the deal. For the purposes of federal income tax, a short sale is a matter of circumstance rather than regulation. The key test is the intention of the seller. Section 1233 is aimed at preventing abuse whereby taxpayers convert short-term gains into long-term gains and long-term losses into short-term losses. To this end, section 1233(a) determines that property acquired to close a short sale is deemed to be capital in nature, and section 1233(b) characterises the gains and losses from short sales as short-term. The straddle rules of section 1092 have largely surpassed the provisions of this section in application.

5.5.6 Sections 1222 and 1223 – Term of gain

Section 1222 provides the general rules for determining when a gain should be characterised as short-term, that is, subject to the higher tax rate of 40 per cent, for instruments ‘held’ for one year or less. Section 1223 sets out the rules for determining how long an option has been held.[33]

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[32] Conlon & Aquilino (n 14) B3.04[1] at B3-24.
[33] Ibid B1.05 n 103.

5.5.7 Section 1256 – Mark-to-market[34]

The application of this section, which requires the recognition of gains or losses on the last day of the tax year, *includes*:

1. regulated futures contracts;
2. foreign currency contracts;
3. all non-equity options; and
4. all dealer equity options.

However, the section *excludes*:

1. business hedging transactions in terms of section 1221;
2. foreign currency hedges in terms of section 988; and
3. securities within the ambit of the dealer mark-to-market rules of section 475(a).

This section therefore departs from the realisations-based methodology of recognising gains or losses and deems the realisation by treating the contract as sold. The annual recognition of gains or losses requires these to be tracked over time so that, at the disposition of the contract, the appropriate adjustment for tax purposes can be made. All gains or losses are treated as capital and the term of the gain is deemed as 40 per cent short-term and 60 per cent long-term.

The section is not subject to the straddle loss deferral (if all the offsetting positions consist of section 1256 contracts) or capitalisation rules. However, there is an important exception whereby a taxpayer may make a *mixed straddle* election when using a section 1256 contract as one of its offsetting positions. This is irrevocable.

The other key exception is for hedging transactions. This provision served as the basis for the formulation of the business hedging regulations of section 1221. Section 1256 provides

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[34] Ibid B1.06[1], B1-34 to 47.

that a gain recognised with respect to personal property that is part of a hedge will not be characterised as capital in nature. This section defines a hedge as a transaction:

1. entered into in the normal course of the taxpayer's trade or business primarily[35] to reduce the risk of price change or currency fluctuations with respect to property held by the taxpayer or to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings or obligations (including future borrowings or obligations) of the taxpayer;
2. the gain or loss on such transactions is treated as ordinary[36] income or loss; and
3. the taxpayer clearly identifies the transaction as a hedging transaction before the close of the day[37] on which such a transaction was entered into.[38]

5.5.7.1 Carryback of losses[39]

When a deeming provision is employed in the mark-to-market methodology, it is of course deemed and not a matter of finality in practical life. In the interests of equity, the question as to the application of losses arises. In this regard, section 1212 provides for an elective carryback (but not for companies, estates or trusts). Should this election be made, the loss is carried back three years and, to the extent that it is not utilised, it is carried forward a year at a time in terms of the carryforward rules of section 1212(b)(1), until fully utilised. The loss bears a statutorily defined 40 per cent short-term, 60 per cent long-term definition in terms of section 1256.

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[35] Conlon & Aquilino (n 14) B1.06[4][b], B1-40 unsurprisingly state that the qualification that the transaction must 'reduce' risk is troublesome. Most commentators preferred the term 'manage risk'. However, the term seems to be liberally applied by the IRS.
[36] This qualification proved troublesome in *Arkansas Best v Commissioner* (n 28). The provisions of section 1256(e)(2)(B) are in effect dealt with by the business hedging rules because of this.
[37] To circumvent the tendency of taxpayers to 'cherrypick' with hindsight.
[38] IRC 1256(e)(2), cited in Conlon & Aquilino (n 14) B1.06[4][b], B1-39.
[39] Ibid B1.06[4][e], B1-45, 46.

5.5.7.2 Trading of section 1256 contracts

Because futures contracts are regarded as being prone to manipulation, section 1256 of the Internal Revenue Code (IRC) treats such contracts as sold at the end of each year for fair market value. Under this mark-to-market system, eventual taxable value at sale will reflect set-off of gains and losses during the holding period. Gains or losses are treated as capital in nature. This is not applicable to any hedging transactions if the loss therefrom might be categorised as ordinary.

5.5.8 Section 1259 – Constructive sales

Section 1259, which includes futures, forwards, short sales and options, was introduced by the Clinton Administration in 1996 and enacted in 1997. This anti-abuse legislation addressed the economic and tax inconsistency when short sales are made on an appreciated asset.

The practice of short selling, which is used quite extensively for equities, typically involves selling short shares that are held and then borrowing scrip, using the owned shares as collateral. Under the previous law, the gain or loss from a short sale was taxed once the underlying shares were either bought or delivered to the lender. This delay in the taxation 'event', which was triggered by the repayment or close out of the loan, meant that the taxpayer in an economic sense was able to achieve a determinable outcome in the form of either a gain or loss at the time of entering into the short sale (as he or she owned the property) and yet no accrual for tax occurred.

The concept of a constructive sale arose out of this concern. This concept deems '*appreciated financial positions*' as sold. A short sale is triggered if a taxpayer enters into:

1. a short sale of the same or substantially identical property;
2. an offsetting notional principal contract with respect to the same or substantially identical property;
3. a futures or forward contract to deliver the same or substantially identical property; or

4. an appreciated financial position that is a short sale or a contract described in items 2 or 3 with respect to any property, and acquires the same or substantially identical property.[40]

There are a few exceptions in the rules, as well as a special rule relating to the treatment of subsequent sales of a position that had been deemed sold in terms of this section.

> Section 1259 does not explicitly provide for an option, or combination of options, as one of the transactions that could result in the requirement to realize gain, perhaps because a single option would not 'have the effect of eliminating' substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to a position. The legislative history notes that combinations of options, such as a put and call on the same underlying with the same or close strike prices, and 'in-the-money' options (e.g., a put option where the strike price is significantly above the current market price of the referenced underlying) may have substantially the same effect as the financial positions explicitly addressed by section 1259. The legislative history anticipates Treasury guidance addressing proper treatment of such positions under section 1259. To date, no such regulations have been published.[41]

5.6 TAXATION OF SWAPS, CAPS, FLOORS AND OTHER NOTIONAL PRINCIPAL CONTRACTS

The tax consequences of the above categories of derivative instruments seem far less certain in the USA, and although certain principles appear to have established themselves, general guidance regarding character definition is outstanding.

Final Treasury regulations do not address the character of notional principal contract payments. However, regulations proposed in 2004 under section l234A provide that any periodic or nonperiodic payment generally constitutes ordinary income or expense.[42]

Regarding the character of payments, the substitution or mimicking of dividends or interest, for instance, does not entitle such payments to like treatment. For instance, if swap payments are in lieu of dividend payments,[43] they are not treated as such, and neither are

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[40] IRC 1259(c)(1)(E); Conlon & Aquilino (n 14) B1.07, B1-50.
[41] See Joint Committee on Taxation (n 18) 16.
[42] Prop. Treasury Regulation section 1.1234A-1. See Joint Committee on Taxation (n 18) 7.
[43] Section 301 of federal income tax law defines dividends as distributions with respect to stock, according to Conlon & Aquilino (n 14) B1.09[2], B1-54.

swapped payments on debt instruments.[44] The notional principal amount or object of the contract is merely used as a reference for the purposes of calculating the payments. In a 1997 technical advice memorandum, the IRS adopted the view that periodic payments pursuant to a commodity swap resulted in ordinary income and expense.[45]

Swaps, caps, floors and similar notional principal contracts[46] have three categories of payments associated with their execution, namely 'periodic payments', 'non-periodic payments' and 'termination payments'. Ongoing payments are widely believed to be viewed as ordinary because they do not possess the realisation trigger necessary to be categorised as a capital item. A similar argument could be made for termination payments, but the regulations released in 1993[47] by the IRS identified them as capital. Section 1234A fulfils the purpose of a character rule deeming 'cancellation', 'lapse', 'expiration' or 'other termination' as capital by nature, ostensibly to remove what would have been an elective choice on the part of a taxpayer to have the payments characterised at will between ordinary for a termination and capital when sold.

5.7 CONCLUSION

This chapter provided a detailed outline of the US tax code on derivatives. This is necessary as an example of a particular policy approach unequalled in the other jurisdictions under review, and essential as a backdrop to chapter 6, which considers case law development in the USA. Table 5.1 below provides a useful summary that illustrates that character generally follows the

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[44] *Deputy v Dupont* 308 US 488 at 497 (1940) is the definitive case in the USA on the definition of the term 'interest'. Conlon & Aquilino (n 14) B1.09[2]n 224, B1-53 pointed out that even though the payments resemble interest, they are not in fact for the 'use or forbearance of money'.

[45] Technical Advice Memorandum 9730004 (10 April 1997), cited in Conlon & Aquilino (n 14) B1.09[2] n 225, B1-53.

[46] Notional principal contracts are believed to include swaps, floors, caps and collars, but exclude contracts that rely on indices or permit changes in the notional principal amount, contracts between a taxpayer and qualified business units, section 1256 contracts, futures contracts, forward contracts, options and debt instruments. See Conlon & Aquilino (n 14) B1.09[3][a], B1-57.

[47] These regulations focused on timing issues and not income characterisation. They were somewhat refined in 1997.

nature of the underlying asset. Much of the US tax code seeks to then manage exceptions to minimise avoidance. Derivatives are defined for taxation purposes by the type of instrument, intention (referred to as motive below), the nature of the taxpayer (referred to as status below), timing (long-term versus short-term), settlement (cash or physical), and intended use of the instrument (investment versus business hedge) when determining character. Notwithstanding the comprehensive and granular treatment, the system of taxation is criticised as lacking in principle and suffering from piecemeal construction (see section 5.3 above).

Table 5.1: Federal taxation of derivative transactions[48]

Attribute	Category	Description	Timing	Character	Source
Type	§1234 Options	Exchange-traded and over-the-counter options on debt, equity, commodities and indices.	Deferred until settlement.	Same as underlying, generally capital.	Taxpayer country of incorporation.
	Forwards	Contracts to buy/sell underlying for specified price at specified time settling in cash or physical delivery.	Deferred until settlement.	Same as underlying.	Taxpayer country of incorporation.
	Securities Futures	Exchanged-traded contracts for sale or future delivery of a single security or narrow-based index.	Deferred until settlement or termination.	Same as underlying.	Taxpayer country of incorporation.
	§1256 Contracts	Regulated futures, exchange-traded non-equity options, and some foreign contracts.	Marked-to-market at year-end.	Generally capital.	Taxpayer country of incorporation.
	Notional Principal Contracts	Contracts providing for payment of amounts at specified intervals calculated in reference to a specified index upon a notional principal amount in exchange for consideration or promise to pay similar amounts.	Termination payments on receipt; other payments amortized.	Same as underlying for termination payments; other payments are ordinary.	Taxpayer country of incorporation unless income earned via U.S. branch.
Motive	Hedge	Transactions initiated in the normal course of business to reduce exposures to risks.	Matched with underlying item.	Generally ordinary.	Taxpayer country of incorporation.
	Straddle	Offsetting position (not designated or qualifying as a hedge) against traded property substantially reducing risk of loss.	Loss deferral; interest and carrying costs capitalized.	Same as underlying.	Taxpayer country of incorporation.
	Constructive Sale	Offsetting position for purpose of locking in gains and avoiding taxes.	Immediate gain recognition at FMV.	Same as underlying.	Taxpayer country of incorporation.
Status	Dealer	Taxpayer who regulatory buys, sells, or otherwise offers securities to customers in ordinary course of business.	Marked-to-market at year-end.	Ordinary.	Taxpayer country of incorporation.
Other	Entity Form	Partnerships, trusts, and other pass-through entities are assessed taxes at the ownership level, but consolidated in financial reports.	May depend on entity form.	May depend on entity form.	May depend on entity form.
	Jurisdiction	The tax treatment of derivatives varies across many foreign tax jurisdictions.	May depend on foreign tax jurisdiction.	May depend on foreign tax jurisdiction.	May depend on foreign tax jurisdiction.

[48] MP Donohoe *Financial Derivatives in Corporate Tax Avoidance* (PhD dissertation, University of Florida, 2011) 38. See http://ufdc.ufl.edu/UFE0043096/00001.

CHAPTER 6

UNITED STATES TREATMENT OF INCOME CHARACTER

6.1 DEFINITION OF INCOME

The most commonly accepted economic definition of income in the US literature seems to be the 'Haig-Simons' definition.[1] Also known as 'mark-to-market', this definition explains income as the net change in the taxpayer's financial position during the tax year, 'the sum of amounts spent on consumption plus net accretions to wealth during the taxable period'.[2] This, Haig-Simons argued, should be subject to uniform taxation to avoid distorting investment decisions. As Simons had stated in *Personal Income Taxation*:[3]

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning. The sine qua non of income is gain, as our courts have recognised in their more lucid moments – and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.
>
> This position, if tenable, must suggest the folly of describing income as a flow and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc. As Schäffle has said so pointedly, 'Das Einkommen hat nur buchhalterische Existenz'. It is indeed merely an arithmetic answer and exists only as the end result of appropriate calculations. To conceive of income in terms of things is to invite all the confusion of the elementary student in accounting who insists upon identifying 'surplus' and 'cash'. If one views society as a kind of giant partnership, one may conceive of a person's income as the sum of his withdrawals (consumption) and the change in the value of his equity or interest in the enterprise. The essential connotation of income, to repeat, is gain – gain to someone during a specified period and measured according to objective market standards.

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[1] See TR Chorvat 'Perception and income: The behavioral economics of the realization doctrine' (2003) 36 *Connecticut Law Review* 2.
[2] Ibid.
[3] *Personal Income Taxation* 1938 (1980 reprint) 50–51, cited in RW Parsons *Income Taxation in Australia, Principles of Income, Deductibility and Tax Accounting* (2011) 1.46.

By distinction, section 61 of the Internal Revenue Code utilises a realisations doctrine for tax gains and losses from the sale or exchange of property. This distinction, which relies on an event, creates a deferment benefit, the longer the asset is held. In *Eisner v Macomber*,[4] the Supreme Court held that income had to be 'separated' from capital to be realised and taxed, but supported a global approach to taxation. Almost 20 years later, *Helvering v Bruun*[5] found this not to be necessary. In *Cottage Savings Ass'n v Commissioner*,[6] the Supreme Court held that holding a materially different asset is proof that realisation has been triggered. Therefore, if the description of the asset has changed significantly, the result is a realisation event.[7]

Exceptions to the realisation principle include securities dealers (who regularly buy securities from customers and sell securities to customers), the constructive sales rules under section 1259, discussed in the previous chapter, an original issue discount instrument (eg zero-coupon bond, where a single interest payment is made at the end of the instrument's life) where accrual occurs over the life of the instrument, and exchange-traded futures contracts under section 1256.

6.2 CHARACTER: DEFINED BY THE STATUTORY NATURE OF THE ASSET

6.2.1 Concept of 'capital asset': Historical development

Given the USA's historical ties with England and Continental Europe, it stands to reason that US definitions of what constitutes capital borrow from these jurisdictions. However, unlike the English beginnings, with the concept of income as separable from a largely inalienable estate in an agrarian system, the availability and tradability of land in the USA called for a different approach.

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[4] 252 US 189 (1920). See Chorvat (n 1) n 31.
[5] 309 US 461 (1940). See Chorvat (n 1) n 34.
[6] 499 US 554 (1991). See Chorvat (n 1) n 45.
[7] Chorvat (n 1) 2–3.

Using English common law and categorising capital investments as a *res*, Congress included gains to such assets in income for taxation in the Revenue Act of 1862.[8]

In *Gray v Darlington*[9] the Supreme Court ruled that accretion should be assessed only in the tax year of sale;[10] this was the beginning of a realisations-based methodology. In *Stratton's Independence Ltd v Howbert,*[11] a broad understanding of income was framed as 'the gain derived from capital, from labour, or from both combined'.[12] In *Eisner v Macomber*[13] the majority followed *Stratton's Independence* but added that 'it be understood to include profit gained through a sale or conversion of capital assets'.[14] Furthermore, the Supreme Court stressed the necessity on constitutional grounds for realisation as a prerequisite to taxing gains, identifying 'severance from the capital' and availability for 'separate use, benefit and disposal' as elements of income from capital. How realisation was achieved was soon identified as including receipt of any exchangeable property, and was not limited to the receipt of money.[15]

> [T]he essential matter [is]: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital … and coming in, being 'derived' ….[16]

In *Helvering v Horst*[17] the realisations requirement was subsequently interpreted as an 'administrative convenience'; in *Helvering v Bruun*[18] that a landlord realised a gain on a

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[8] Revenue Act of 1862, ch. 119, section 90, 12 Stat. 432, 473. See Lawrence H Seltzer *The Nature and Tax Treatment of Capital Gains and Losses* (1951) 26, cited in JB Cartee 'A historical essay and economic assay of the capital asset definition: The taxpayer and courts are still mindfully guessing while Congress doesn't seem to (have a) mind' (1993) *William & Mary Law Review* 16.
[9] The case concerned an accretion of $20 000 on a bond held for four years. 82 US (15 Wall.) 63 (1872). See Cartee (n 8) 17.
[10] The Civil War Income Tax Act of 1867 stipulated that it should be assessed for income tax annually. See Cartee (n 8) 3.
[11] 231 US 399 (1913). See Cartee (n 8) 4.
[12] 231 US 399 (1913) at 415.
[13] 252 US 189 (1920). See Cartee (n 8) 4.
[14] 252 US 189 at 207.
[15] See *Peabody v Eisner* 247 US 347 at 349–50 (1918) in Cartee (n 8) 18.
[16] *Eisner v Macomber* 252 US 189 at 207 (1920), quoting *Doyle v Mitchell Bros Co* 247 US 179 at 185 (1918). See Cartee (n 8) 19.
[17] *Helvering v Horst* US 112 at 116 (1940). Statutorily reversed by IRC section 109. See Cartee (n 8) 19.
[18] *Helvering v Bruun* 309 US 461 at 469 (1940). See Cartee (n 8) 19.

lessee's capital improvement upon repossession; and in *United States v Kirby Lumber Co*[19] that a corporation realised income when it purchased its own bonds at less than issue price.

The moment when an asset traverses the border between capital and ordinary income has been influenced by the significance, purpose, nature, frequency and regularity of a transaction. In *Higgins v Commissioner*[20] the court held that investing for one's own account does not constitute a trade or business; in *Reese v Commissioner*[21] the court held that a single venture without expectation of continuation in the field is not ordinarily a business; and in *International Shoe Mach Corp v United States*[22] the court found that although the taxpayer leased machines, he held the machines primarily for sale in the ordinary course of business. Securities will normally be regarded as being on capital account if no sales *to clients* are engaged in, although in *Carl Marks & Co v Commissioner*[23] certain securities held by the dealer were nonetheless regarded as being on capital account. The 'to customers' requirement is a legislative amendment affected in 1934 to which we will return. These issues are explained in more detail below.

6.2.2 Defined by statute exclusion – the US capital asset definition

'Capital assets', as defined in section 117(a) of the Revenue Act of 1934, is used within the ambit of its ordinary meaning of capital invested, plus all surplus accounts or undivided profits.[24] Congress' recognition of a different category of income in justifying a relief

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[19] *United States v Kirby Lumber Co*. 284 US 1 at 2–3 (1931). See Cartee (n 8) 19.
[20] 312 US 212 at 218 (1941). See Cartee (n 8) 19.
[21] 615 F.2d 226 at 230–1 (5th Cir. 1980). See Cartee (n 8) 19.
[22] 491 F.2d 157 at 160–1 (1st Cir.), cert. denied, 419 US 834 (1974). See Cartee (n 8) 19.
[23] 12 TC 1196 at 1200 (1949).
[24] *Commissioner v Shapiro* (1942 CA6) 125 F2d 532, 42-1 USTC P 9260, 28 AFTR 1079, 144 ALR 349. See 26 USCS section 1221 at 8.

recognised the hardship effects of realisation proceeds after holding an asset for a substantial period of time.[25]

In the USA, the taxation of capital transactions has been afforded special treatment dating back to the Revenue Act of 1921. Prior to the Tax Reform Act of 1986[26] (TRA 1986), individual and other non-corporate taxpayers could deduct 60 per cent of the amount of any net capital gain from gross income, resulting in a net rate of 20 per cent (50 per cent maximum individual tax rate times the 40 per cent of net capital gain included in adjusted gross income). Congress believed that–

> [t]his will result in a tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterisation of income as ordinary or capital gain. In addition, this will eliminate any requirement that capital assets be held by the taxpayer for any extended period of time in order to obtain favourable treatment. This will result in greater willingness to invest in assets that are freely traded (e.g. stocks) and make investment decisions more neutral.[27]

TRA 1986 ended a 65-year legacy of taxing long-term capital assets at a preferential rate. However, the legislative framework was kept intact. IRC section 1221, which defines capital assets by exclusion remained, as did the netting rules in IRC section 1222 and the holding period rules of IRC section 1223. The 2003 Tax Act[28] again reduced the tax rate on long-term capital gains, increasing the incentive once again for higher marginal rate taxpayers to qualify for the long-term rate of 15 per cent.

'Capital assets' includes all property held by a taxpayer, regardless of duration, irrespective of whether the property is used in the taxpayer's business or trade. Receipts from

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[25] *Commissioner v Gillette Motor Transport, Inc* (1960) 364 US 130, 4 L Ed 2d 1617, 80 S Ct 1497, 60-2 USTC P 9556, 5 AFTR 2d 1770; *United States v Midland-Ross Corp* (1965) 381 US 54, 14 L Ed 2d 214, 85 S Ct 1308, 65-1 USTC P 9387, 15 AFTR 2d 836.
[26] United States *Tax Reform Act of 1986* (H.R. 3838, 99th Congress; Public Law 99-514).
[27] Joint Committee on Taxation *Staff Paper on the Tax Reform Act of 1986*.
[28] United States *Jobs and Growth Tax Relief Reconciliation Act of 2003* Pub. L. No. 108-27, 117 Stat. 752 (May 28, 2003) (2003 Tax Act).

the assets described in IRC section 1221 or 1231 (assets used in the taxpayer's trade or business) are excluded from the definition of 'gross receipts' as follows:

> (a) **In general**
>
> For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
> (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business; …
> (6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless—
> (a) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and
> (b) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);
> (7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or
> (8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.[29]

IRC section 1221 therefore specifically excludes any commodity derivative financial instruments[30] held by a commodities dealer,[31] unless an instrument can be specifically identified as having no connection with the business of the dealer.[32] There is therefore an onus

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[29] 26 US Code 1221, RC 5751.01(F)(2)(c).
[30] See B1221(a)(1)(B):
'(B) Commodities derivative financial instrument.
(i) In general. The term 'commodities derivative financial instrument' means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b) [26 USCS ß 1256(b)])), the value or settlement price of which is calculated by or determined by reference to a specified index'.
[31] See B1221(a)(1)(A):
'(A) Commodities derivatives dealer. The term 'commodities derivatives dealer' means a person who regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.'
[32] B1221(a)(6)(A), (B).

on the dealer to clearly identify such instrument on the day it was acquired, originated or entered into. It does not, however, exclude any other derivatives from capital treatment.

6.2.3. IRC section 1221 and the *Corn Products* vs *Arkansas Best* doctrines

Two landmark cases have featured prominently in the interpretation of the application of IRC section 1221. Both concern the latitude allowed by the court for the interpretation of IRC section 1221, and yet both, in trying to favour the intent of Congress, adopted divergent views: a 'slavish literalism and a brushing aside of formulations to reach what the Court rightly sensed to be the correct result'.[33]

Corn Products v Commissioner[34] concerned a business, Corn Products Refining, which manufactured products made from corn. The business was unable to store sufficient corn and found itself in an unfavourable market for its raw product (from which it produced corn sugar) in 1934 and 1936. This led to the practice of purchasing corn futures to ensure price stability. Having realised a profit of $680 000 on its futures in 1940 and a loss of $110 000 in 1942, the business claimed the proceeds were capital in nature, being a distinct activity from its core manufacturing or processing business. The Tax Court, the Court of Appeal and the US Supreme Court found otherwise. The courts found that the hedging activity was integral to the company's trade and therefore revenue in nature. To find otherwise would present the taxpayer with an opportunity to either sell the futures and realise a capital gain (with preferential tax rate treatment) or take physical delivery under the contract at a loss against its trading income, thereby reducing its tax liability.

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[33] M Grauer 'A case for congressional facilitation of a collaborative model of statutory interpretation in the tax area: Lessons to be learned from the *Corn Products* and *Arkansas Best* cases and the historical development of the statutory definition of "capital asset(s)"' (1996) *Kentucky Law Journal* 4.

[34] *Corn Prod Ref Co v Commissioner* 16 TC 395 (1951), 11 TCM (CCH) 721 (1952), supplemented by 20 TC 503 (1953), aff'd in part and review dismissed in part, 215 F.2d 513 (2d Cir. 1954), aff'd, 350 US 46 (1955).

This finding by the court spawned a hedging exception, known as the '*Corn Products* doctrine', which included a *business motive test* to distinguish between an investment or speculative motive and the core business engaged in. Although the decision was unfavourable to the taxpayer, it was used and broadened over the next 23 years to allow taxpayers to deduct losses against trading income, whereas capital gains were seldom challenged in court. This allowed a 'whipsaw' effect whereby the IRS was disadvantaged on both counts.[35]

Arkansas Best Corporation v Commissioner[36] resulted in a profound reversal, based on a narrow interpretation of the meaning of 'capital asset'.[37] The issue in this case was whether a corporate taxpayer is entitled to ordinary loss treatment for losses incurred on transactions in the capital stock of another corporation.

> In 1968, Arkansas Best, a diversified holding company, acquired 65 percent of the stock of National Bank of Commerce in Dallas, Texas (NBC). As the Dallas real estate market declined, so did the financial condition of NBC. The taxpayer sought to protect its business reputation by buying additional stock in an effort to prevent NBC's failure. The NBC stock became unmarketable. In 1975, the taxpayer sold a substantial portion of its NBC stock at a loss. On its 1975 tax return, the taxpayer claimed an ordinary loss deduction on the stock, and the IRS challenged the deduction. All parties agreed that the taxpayer's NBC stock fell within the capital assets definition in IRC §1221.2. As Arkansas Best Corporation was a holding company and earned income in the form of fees for management services and dividend income, rather than to trade in its holdings, the transactions could not qualify for the provisions applicable to securities dealers in terms of 26 USC §1236, which grants special recognition in this regard to securities dealers.[38]

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[35] See generally the discussions in Steven D Conlon & Vincent Aquilino *Principles of Financial Derivatives, US and International Taxation* (2000) B3.04[2][b]; Grauer (n 33); D Tolman 'The *Arkansas Best* decision: Taking *Corn Products* off the taxpayer menu' (1989) 8 *Virginia Tax Review* 705; and Cartee (n 8).

[36] *Arkansas Best Corp v Comm'r* 485 US 212 (1988).

[37] 'Whether these arguments have merit depends upon whether any of the Bank stock that Arkansas Best acquired can be characterized as not being a "capital asset" within the meaning of 26 USC §1221. This section establishes a general rule defining capital asset as "property held by the taxpayer" (whether or not connected with his trade or business) .... The corresponding federal regulation, 26 CFR § 1.1221-1(a) states that the term "capital assets" includes all classes of property not specifically excluded by section 1221. The property that section 1221 excludes from the general rule is (1) stock in trade or inventory; (2) business property subject to the depreciation allowance or real property used in business; (3) copyrights, literary or artistic compositions, and similar property; (4) business-related accounts or notes receivable; and (5) federal government publications. Because capital stock plainly does not fall into any of the last four categories, we consider only the first exception, 26 USC §1221(1), which excludes from "capital asset" stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business ... '. Ibid [217 II].

[38] A Kramer *Financial Products: Taxation, Regulation and Design* (1999) 24,007.

Arkansas Best argued that all the purchases of bank stock that it made after declaring that it would divest itself of the stock were made in the ordinary course of business. Distinguishing its concededly pre-August 1971 investment motives for buying the bank stock, Arkansas Best asserted that its subsequent purchases were intended to preserve its business reputation by preventing the bank from failing, and that losses incurred on the sale of the stock so acquired were ordinary business expenses that it could deduct in full from gross income. Arkansas Best effectively argued that its purpose or motive in acquiring or selling the stock determined its character. The court, unsurprisingly, disagreed. Mixed motives in the holding of stock by holding companies is not uncommon. The courts usually treat such assets as capital.[39] The Supreme Court found that 'the taxpayer's motivation in acquiring an asset is not relevant in determining whether that asset is capital or ordinary' and that there was no link between the transactions that were geared towards the protection of an investment and the business operations.[40]

In the judgment cited below, the effect of statutory definition within a framework of long-established common law is evident. What might be described as an attempt by lower courts to previously meld common law with statute, by inferring the intent of Congress, was swept away:

> We conclude that a taxpayer's motivation in purchasing an asset is irrelevant to the question whether the asset is 'property held by a taxpayer (whether or not connected with his business)' and is thus within §1221's general definition of 'capital asset'. Because the capital stock held by petitioner falls within the broad definition of the term 'capital asset' in §1221 and is outside the classes of property excluded from capital-asset status, the loss arising from the sale of the stock is a capital loss. *Corn Products Refining Co. v Commissioner*, supra, which we interpret as involving a broad reading of the inventory exclusion of §1221, has no application in the present context. Accordingly, the judgment of the Court of Appeals is affirmed. It is so ordered.[41]

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[39] Ibid 22 nn 10 and 13.
[40] *Arkansas Best Corporation* (n 36) 223.
[41] Ibid.

6.2.3.1 Impact on the capital/revenue treatment distinction

The narrow interpretation of what constitutes an ordinary transaction according to this case impacted negatively on the requirement that, for hedging purposes, a transaction had to be ordinary in nature. The Supreme Court effectively declared that the *Corn Products* decision did not provide a non-statutory 'business purpose' exception from capital asset treatment. The court explained the *Corn Products* interpretation as applying to a very narrow capital asset exception for transactions that were 'an integral part of the business inventory–purchase system', under the inventory exception for capital classification. This made many hedging transactions vulnerable to attack by the IRS, justified by the *Corn Products* doctrine, and resulted in uncertainties and inefficiencies in the market.[42] Section 1256(e)(2)(B) of the business hedging regulations sought, at least in part, to address these concerns.[43]

Businesses that may wish to avoid the storage of physical goods in anticipation of seasonal demand, for example, may purchase long positions in commodities (sold in the ordinary course of their business), but the transaction does not constitute a hedge as they do not reduce risk, nor do they receive ordinary treatment as a 'surrogate for inventory'.[44]

The antagonism[45] in the judgment towards the progeny of the *Corn Products* doctrine may be traced to the appellate court's approach to interpretation, which sought to divine the intention of those involved in passing the law. The *Arkansas Best* decision requires a literal application of the statute. In this sense, this case represents a clash of two doctrines of

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[42] Conlon & Aquilino (n 35) B3.04[2][c], B3-27.
[43] Ibid B1-41.
[44] Ibid B3.04[3][g], B3-37.
[45] '*Corn Products* and its progeny, which we respectfully view as misbegotten, have done precisely that, leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock. Congress could have written section 1221 to incorporate some sort of exception regarding capital stock, just as it recognized the unique position of securities dealers in 26 USC §1236, but it did not do so. We believe that the judiciary lacks authority to create exceptions to section 1221 that Congress did not choose to make'. See *Arkansas Best v Comm'r* (US) 485 US 212 (1988) [22].

interpretation.[46] This decision effectively concluded that 'the *Corn Products* doctrine never existed … This provided the Service the opportunity to challenge the character of a wide range of hedging transactions … causing ongoing inefficiencies in the federal taxation of hedging transactions'.[47]

The Solicitor General, in his brief on behalf of the IRS, referred to the *Corn Products* doctrine as a 'frolic by the lower courts'.[48] The Supreme Court stated that the *Corn Products* doctrine should be limited to narrow application where hedging transactions 'that are an integral part of an "inventory purchase system" fall within the inventory exclusion in IRC §1221.'[49]

This ruling by the Supreme Court caused much practical difficulty for financial services companies and corporate treasuries that used hedging as part of their business, unrelated to inventory.

The Treasury eventually responded to the confusion raised by *Arkansas Best* by issuing business hedging regulations under Treasury Regulation §1.1221-2. In addition, statutory amendments have been made to IRC §1221 to 'clarify' that business hedges and the positions of derivatives dealers, and 'supplies' obtain ordinary income or loss.[50]

While I am less concerned with the doctrine of interpretation here, the following aspects are of practical interest:

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[46] 'The underlying purpose of section 1221 and its legislative history reinforce our conclusion. According to H.R. Rep. 704, 73d Cong. 2d Sess. (1934), the purpose of the tax code amendments, part of which defined "capital asset", was to increase revenue by preventing tax avoidance. … Elsewhere, the report specifically refers to the definition of capital asset: "It will be noted that the definition includes all property, except as specifically excluded". … See dissenting opinion by Hanson, "It appears to me, however, that *Corn Products* was merely an attempt to *divine congressional intent*. As such, it is a compelling rejoinder to those who believe "that legislative draftsmen and the tax-writing committees of the Congress are the most desirable forum for illuminating a subject matter they themselves made obscure and interminable".'

[47] See Conlon & Aquilino (n 35) B3.04[2][d], B3-28.

[48] See Kramer (n 38) 24,008 n 31. Brief for the Respondent at 37, *Arkansas Best Corp. v Comm'r* (n 36) 274.

[49] Kramer (n 38) 24,009.

[50] Ibid. See footnote 39, IRC sections 1221(a)(6) to (8). See, eg, Staff of the Joint Committee on Taxation, 106th Cong, 1st Sess, Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal 132 (Joint Comm Print 1999); Treasury Summary of Tax Simplification Plan, Including T3, 97 TNT 72-16 (15 April 1997).

a) In both cases the courts were trying to protect the fiscus, which in both cases led to unintended consequences: in the case of *Corn Products*, a whipsaw effect for the fiscus on losses, and in the case of *Arkansas Best*, a contrived result that narrowly favoured IRC section 1221, to the exclusion of business reality in many instances, requiring statutory amendment.

b) From a purely doctrinal standpoint, the cases overturned the *intent test* which features so prominently in determining the facts of the case in income character determinations (the dominant doctrine in South Africa).

c) The cases overturned the *business purpose* doctrine, which is now enshrined in Accounting Standard IFRS 9.

d) In 1999, Congress amended section 1221 to include business hedging transactions as exceptions to the definition of capital.[51]

6.3 CHARACTER: DEFINED BY THE PURPOSE OF THE TAXPAYER

In the USA, a distinction is drawn between *traders*, *dealers* and *investors*. An *investor* is someone who typically holds capital assets with a view to appreciation over a long term (generally longer than 12 months).[52] A *dealer*, on the other hand, holds assets as inventory, which is on-sold to customers. *Traders* lie somewhere in between the two groups. A taxpayer may qualify for simultaneous characterisations based on different instruments.[53]

6.3.1 Dealer – the 'to customers' requirement

The concept of a securities dealer in the USA is a combination of deductions as expected in the ordinary course of business and, yet, a characterisation of 'capital' is given to his or her trading

[51] See Joint Committee on Taxation *Description of the Modernization of Derivatives Tax Act of 2017* (2017) 14.
[52] IRC sections 1(h)(1), 1222(3), 1222(4).
[53] Joint Committee on Taxation *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (2011) 14.

stock. This is the product of a legislative amendment in 1934 to the capital asset statute, which excludes rather than defines capital assets as follows:

> §1221. Capital asset defined
>
> (a) In general. For purposes of this subtitle [26 USCS §§1 et seq.], the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include:
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.[54]

This 1934 legislative amendment[55] results in the character of income not being defined by whether a trade or business is being engaged in by the taxpayer, but rather by exclusion from the definition of 'capital asset' as defined. An examination of the Conference Report indicates that it was a measure motivated by Congressional concerns (no doubt following the 1929 crash) that the State was vulnerable to 'stock traders (or "speculators" as they were then called) from contending that they were eligible for ordinary gain and (more pertinently) ordinary losses from their trading activities'.[56]

While it is important to note this legislative exception so as to understand the thinking of the courts, it is of course a legislative intervention to sidestep a natural logic that applied before[57] and thus create a policy 'carve out'. Whether the taxpayer is marking up stock (securities) for on-selling to others as a securities dealer or holding them as trading inventory in a business of securities dealing for his or her own account seems to be equivalent in concept. In both cases those assets seem to represent working capital, were it not for the 'to customers'

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[54] IRC section 1221.
[55] United States *Revenue Act of 1934* Pub L. No. 73-216, ß 117(b), 48 Stat 680, 714 (1934). See S Oei 'A structural critique of trader taxation' (2008) 8(10) *Florida Tax Review* 1113.
[56] Oei (n 55) 1040.
[57] See *Schwinn v Commissioner*, which was decided before 1934, where it was referred to as inventory. Oei (n 55) 1040.

requirement of IRC section 1221. Attempts to argue that counterparties were 'customers' have failed in the courts.[58]

6.3.2 Trader

A trader 'devotes a major portion of his time to speculating on the stock exchange',[59] as first defined in *Snyder v Comm'r* in 1935, but does not have clients.[60] Unlike the case in South Africa, designation as a trader affords the taxpayer preferential tax treatment, whereby the assets are held on capital account, yet various expenses attributable to the trading are deductible.[61] Traders are also allowed an election under IRC section 475(f) whereby they can be subject to a 'mark-to-market' taxation of gains and losses from their securities dealing on the last business day of the tax year, and they can convert such gains or losses to ordinary rather than capital proceeds.[62] The IRC does not define the term 'trade or business'.[63] Therefore, the issue of qualifying for the status has been examined by the US courts over the decades.[64] As

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[58] Oei (n 55) n 137: 'See, e.g., *Archaya*, 225 F.App'x 391 (7th Cir. 2007) (Fed. R. App. P. 32.1 nonprecedential disposition) (taxpayer argued that the people who bought the securities he had sold were "customers"); *Marrin*, 73 TCM (CCH) at 1751 (taxpayer argued that the broker-dealers were his customers, or, alternatively, that the customers of the broker-dealers were his customers under agency law); see also, generally, *Groetzinger*, 480 US at 33-34 n.12 (citing Boyle, What is a Trade or Business? 39 Tax Lawyer 737, 763 (1986) ("It takes a buyer to make a seller and it takes an opposing gambler to make a bet").'

[59] *Snyder v Comm'r* 295 US 134 (1935) at 139 (citing *Schwinn v Comm'r* 9 BTA 1304 (1928); *Elliott v Comm'r* 15 BTA 494 (1929); *Hodgson v Comm'r* 24 BTA 256 (1931); *Schermerhorn v Comm'r* 26 BTA 1031(1932)). See Oei (n 55) n 20.

[60] B Bittker & L Lokken *Federal Income Taxation of Income, Estates & Gifts* 3 ed (2005) 47.2 ('the terms "dealer" and "trader", which do not appear in ß 1221(a)(1) itself, are simply labels – the "dealer" referring to a taxpayer who holds securities for sale to customers in the ordinary course of a trade or business and the "trader" to a taxpayer who does not have "customers" even though he or she buys and sells securities with great frequency'). See Oei (n 55) n 23.

[61] These include 'all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business' in terms of IRC section 162; interest deductions under IRC 163; the depreciation of property under IRC section 179(a); start-up expenses under IRC section 195; home office deductions under IRC section 280A(a); and various other deductions such as depreciation and net operating loss deductions. See Oei (n 55) 4 and 5.

[62] Oei (n 55) 2.

[63] *Commissioner v Groetzinger* 480 US 23 at 27 (1987); *Estate of Yaeger v Commissioner* 889 F.2d 29 at 33 (2d Cir. 1989).

[64] Oei (n 55) nn 21 and 22. *Comm'r v Groetzinger* 480 US 23 at 33–4 (1987) (noting Justice Brandeis' '[implication] that a full-time trader may qualify as being in a trade or business'. In this instance the taxpayer was a full-time gambler); *Higgins v Comm'r* 312 US 212 (1941); *Chen v Comm'r* 2004 TCM (RIA) 2004-132; *Archaya v Comm'r* No. 9461-05 (7th Cir. 2007) (Fed. R. App. P. 32.1 non-precedential disposition).

categorisation as a trader in the US affords favourable tax treatment,[65] the burden of proof is that much more onerous than in South Africa, where it is often petitioned against, because of the tax differential between capital and revenue income. The following essential tests are used by the courts to determine whether a taxpayer is 'engaged in a trade or business':[66]

6.3.3 Frequent, regular and continuous securities trading

In *Fuld v Commissioner*,[67] a brother and sister changed their intention from investing to trading in October 1930. The Commissioner, however, refused to allow the offsets on the ground that the losses resulted from the sale of capital assets and were, therefore, capital and not ordinary losses:

> From 1930 and during 1933 Leonhard Fuld devoted an average of eight hours per day to the study of new texts, reading services, charting prices of securities, conferring with his broker, attending meetings of corporations in which he owned securities, and consulting with corporate executives …. He spent about one or two hours per day at the broker's office. Florentine Fuld similarly … The main source of livelihood of both petitioners was from their securities transactions. They maintained no business office, had no customers to whom they might sell securities, practically never sold securities short, and never advertised or held themselves out to the public as dealers. However, Leonhard Fuld was registered with the Securities Exchange Commission as a dealer and as an investment counselor and was listed in the stock directories throughout the United States. … Some of the securities held by petitioners for more than 2 years and sold in 1933 were acquired prior to the beginning of their new policy, October 9, 1930, and some of such securities were acquired subsequent to that date. In 1933, Leonhard Fuld made approximately 249 sales of securities held for more than 2 years and approximately 98 held for 2 years or less. Also, in the same year Florentine Fuld made approximately

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[65] Such as IRC section 162 trade or business deductions, IRC section 280A home office deductions, unlimited interest deductions under IRC section 163, the election to deduct 'section 179 property', the election to deduct start-up expenses under IRC section 195, and the mark-to-market election under IRC section 475(f). 'See, e.g., *Yaeger*, 889 F.2d at 29 (finding that taxpayer was an investor not engaged in a trade or business meant that he was subject to the IRC ß 163(d) investment interest limitation); *Paoli*, 62 TCM (CCH) 275 (same); *Hart*, 73 TCM (CCH) 1684 (same); *Boatner*, 74 TCM (CCH) at 345 (determination that taxpayer was not engaged in the trade or business of buying and selling stock meant that he was not eligible for business deductions but rather had to itemize deductions); *Moller*, 721 F.2d 810 (finding that taxpayer was an investor and not in the "trade or business" resulted in disallowance of IRC ß 280A home office expense deductions); Cameron, 2007 TCM (RIA) 2007-260, 94 TCM (CCH) 245 (taxpayer who was an investor, not a trader, was disallowed IRC ß 162 trade or business deduction); *Mayer v Commissioner*, 67 TCM (CCH) 2949 (same)'. Ibid at 10 and note 112 respectively.

[66] The Internal Revenue Code does not define the term 'trade or business'. Although the term 'engaged in a trade or business' appears in the Code, it is not defined.

[67] *Fuld v Comm'r* 139 F.2d 465 (2d Cir. 1943), aff'g 44 BTA 1268 (1941).

> 229 sales of securities held for more than 2 years and approximately 89 held for 2 years or less. The sales of both petitioners ranged as high as 1,000 shares per transaction.

The tax court found that from October 1930 until 1933, the taxpayers were indeed 'engaged in the business of trading in securities'. The court therefore emphasised the continuity, dedication and intensity of their activities, as well as their reliance on this as a sole source of income.

In *Chen v Commissioner*,[68] the taxpayer did not qualify as a 'trader in securities'. The taxpayer conducted 94 per cent of his securities trades during only three months of the year, and he held a full-time job; accordingly, the taxpayer could only deduct $3,000 of his net loss.

In *Mayer*,[69] citing *Higgins v Commissioner*,[70] the court reiterated that even 'full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business".' The fact that the taxpayer had substantial investments, devoted considerable time to the oversight of investments and maintained two offices, one in New York and the other in Paris, employing an office manager, accountant, an assistant and a clerk in New York and a staff member in Paris, did not in the opinion of the court amount to a trade or business. 'Thus, we find that despite the scope and extent of his activity,[71] Mr. Mayer was an investor, not a trader.'[72] He merely had a very well-resourced investment management operation for his own account. No matter how extensive these managerial activities were, they did not amount to carrying on a business.

In *Cameron v Commissioner*,[73] the taxpayer began trading a portfolio of shares after a car accident rendered him unable to work. However, because the volume of trades was not

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[68] *Chen v Comm'r* No. 1271-03 , UNITED STATES TAX COURT, TC Memo 2004-132; 2004 Tax Ct. Memo LEXIS 131; 87 TCM (CCH) 1388, June 1, 2004, Filed.
[69] *Mayer* 67 TCM (CCH) 2949 at 2949-4 to 2949-5 (1994).
[70] *Higgins v Commissioner* (n 65) 213.
[71] Over 1,100 executed sales and purchases in each of the years in issue.
[72] *Mayer* (n 69) 2950.
[73] *Cameron v Comm'r* 2007 TCM (RIA) 2007-260 at 1510.

viewed as substantial, that is 'frequent, regular, and continuous', the court found in favour of the respondent.

The above cases illustrate that in the USA, unlike in South Africa, there is an onerous burden of proof to establish the status of a trader or, more descriptively, a taxpayer who runs a business of share dealing for his or her own account. Oei pointed out that the exact level of trading activity is not clear and that the hurdle set by the courts is substantial: 'proving that one's investment activities rise to the level of carrying on a trade or business is a difficult hill to climb'.[74] The only guidance from the Service is found on Form 1040[75] and Publication 550,[76] where the qualifications for successful categorisation are given as follows:

> You are a trader in securities if you are engaged in the business of buying and selling securities for you own account. To be engaged in business as a trader in securities:
>
> - You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
> - Your activity must be substantial.
> - You must carry on the activity with continuity and regularity.
> - The following facts and circumstances should be considered in determining if your activity is a business:
>   - Typical holding period for securities bought and sold
>   - The frequency and dollar amount of your trades during the year
>   - The extent to which you pursue the activity to produce income for a livelihood
>   - The amount of time you devote to the activity.
> - You are considered an investor, and not a trader, if your activity does not meet the above definition of a business. It does not matter whether you call yourself a trader or a 'day trader'.

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[74] See Federal Tax Coordinator (RIA) 2d at section L-1112 ('[p]roving that one's investment activities rise to the level of carrying on a trade or business is a difficult hill to climb), cited by Oei (n 55) n 100.
[75] Internal Revenue Service, Department of the Treasury, 2002 1040 Instructions D-3 (2002), available at http://www.irs.gov/pub/irs-pdf/i1040.pdf. See GP Schwartz 'How many trades must a trader make to be in the trading business?' (2003) *Virginia Tax Review* 429 n 186.
[76] Internal Revenue Service, Department of the Treasury, Publication 550: Investment Income and Expenses 68 (2002), available at http://www.irs.gov/pub/irs-pdf/p550.pdf. See Schwartz (n 75) 429 n 189.

6.3.4 The nature of the income derived from the activity and intent

In *Deputy v Pont*,[77] Justice Frankfurter held that 'trade or business' implies 'holding one's self out to others as engaged in the selling of goods or services'. In the US context of 'trader' this would imply that no amount of trading, no matter how frequent or extensive, would qualify the taxpayer. However, the court rejected this interpretation, implying that one can be engaged in a trade or business without doing so on behalf of others. This makes logical sense, since the individual is trading with others via the market, in the business of securities trading, as one would be in the market for the trading of a commodity. In *Groetzinger*,[78] a case that involved a gambler, the court expressed itself as follows:

> If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges .... . We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit.[79]

The comparisons are clearly drawn, although ironically here, for a case involving a gambler. Even though Groetzinger was not a casino operator or placing bets on behalf of others, he engaged in gambling via the market as a 'trade or business' for his own account. He did not have to take bets on behalf of clients or operate a casino or exchange. A taxpayer can therefore have income that is in its nature 'business' income, without that impinging on what might be considered extensive professional self-management of the taxpayer's investment portfolio.[80] The key to the distinction is therefore *intention*, with the facts merely illustrating intent.

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[77] 308 US 488 (1940). See Schwartz (n 75) n 186.
[78] *Groetzinger* 480 US paras 27, 33–6.
[79] Ibid para 33.
[80] *Higgins v Commissioner* (n 65).

6.4 CHARACTER: DEFINED BY THE HOLDING PERIOD

In *Yaeger v Commissioner*[81] the taxpayer had initiated over 2,000 securities transactions in 1979 and 1980. He had done so 'vigorously and extensively'. However, the court noted that most of the taxpayer's securities were held for longer than a year, and he did not sell any securities held for less than three months. His profits were by nature[82] dividends, interest and capital appreciation (as a consequence of the holding period).[83] The court found that the holding periods were unacceptably long and that the taxpayer was not trying to 'catch the swings in the daily market movements and profit thereby on a short-term basis'.[84] Clearly, this distinction amounts to one of degree. How degree is defined seems to be greatly influenced by the advantage that the legislation affords the taxpayer. If that position is favourable for the taxpayer, proving that he or she is a trader becomes a hard hill to climb.

6.5 CONCLUSION

The US treatment of derivatives provides an interesting policy contrast to a pure 'facts and circumstances' determination as to whether a 'scheme of profit-making' exists.[85] Capital assets are defined by exclusion in statute,[86] and yet this has not limited litigation, as seen in the *Corn Products* and *Arkansas Best* cases. The contrasts between *Yaeger v Commissioner, Cameron v Commissioner, Mayer, Chen v Commissioner* and the South African case *CIR v Nussbaum*, discussed in chapter 5, make for interesting countervailing perspectives, no doubt influenced by legislative context rather than the facts and circumstances associated with common-law principles.

Furthermore, the generally accepted US principle that the nature of the derivative follows the underlying asset seems clear enough at first, but soon becomes ensnared in exceptions, such as the straddle rules in section 1092, the business hedging rules in section 1221, the short sale

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[81] *Yaeger v Commissioner* 92 TC 180 (TC 1989).
[82] See also *Moller v Commissioner* 721 F.2d 810 where 98 per cent of the taxpayer's income constituted interest and dividends. See Oei (n 55) 9.
[83] Ibid. *Yaeger* 889 F.2d at 34.
[84] Ibid.
[85] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[86] Section 1221.

rules in section 1233, the conversion rules in section 1258, and the constructive sale rules in section 1259, which are but some examples. Notwithstanding all these exceptions which try to capture market developments and protect the fiscus through anti-avoidance rules, the measures inevitably seem inadequate and late in design and promulgation. By way of example, a 2014 US Senate investigation[87] into the abuse of structured products by Barclays Bank PLC and Deutsche Bank AG found that the two banks had sold what were called 'basket options' to 13 hedge funds in securities transactions, totalling $100 billion and trading profits of $34 billion, where many of the transactions lasted only seconds[88] and most used the structure to recharacterise short-term gains as long-term. The concluding remarks in the report point to the fact that these are not isolated examples:[89]

> [T]he financial sector and the corporate community are using derivatives to try to achieve a variety of favorable outcomes in accounting, tax, financial, and other regulatory contexts, even when the derivative instruments mimic economic activities that by themselves yield different results. Two examples have been highlighted in this report. Congress and the appropriate agencies should closely examine the growing use of derivatives to circumvent accounting, tax, or regulatory rules, and what steps should be taken to prevent disparate outcomes, particularly when they may pose a threat to the transparency, safety, soundness of our financial system or the economy as a whole.[90]

The two banks started selling these products in 1998 and 2002.[91] The abuse was identified in 2010 and the investigation report cited above was dated 2014. At this point none of the

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[87] US Senate Permanent Subcommittee on Investigations Reports and Hearings *Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits* (30 September 2014).
[88] Ibid 3: 'In some cases reviewed by the Subcommittee, the investment advisor used algorithms to engage in a high volume of trading, executing more than 100,000 transactions per day. Many of those trading positions lasted minutes, and the overall composition of the securities basket changed on a second-to-second basis. One basket option account later reviewed by the U.S. Securities and Exchange Commission (SEC) was found to have experienced 129 million orders in a year. In other cases, the investment adviser purchased securities whose positions remained unchanged for weeks, but all of the basket option accounts reviewed by the Subcommittee were dominated by short-term trading involving assets held less than one year.'
[89] Ibid. See US Senate Permanent Subcommittee on Investigations Reports and Hearings *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions* S. Prt.107-82 (1/2/2003) n 503; 'U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals' S. Hrg. 108-473 (11/18 and 20/2003); 'Tax Haven Abuses: The Enablers, the Tools and Secrecy' S. Hrg 109-797 (8/1/2006); 'Tax Haven Banks and U.S. Tax Compliance' S. Hrg. 110-614; 'Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends' S.Hrg. 110-778 (9/11/2008).
[90] US Senate Permanent Subcommittee (n 87) 91.
[91] Ibid 2.

evaded taxes had been recovered. This practically illustrates why there have been calls for a complete revision of the tax code on derivatives.[92] The currently favoured approach seems to be a broadening of the mark-to-market methodology currently applied to dealers, which would in effect create a deemed realisation event every tax year for these instruments.[93]

[92] See Joint Committee on Taxation *Description of the Modernization of Derivatives Tax Act of 2017* n 2: 'For additional reading regarding the issues discussed herein, see, for example, American Bar Association Section of Taxation, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," 2011; Eric Toder and Alan D. Viard, "Replacing Corporate Tax Revenues with a Mark-To-Market Tax on Shareholder Income," National Tax Journal, Vol. 69(3), 2016; Alex Raskolnikov, "Taxation of Financial Products: Options for Fundamental Reform," Tax Notes, Vol. 133, 20 I I, p. 1549; Reed Shuldiner, "A General Approach to the Taxation of Financial Instruments," Texas Law Review, Vol. 71, 1992, p. 243; David A. Weisbach, "Tax Responses to Financial Contract Innovation," Tax Law Review, Vol. 50, 1995, p. 491; Alvin C. Warren, Jr., "Financial Contract Innovation and Income Tax Policy," Harvard Law Review, Vol. 107, 1993, p. 460.'

[93] See Joint Committee on Taxation (n 92).

CHAPTER 7

UNITED KINGDOM: LEGISLATIVE AND REGULATORY OUTLINE

7.1 FINANCIAL REGULATORY FRAMEWORK IN THE EUROPEAN UNION AND THE UNITED KINGDOM

Notwithstanding the UK's exit from the EU following the referendum of 23 June 2016, it is relevant to consider UK regulation within an EU context as it will still have to provide some form of equivalence to enable business within Europe. Financial regulation is increasingly determined within economic groupings, such as the G20, of which South Africa is a member. The Financial Stability Board has a central influence over regulatory norms and members are expected to conform to retain their membership.

For members of the EU, regulatory development is influenced by directives, which frame best practice or principles as agreed at a collective level, but are of no legal effect until transposed in some version within domestic legislation. A four-level legislative process for the development of financial services legislation, known as the Lamfalussy approach,[1] is applied. Key EU institutions include:

1. the European Community, which represents the interests of the EU in its entirety, and has the sole right to propose new legislation;
2. the Council of the European Union, which represents the interests of the member states; and
3. the European Parliament, which represents the interests of EU citizens and is elected by them.[2]

[1] Named after its proposer, Alexandre Lamfalussy.
[2] P Dickson *The Asset Management Review* (2012) 2.

Macro-prudential oversight is provided via the European Systemic Risk Board and micro-prudential financial supervision is conducted through three pan-European Supervisory Authorities:

1. the European Banking Authority (EBA);
2. the European Insurance and Occupational Pensions Authority (EIOPA); and
3. the European Securities and Markets Authority (ESMA).

What began as purely advisory powers by the EU committees have evolved to include binding powers over member states under certain circumstances.[3] Examples of directives that have been transposed into domestic legislation, all falling under a like naming convention within Europe, include the Markets in Financial Instruments Directive (MiFID or MiFID II from 3 January 2018) and the Undertakings for Collective Investments in Transferable Securities (UCITS) regime. The European Market Infrastructure Regulation (EMIR) was published in 2011 and deals with OTC derivative clearing and trade repository regulation.[4] The Markets in Financial Instruments Regulation (MiFIR) was also published in 2011, with the intention of bringing derivative trading onto multilateral trading platforms that would improve price disclosure.[5] Coupled with EMIR, this provides for a more orderly alignment within the market through better price discovery, regulatory visibility and trading, and legal settlement synchronisation. These initiatives are aimed at harmonising the legislative and regulatory systems, which provide for the portability of products within the EU and some parity of regulatory standards, although application across Europe can vary significantly in practice. Prudential standards such as Basel III for banks and Solvency II for insurers are aimed at shoring up capital structures after the 2008 crisis and ensuring better risk management. As a matter of interest and relevance, South Africa, as a member of the G20, subscribes to these

[3] Ibid 3.
[4] A Hudson *The Law on Financial Derivatives* 6 ed (2018) 3-27.
[5] Ibid 3-56.

standards within a permitted national discretion. With respect to derivatives, the European Regulation on short selling[6] and credit default swaps was published in the Official Journal on 24 March 2012 and took effect on 1 November 2012. This EU Regulation does not require any transposition into national law and is aimed at harmonising short-selling across the EU for the first time.[7] The Financial Services and Markets Act 2000 (FSMA 2000) is the central statutory instrument governing the law of finance in the UK.[8]

On 31 January 2020, the UK exited the European Union. Negotiations on the terms of that exit continue during the 2020 transition period until 31 December 2020. The potential failures of retained EU law need to be reviewed to ensure the effective operation of financial services and markets. Much of this is centred on how equivalence can be maintained. Whereas the European Commission fulfils the function of determining equivalence for countries, Her Majesty's Treasury will in future be responsible for making these determinations. Amending regulations for the entire breadth of financial sector legislation needs to be considered under the European Union (Withdrawal) Act 2018 (EUWA 2018).[9]

7.2 TAX LAW WITHIN THE EUROPEAN UNION

By contrast, there is as yet no tax harmonisation across EU member states affecting the policy and legislative independence of the various jurisdictions, due to the discretion afforded to member states. Directive 2013/34 of the European Parliament and Council regulates the taxation of financial instruments, including derivatives.[10] Fair value accounting is the chosen

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[6] The practice of selling a share or other instrument that one does not own in the expectation that the price will drop.
[7] Dickson (n 2) 35 and 36.
[8] Hudson (n 4) 4-01.
[9] Explanatory Memorandum, Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020, No 628, para 2.4.1.
[10] Amending Directive 2006/43/EC and repealing Directives 78/660/EEC and 83/349/EEC. See A Nesvetailova et al 'Tax evasion and avoidance through financial engineering: The state of play in Europe' Coffers EU Horizon 2020 Project (2018) 50.

basis of taxation within the EU, which includes derivatives, according to Articles 8, 16 and 17. However, Articles 4, 5 and 6 allow exceptions to the general principle in member states, resulting in differences in application A recent EU-funded study examining tax evasion and avoidance concluded that 'the EU's position on the taxation of derivatives deployment by companies remains highly varied across the block, with main expertise driven by the industry itself, and with many existing provisions allowing considerable discretion to the companies and member states.'[11] The OECD and G20's Base Erosion and Profit Shifting (BEPS) project, initiated in 2013, was intended to reduce regulatory divergences that provided opportunities for tax manipulation by corporations. However, this EU-funded study[12] finds that BEPS has tended to be more concerned with the transactional form of international money flows as opposed to the economic positions that they reflect and does not explicitly deal with financial engineering:

> Despite the relative appreciation and success that BEPS has enjoyed to date, as far as we can estimate, BEPS does have a potentially major blind spot in its scope. That is the issue of sophisticated financial instruments put to use by MNCs for tax planning purposes. BEPS itself makes no mention, for instance, of financial derivatives, which are, as argued above, part and parcel of the financial toolkit that MNCs deploy in managing the various international risks to which they are exposed.[13]

7.3 TAX LEGISLATIVE FRAMEWORK

7.3.1 General derivative treatment

> Whereas regulatory authorities and governments in the EU, the US and the UK have taken many years to begin the work of regulating derivatives, the taxing authorities in the UK ('HMRC') have long addressed the problem, to their eternal credit.[14]

Previously the UK had a schedule-based tax system, with various categories of income set out on six separate schedules. The Tax Law Rewrite project, which began in 1997, sought to

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[11] Ibid 52.
[12] Ibid.
[13] Ibid 43.
[14] Hudson (n 4) 18-03.

improve consistency and simplify the system. Inland Revenue Technical Note, dated 8 November 2000, notes a marked and notable shift in tax policy with the Finance Acts of 1993, 1994 and 1996, the policy of which was to bring profits on debt and debt-based products into income taxation, while leaving gains on shares and equity-linked instruments within the capital gains rules:[15]

> [The Acts] effected a revolution … [They] abolished a cornerstone of UK tax law – the distinction between capital and revenue – in taxing profits from these instruments. It started the trend … of tying the tax result much more closely to the profit figure revealed in a company's [financial] accounts.[16]

Derivative contract tax legislation is now contained in the Corporation Tax Act (CTA) 2009, as amended by the Finance (No. 2) Act 2015 and by the Finance (No. 2) Act 2016.[17] Derivative contracts are catered for in Part 7 of CTA 2009 and are defined as:[18]

(a) an option;

(b) a future; or

(c) a contract for differences.

The principle in the derivative tax code is that gains and losses are ordinarily treated as income.[19] A taxpayer who uses derivatives as stock in trade as part of a business (eg a dealer) would include the income for corporation tax purposes under the general provisions in Part 3 of the CTA 2009.[20] Non-trading derivatives are included as 'loan relationships' under Part 6 of the CTA 2009.[21]

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[15] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 370.
[16] Ibid 64 and 65.
[17] Hudson (n 4) 931.
[18] Section 577. These terms are defined in ss 580, 581 and 582 respectively.
[19] Corporation Tax Act 2009, s 571(1); Hudson (n 4) 18–19 n 12.
[20] Corporation Tax Act 2009, s 573; Hudson (n 4) 18–19 n 14.
[21] Corporation Tax Act 2009, s 574; Hudson (n 4) 18–19 n 15.

Section 412(2) of the Financial Services and Markets Act 2000 (FSMA) defines these contracts very similarly to the tax code, while the tax code has its own internal logic that is distinct from regulation. The FSMA defines derivatives as follows:

> This section applies to a contract if:
> a. it is entered into by either or each party by way of business;
> b. the entering into or performance of it by either party constitutes an activity of a specified kind or one which falls within a specified class of activity; and
> c. it is related to an investment of a specified kind or one which falls within a specified class of investment.[22]

Specific exclusion in section 412(1) states that these instruments are not 'void or unenforceable because of s. 18 of the Gaming Act 1845'[23] to avoid a contention that 'two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other … a sum of money.'[24]

Southern[25] pointed out that under section 576 of CTA 2209, in relation to a company, a 'derivative contract' is a 'relevant contract' which either:

1. satisfies the accounting test; or
2. though it does not satisfy the accounting test, is nevertheless classified a derivative contract.

The following components must be present:

1. an agreement;
2. contractual intention; and
3. consideration.

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[22] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 64.
[23] Ibid.
[24] *Carlill v The Carbolic Smoke Ball Company* (1892) 2 QB 484 at 490, per Hawkins J; D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 64.
[25] D Southern 'The taxation of derivatives' (1998) 4 *British Tax Review* 348–63 at 357 and 358.

These must be binding on the company and must be accompanied by sufficient evidence. Section 577 states that a 'relevant contract' is:

1. an option;
2. a future; or
3. a contract for differences.

In terms of sections 589 to 593 of CTA 2009, contracts excluded by legislative design are futures and options over intangible fixed assets, contracts where the underlying subject matter consists of shares,[26] or the rights of a unit holder under a unit trust scheme.[27] Section 591(2) to (6) sets out the defining qualifications relating to the application of the instrument:[28]

a. plain vanilla contracts held by a life assurance company which are approved derivatives for the purpose of Rule 3.2.5. of the Insurance Prudential Sourcebook;
b. equity derivatives held for non-trading purposes which are in a hedging relationship;
c. quoted warrants entered into or acquired for non-trading purposes;
d. equity derivatives acquired or held for non-trading purposes which are options or futures to acquire shares in a company, and the shares to be acquired or delivered constitute a substantial shareholding;
e. there is a hedging relationship between the relevant contract and a loan relationship with an embedded derivative.

Sections 661 and 662 of CTA 2009 provide that contracts whose underlying asset is units in unit trusts and open-ended investment companies (OEICs) are also excluded to make them chargeable assets within the capital gains tax regime, as with the above.[29]

The general rule for UK corporation tax purposes is that all profits accruing to a company from its derivative contracts are chargeable to corporation tax as income in accordance with this Part. Chapter 7 identifies certain assets (property, certain tangible movable property and

[26] Corporations Tax Act 2009, s 591.
[27] Corporations Tax Act 2009, s 589(2).
[28] D Southern 'The taxation of derivatives' (1998) 4 *British Tax Review* 348–63 at 361.
[29] Ibid 360 and 361.

creditor relationships, in terms of section 641) as exclusions to that general principle. Sections 633 to 638 exclude certain entities from inclusion in the concept of trading income (the basis for corporations tax): mutual trading companies, insurance companies, investment trusts and venture capital trusts. Chapter 3 deals specifically with investment vehicles. OEICs, unit trusts and offshore funds fall outside of the CTA on the proviso that a 'qualifying investment purposes' test is passed.[30] This test is one of proportionality (60 per cent) for 'qualifying investments', defined as follows in section 494:[31]

> In Section 493 'qualifying investments', in relation to an open-ended investment company, a unit trust scheme or an offshore fund, mean investments of the company, scheme or fund of any of the following descriptions—
>
> (a) money placed at interest,
>
> (b) securities,
>
> (c) shares in a building society,
>
> (d) qualifying holdings in an open-ended investment company, a unit trust scheme or an offshore fund,
>
> (e) alternative finance arrangements,
>
> (f) derivative contracts whose underlying subject matter consists wholly of any one or more of—
>
> (i) the matters referred to in paragraphs (a) to (e) (other than diminishing shared ownership arrangements), and
>
> (ii) currency,
>
> (g) contracts for differences whose underlying subject matter consists wholly of any one or more of—
>
> (i) interest rates,
>
> (ii) creditworthiness, and
>
> (iii) currency, and
>
> (h) derivative contracts not within paragraph (f) or (g) where there is a hedging relationship between the contract and an asset within paragraphs (a) to (d).

[30] Corporations Tax Act 2009, ss 493–496.

[31] See Her Majesty's Revenue and Customs (HMRC) 'Modernising the taxation of corporate debt and derivative contracts' Consultation document (6 June 2013) 78 para 13.7.

Table 7.1: Key statutory provisions for computing income (Part 7 Derivative Contracts)[32]

Section	Subject
576 and remainder of Chapter 2	Meaning of derivative
572	Profits and losses to be calculated
573	Trading credits and debits
574	Non-trading credits and debits to be brought into account
Part 3	OEICS, Unit Trusts and Offshore Funds
Part 7	Chargeable gains arising in relation to derivative contracts

7.4 LEGISLATIVE APPROACH IN PRACTICE

Her Majesty's Revenue and Customs (HMRC) commissioned qualitative research, published in 2011,[33] on the impact of the new format of tax legislation on professionals resulting from the Tax Law Rewrite Project (TLRP).[34] The objects of the HMRC rewrite are as follows:

> [The rewrite has] the aim of making the UK's direct tax legislation clearer and easier to use. The TLRP intended to make the language of tax law simpler, while preserving the effect of the existing law, subject to some minor changes. It aimed to reorder legislation, use modern language and shorter sentences, and provide consistent definitions and clearer signposting. Its remit did not cover changing the law except in minor, well-defined ways. The Income Tax Act (ITA) of 2007 completed the process of rewriting the income tax legislation which began with the Income Tax (Earnings and Pensions) Act of 2003 and continued with the Income Tax (Trading and Other Income) Act of 2005.[35]

Interestingly, the legal profession was critical of the revision, given its departure from well-established words, precision, case law and concepts over time:

> All the cases are on the old notions. So now the cases are no longer helpful in construing the current legislation. So any case now before the courts, you're going to have to find the old principle which is the subject of the new legislation, and you're going to have to work your way backwards – Tax lawyer.[36]

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[32] At http://www.legislation.gov.uk/ukpga/2009/4/part/7 (accessed 15 January 2014).
[33] Ipsos MORI *Review of Rewritten Income Tax Legislation* Research Report Number 104 (2011).
[34] Ipsos MORI cite their terms of reference as 'was commissioned by HMRC to explore the experiences of tax professionals who have been working with rewritten income tax legislation, and to ascertain whether the Tax Law Rewrite Project has made the legislation easier to use.' Ipsos MORI (n 33) 6.
[35] Ipsos MORI (n 33) 6.
[36] Ibid 23.

It was felt that the old ICTA had become the subject of so many amendments that it had become difficult to navigate, but that the length of the new statute and the loss of well-established meaning was not contributing towards efficiency of understanding: 'There was a strong sense among tax professionals that the rewrite had been something of a missed opportunity for simplification of tax legislation.'[37]

The need to retain the certainty and fixity of law, while also capturing the dynamics of the economy, was expressed by Southern as follows:

> Confusion arises from demanding the appearance of certainty where certainty cannot exist. Taxation law in general, and anti-avoidance rules in particular, rely for their operation and effect on open-textured concepts and terms, which in turn introduce other concepts which themselves require further clarification. Such provisions may lose the name of law, and simply become enabling provisions to allow the executive to act on a pseudo-legal basis.[38]
>
> The apparent adoption of accounting principles by statute is to some degree an illusion. In the world of accountancy, there is no sovereign legislature or final court of appeal.[39]

Hudson, writing in 2002 at the time that the draft Finance Bill was available for comment, stated:

> The key provision is then that the derivative contract must have been transacted for the purposes of a trade … In effect, the proposed code is passively reliant on good faith in accounting procedures such that it is possible for the Revenue authorities to bring a reasonable amount into account in any tax year.[40]

The HMRC issued a consultative paper on 6 June 2013, entitled 'Modernising the taxation of corporate debt and derivative contracts'. The scope of the consultation includes 'proposed changes to the structure of the regime and … Parts 5, 6 and 7 of the Corporation Tax

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[37] Ibid 22.
[38] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 2.
[39] Ibid at 65 para 3.38.
[40] Hudson (n 4) 14-52 and 14-53.

Act (CTA) 2009'.[41] The HMRC explained the main proposals; at the top of the list was the need for clarity relating to a drafting regime, which has used accounting rules. 'Although accountancy will very often give an appropriate outcome for tax purposes, the tax regime will sometimes need to take a different approach, … . The Government considers that the tax regime should be clearer as to when taxation is to depart from the accounting treatment.'[42] Derivatives and related structures have contributed to 'more fluid boundaries between debt, equity and derivatives' which have necessitated continual piecemeal changes to the legislation, which in turn compromise the coherence of the regime. This in turn introduces complexity and further loopholes. This is a typical symptom of a rules-based approach that tries to capture all circumstances (in the UK through accounting standards) and in the USA through tax code rules, rather than a principles-based regime.

> In some cases of avoidance, HMRC may challenge the accountancy used by a company; but, if the scope of the regime ultimately rests on and defers to the accounting view, there will be cases in which no successful challenge is possible – for instance where accounting rules have been correctly applied, but the result is nonetheless incompatible with the intention of tax rules … it is not that the accounts are 'wrong' … the accounting treatment may give an entirely reasonable answer, but it may not be addressing, from the point of view of the … derivatives contract rules, the right question – namely, what are the profits, gains and losses from a particular … derivative which fall to be taxed in a given period?[43]

Amendments were incorporated in the Finance Act (No. 2) 2015[44] to clarify the relationship between tax and accounting, to clarify hedging, and to align taxable loan relationship profits with accounting profit and loss entries.

The dogma pendulum for designing tax statutes seems to be returning to a more moderated approach: 'The Government believes that an explicit stipulation that the existence

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[41] Her Majesty's Revenue and Customs (HMRC) 'Modernising the taxation of corporate debt and derivative contracts' Consultation document (6 June 2013) at 2.
[42] Ibid at 4.
[43] Ibid at 15.
[44] Schedule 7: Loan relationships and derivative contracts, amendments of Part 7 of CTA 2009.

of a matter within the regime is not ultimately dependent on accounting treatments would provide a clearer legislative mechanism'.[45] The government has followed the principle since the rewrite that 'aligning the tax treatment of profits, gains and losses on financial instruments with the accounting treatment … has been a cornerstone of the regime since its introduction'.[46]

The Explanatory Notice to the Finance Act (No. 2) of 2015 summarises the background to the changes effective on 1 January 2016 as follows:

> The rules for the taxation of loan relationships, now contained in Part 5 of CTA 2009, date from 1996. A similar but standalone regime for derivative contracts, contained in Part 7, was introduced in 2002. Parts 5 and 7 are based on the concept of deriving taxable profits and losses on these instruments from accounting entries. They do however incorporate some highly complex features, particularly around debt held between connected companies and within groups. The government has in the past frequently received adverse comment on the complexity of the current rules. The regimes for both loan relationships and derivative contracts have developed significantly over time, evolving in response to emerging avoidance risks and to changes in commercial and accounting practice. Accountancy standards, on which the tax rules are based, have not remained static. Standard setters for both UK GAAP and International Financial Reporting Standards (IFRS) have made significant changes to the accounting treatment of financial instruments. New UK GAAP and IFRS standards have recently been issued (including IFRS 9 in 2014) which will be adopted over coming years, and which should cement the accounting treatment of financial instruments for some time to come. Historically, the complexity in the loan relationships and derivative contracts regimes has provided repeated opportunities for tax avoidance. Reactive measures to counter this avoidance have contributed to further complexity and to some loss of structural clarity in the regime, tending to leave further potential loopholes …[47]

7.5 INTERPERATIVE GUIDANCE ON FINANCIAL DERIVATIVES

7.5.1 HMRC policy evolution on financial derivative nature

The HMRC has expressed the following significant opinions on the tax nature of the instruments, even when involving complexity. The following extract is taken from a revision to their manual, published on 15 March 2015. It is the most promising demonstration of policy advancement analogous to the reasoning of this thesis:

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[45] HMRC (n 41) 16.
[46] Ibid 29.
[47] Finance (No. 2) Act 2015, Explanatory Notes, 852–854.

Box 7.1: The HMRC's view on substance and form of complex derivatives[48]

Derivatives that give exposure to part of an asset are conceptually the same as derivatives that give exposure to the whole asset.

A view may be expressed on a bundle of components embedded in an instrument, for example the coupon, liquidity, credit risk and currency of a bond, or alternatively a view may be expressed on one or a combination of these components. There is no conceptual difference between taking a view on all components by buying the instrument or entering a derivative contract that replicates ownership, or taking a view on one or a combination of the components via derivatives. There is no conceptual difference between taking a view on the direction of movement (as with simply long and short positions) or taking a view on the magnitude or timing of movements, or other components.

Multi-derivative or hybrid strategies should not be unbundled.

Given the wide range of situations this principle can apply to, three examples are set out below. These are intended to be illustrative and not a definitive list.

In all cases involving any such 'bundling' we would expect there to be evidence that the transactions were executed in pursuit of a clear prior strategy.

Two or more derivatives

Where, for example, the view is that the price will increase but only within a certain band, and the most efficient way to express that single view is via a series of derivative transactions, those transactions should be considered as a whole and not each in isolation.

A derivative and another financial asset (for example shares)

Where the view is that an asset would not be acquired at current value but would be at a set lower value, a put option is written at that lower value, i.e. as a cost efficient method of acquisition. The writing of the option and the potential acquisition of the asset should be considered as a whole and not each in isolation.

A sequential series of similar derivative strategies

A derivative that is close to maturity generally has greater liquidity than a derivative identical in every way, other than having a longer period to maturity. 'Rolling' short dated derivative strategies such that there is a sequential series of similar derivatives should be viewed as a whole and not each in isolation.

[48] See Her Majesty's Revenue and Customs (HMRC) 'Business Income Manual (BIM) 56910' (undated). At https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim56910 (accessed 7 April 2015).

The above statements of interpretation are significant, demonstrating an evolutionary change in the way that derivatives are conceived, given the long debates that have been discussed in this thesis. The views are also significant given the common-law tradition of the UK. The HMRC makes the following statements of importance:

1. A view may be expressed on a bundle of components embedded in an instrument, for example the coupon, liquidity, credit risk and currency of a bond, or alternatively a view may be expressed on one or a combination of these components.
2. There is no conceptual difference between taking a view on all components by buying the instrument or entering a derivative contract that replicates ownership, and taking a view on one or a combination of the components via derivatives.
3. There is no conceptual difference between taking a view on the direction of movement (as with simply long and short positions) and taking a view on the magnitude or timing of movements, or other components.
4. Multi-derivative or hybrid strategies should not be unbundled.

It is interesting that (1), which relates to embedded derivatives, expresses the opinion that components may either be taken together as a unitary tax outcome or be isolated.[49] This correlates with sections 640 to 659 of the CTA 2009, where certain derivative contracts are taken out of the derivative contract rules in a range of circumstances. Section 640 states that in the case of deemed relevant contracts resulting from bifurcation (disaggregation), and which fall within the stated subsection, profits and losses will not be treated as 'income' for tax purposes, but as capital for CGT purposes:

[49] Embedded derivatives refer to hybrid instruments that combine a non-derivative host contract with a derivative included in the (non-derivative) contractual structure. The presence of the derivative might alter the economic structure (such as cash flow).

> [F]or non-trading investors, who are not insurance companies or collective investment schemes, the credits and debits representing the fair value movements in the equity element in certain convertibles, and the land or equity element in asset-linked contracts, are brought into account as capital gains and not as income in relation to the holders. These rules apply to convertibles (as regards the investor) and asset-linked securities (as regards both debtor and creditor). The contracts must not be held for trading purposes.[50]

The above is effectively a reservation of rights by the HMRC to break up a derivative if necessary or when certain underlying subject matter (reference asset value) applies (land, tangible moveable property, certain share options, creditor relationships that are tracking a CFD, and property-based total return swaps). In terms of section 645, equity options are treated as capital subject to certain conditions. In order to convert debt instruments into equity, the shares into which they convert must be ordinary shares or mandatorily convertible preference shares.[51]

Of significance to this policy conclusion is the issue of ownership in (2) above, which acknowledges economic replication of ownership as no different from ownership itself, when considering the attributes of the derivative instrument. The corollary is that they should be treated no differently for taxation purposes either.

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[50] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 433 para 15.32.
[51] Ibid para 15.36.

CHAPTER 8

UNITED KINGDOM: TREATMENT OF INCOME CHARACTER

8.1 INTRODUCTION

The US Supreme Court decision in *Eisner v Macomber*[1] is one of the first tax cases that students are taught: the concept of a tree as a capital asset that bears fruit (income). Yet, this American tree has given rise to two opposing doctrines on income. While the court acknowledged the basis in trust law (in the Anglo tradition) for distinguishing between these two categories of proceeds, it went on to state that if a taxpayer sold the tree, that too would constitute income – a point ignored by the Anglo courts.[2] However, the Anglo courts used the distinction to support a definition of income characterised by a schedule-based approach and the transposition of precedent in other branches of law (in this instance, trust law) to ascribe meaning to tax law. The USA, within the broad concept of income, which did not distinguish between income and capital gains, then sought to provide relief statutorily within the US broad meaning.[3] This resulted in a fundamentally different departure point in the US analysis, from where one might begin in the Anglo tradition.[4] In the latter half of the twentieth century, the UK (as well as Canada, Australia and South Africa in 2001) broadened the tax base and its concept of income by devising a separate tax dispensation for chargeable gains, with its distinguishing feature being a lower rate of taxation for capital gains.

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[1] *Eisner v Macomber* 252 US 189 (1920).
[2] Referred to by some as the 'logical fallacy of the transplanted category'. See N Brooks 'The role of judges' referred to by R Krever 'Interpreting income tax laws in the common law world' in M Achatz et al (eds) *Steuerrecht Verfassungsrecht Europarecht: Festschrift für Hans Georg Ruppe* (2006) 357 n 6.
[3] IRC §1221, which defines capital assets by exclusion.
[4] The agrarian tradition has been referred to above, with a distinction being drawn between landowners and those who used the land to produce income.

8.2 NEXUS-WITH-A-SOURCE TEST

The primary UK judicial test in identifying income is determining its source. The three possible sources are labour income, business or the use of property. The fruits of these activities have to be cash or be convertible into cash. This is in contrast to US recognition, which includes any net accretion of economic capacity, realised or not. Krever pointed out that the US courts do not have any independent power in defining income as in the UK; they simply identify via external objective criteria whether income is present.[5]

In *Federal Coke*,[6] the receipts in the absence of a source were simply held to be a windfall in the hands of the recipient company. The perspective considered is that of the recipient, not the payer.[7]

8.3 SUBSTITUTION AND FORM AND NATURE TESTS

Two supplementary tests accompany the source test. An amount received in substitution for income or its non-payment assumes an income character. The second test is the form and nature test. An example thereof is the payment of an annuity that has the 'feel' or characteristic frequency of income (form of payment). Furthermore, it involves the extent to which the taxpayer anticipated the payment and how it was applied. In *FCT v Dixon*,[8] whether the income flows from a business venture or is a 'mere enterprising realisation of capital' is a central enquiry. 'The sale of an investment asset generates a capital gain. The sale of a business asset … used to produce income generates a capital gain unless the taxpayer is also in the business of selling its depreciated property.'[9]

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[5] Krever (n 2) (2006) 363.
[6] *Federal Coke Co Pty Ltd v Federal Commissioner of Taxation* 77 ATC 4255.
[7] *Hayes v FCT* (1956) 96 CLR 47; *Scott v FCT* (1966) 117 CLR 514.
[8] *FCT v Dixon* (1952) 86 CLR 540.
[9] Krever (n 2) 365.

8.4 INTENT

> [T]here is an abiding myth in the derivatives markets that everyone uses the same products in the same way and that all products share the same features in all contexts.[10]

Subjective intent is used to discern the business motive. Was the property that was sold acquired with the purpose of resale at a profit or in the course of a profit-making scheme, or was it acquired without these motives? As in South Africa, intentions can also change during the holding period.[11]

Although the case law on characterisation is incomplete, Hudson indicates[12] that, much like in the USA, income character is likely to be determined by the functional context of the taxpayer. A corporate client who rarely uses an interest rate swap would likely receive capital treatment, whereas a dealer selling that swap would need to treat the item as income, regardless of intent (whether used as a hedge or stock in trade). The context of each individual party will therefore have a bearing on the characterisation of the income.

The legislative approach is therefore to follow the accounting treatment applied by the taxpayer and challenge that where required as avoidance. Attempting to categorise derivatives by instrument type assumes that all taxpayers use the same instrument in the same way, which is simply not the case. It would also mean an endless game of catch-up which would never yield its desired result for the fiscus.

8.5 TAX AVOIDANCE

8.5.1 General interpretative approach

> The office of the Judges is always to make such construction as shall suppress the mischief, and advance the remedy, and to suppress subtle inventions and evasions for continuance of the mischief, … according to the true intent of the makers of the Act ….[13]

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[10] A Hudson *The Law on Financial Derivatives* 6 ed (2018) 18-07.
[11] *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd* (1982) 150 CLR 355.
[12] Hudson (n 10) 18-03.
[13] (1584) 3 Co. Rep. 7a, 7b, in VanderWolk 'International Bureau of Fiscal Documentation' (2002) *Bulletin*.

The use of tax planning arrangements which often includes derivatives necessitates an understanding of how courts have developed a doctrine of interpretation to these contracts. The UK courts have traditionally focused on legal form to preserve correctness, but the approach of the courts did drift towards more expansionary interpretative dogma and then pulled back as the consequences of this line of reasoning sought expansion by Revenue.

The already quoted decision of *IRC v Duke of Westminster* is an example of textual literalism. The overall nature of 'what is actually going on' economically (the payment of a gardener's wages) was ignored by Lord Tomlin. Krever explained as follows:

> For example, while an Anglo court would view a standard 'repo' transaction as a separate sale of an asset, put option for the repurchase, and further sale back to the original vendor, a US court would simply collapse the arrangements for tax purposes into a secured loan and apply the tax provisions relevant to debt to the transaction.[14]

In an attempt to establish the true 'facts of the case', the landmark judgment of *WT Ramsay Ltd v Inland Revenue Commissioners*[15] in the House of Lords in 1981 went beyond the traditional analysis and required an economic reality (real economic loss as opposed to a paper loss) to the legally valid transaction.

The oft-cited Duke of Westminster principle[16] was contextualised by Templeman LJ as lending itself to a performance:

> The game is recognised by four rules. First, the play is devised and scripted prior to performing. Secondly, real money and real documents are circulated and exchanged. Thirdly, the money is returned by the end of the performance. Fourthly, the financial position of the actors is the same at the end as it was in the beginning save that the taxpayer in the course of the performance pays the hired actors for their success. The object of the performance is to create the illusion that something has happened, that

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[14] Krever (n 2) 374, also n 42. *Nebraska Dept of Revenue v Loewenstein* 513 US 123, 128 n. 3 (1994). See also *First American Nat'l Bank of Nashville v United States* 467 F.2d 1098 (6th Cir. 1972); *Union Planters Nat'l Bank of Memphis v United States* 426 F.2d 115 (6th Cir.), cert. denied, 400 US 827 (1970); *American Nat'l Bank of Austin v United States* 421 F.2d 442 (5th Cir.), cert. denied, 400 US 819 (1970).

[15] *W T Ramsay Ltd v Inland Revenue Commissioners, Eilbeck (Inspector of Taxes) v Rawling* [1982] AC 300.

[16] 'Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax' (per Lord Tomlin).

> Hamlet has been killed and Bottom did don an ass's head, so that tax advantages can be claimed as if something had happened. The audience are informed that the actors reserve the right to walk out in the middle of the performance but in fact they are creatures of the consultant who has sold and the taxpayer who has bought the play; the actors are never in a position to show a profit and there is no chance that they will ever go on strike. The critics are mistakenly informed that the play is based on a classic masterpiece called 'The Duke of Westminster' but in that piece the old retainer entered the theatre with his salary and left with a genuine entitlement to his salary and to an additional annuity.[17]

The court sought to apply a purposive interpretation by looking to economic substance or reality. It was therefore not incumbent upon the court to examine each constructed step in the composite transaction, but to view the transaction as a whole. There was no commerciality and no gain or loss. In a subsequent and supporting decision, Lord Browne-Wilkinson's *dictum* in *Fitzwilliam v Inland Revenue Commissioners* referred to the necessity to identify the 'real transaction'.

In *MacNiven v Westmoreland Investments Ltd*[18], Revenue sought to widen the purposive approach of *IRC v McGuckian*[19] as a means to anti-avoidance. The House of Lords chose not to strip out what were circular payments on the grounds of artificiality, choosing rather to allow the transactions if they followed the statutory description for the exemption of liability to tax.[20] In *Barclays Mercantile Business Finance Ltd v Mawson*[21] the House of Lords sought to bring final clarity to what *Ramsay* had established as principle. The five Lords preferred a natural interpretation of a given statutory provision rather than the purposive approach of *Ramsay*, which stripped away what were viewed by the court as artificial steps in a series of transactions.[22] This would require a court 'to give the statutory provision a purposive construction in order to determine the nature of the transaction … and then to decide whether

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[17] [1979] STC 582 at 583H–584B.
[18] *MacNiven v Westmoreland Investments Ltd* [2003] 1 AC 311.
[19] *IRC v McGuckian* [1997] 1 WLR 991, 3 All ER 817, STC 907.
[20] Hudson (n 10) 18-48.
[21] *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51.
[22] See discussion in Hudson (n 10) 18-45, 48.

the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description.'[23]

So it seems the pendulum has arced a return after *Ramsay*, where statutes must be given their natural meaning again. Hudson's view is that 'UK revenue law will no longer be astute to combat commercial artificiality in tax avoidance transactions but rather will simply construe the appropriate revenue statute and permit a tax avoidance scheme to be effective if that is in line with a natural interpretation of the statute.'[24]

8.5.2 The ISDA agreement and composite transactions

In *Inland Revenue Commissioners v Scottish Provident Institution*[25] the court disregarded the consolidation of the collateral agreement with the transaction involving offsetting options under the ISDA Master Agreement. This tax arbitrage scheme, designed by Citibank, was intended to take advantage of a change in the tax law. The scheme would allow the life assurer to be able to take advantage of an oversight in the transitional drafting provisions of the Finance Act 1994 from accrual accounting to mark-to-market taxation, generating a loss of £20 million, for which premiums on the offsetting options of £30 million and £10 million were paid.[26] This decision was appealed to the House of Lords and overturned in a unanimous decision.[27] Lord Nicholls ruled that the above treatment by the Special Commissioners was a meaningless outcome when derivatives within a composite were designed to interact:

> We think that it would destroy the value of the *Ramsa*y principle of constructing provisions such as s 150A(1) of the 1994 Act as referring to the effect of composite transactions if their composite effect had to be disregarded simply because the parties had deliberately included a commercially irrelevant contingency, creating an acceptable risk that the scheme might not work as planned. We would be back in the world of artificial tax schemes, now equipped with anti-*Ramsay* devices. The composite effect of

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[23] *Barclays Mercantile Business Finance Ltd v Mawson* (n 21) [32]. See Hudson (n 10) 18-47.
[24] Hudson (n 10) 18-48.
[25] *Inland Revenue Commissioners v Scottish Provident Institution* [2003] STC 1035. Hudson (n 10) 18-50.
[26] Hudson (n 10) 18-50.
[27] Ibid 18-51.

> such a scheme should be considered as it was intended to operate and without regard to the possibility that, contrary to the intention and expectations of the parties, it might not work as planned.[28]

In *Citibank Investments Ltd v Griffin (Inspector of Taxes)*[29] Citibank NA (an investment company within the Citibank Group) took advice on an offsetting equity option structure that would enable the company to establish a known return on the exercise of the options, regardless of the movement of the underlying equity index (Financial Times Stock Exchange (FTSE) 100) on which the options would be written. The ability to foreknow the return would allow the company to price the transactions akin to a money deposit. As no trading was taking place, the advisory firm stated that capital treatment was in order.

The reason for this desired 'equity box' structure was the efficient investment of surplus capital of £150 million for 16 months until certain borrowings had to be repaid. As the company had assessed capital losses, capital gains were sought to offset the losses, rather than incur corporation tax. The board therefore approved the purchase of a capped call option and a floored put option.

Revenue took the view that, taken together, the options constituted a single transaction that constituted a loan, not an option. Revenue acknowledged that two separate options were required, but held that the one would not have been bought without the other and had, by design within the equity box structure, eliminated risk (equity risk) and choice (fixed date of exercise). The operation of the reference asset (the FTSE index) was irrelevant and their separate natures as options were irrelevant. The Commissioners' prime focus was on whether the transaction was a debt-based return masquerading as equity, and whether the equity structure was therefore an artificiality.

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[28] Ibid 18-53; *Inland Revenue Commissioners v Scottish Provident Institution* [2004] UKHL 52, [2005] STC 15 [23].
[29] *Citibank Investments Ltd v Griffin* (2000) STC (SCD) 92.

Even though the transaction was established to fix a tax outcome as capital in nature, the contracts could not be construed as single by virtue of the principles in *Ramsay*. In summary, the transactions were real and not the 'performance' referred to by Templeman LJ.

On appeal, the decision was upheld in the High Court. Patten J in *Griffin (Inspector of Taxes) v Citibank Investments Ltd*[30] explained as follows:[31]

> The development of the law in *Burmah* and *Furniss v Dawson* gives the court a limited power in appropriate cases to reconstruct a series or sequence of transactions which are indissolubly linked and which contain the features described by Lord Brightman in his speech in *Furniss v Dawson*. Outside these limitations it is not open to me on the present state of the authorities to apply the *Ramsay* principle so as to convert genuine transactions such as the two options under consideration into something quite different. To do so would be, as I see it, to attribute to the options a substance and legal effect which they do not have and which the Crown accepts the court would not give them upon the application of the ordinary principles of construction adopted in cases such as *Lloyds & Scottish Finance v Cyril Lord Carpets Sales Ltd*.[32] True it is that the purpose of the equity box structure was to allow investment in a form which produced a capital gain rather than an income profit. But that is no more than the choice which faces any investor … .[33]

HSBC Life (UK) Ltd v Stubbs[34] involved a similar attempt by Revenue to have equity-linked returns re-characterised as taxable income rather than capital gains, because the aggregate product structure provided the features of an interest-based return with equity upside, using derivatives. Amongst others, Revenue used economic equivalence as justifying re-characterisation, given that the aggregate profile of the product was not unlike a zero-coupon bond. The taxpayer admittedly sought to avoid having the product falling within the loan relationship regime. The case involved a product sold by many life insurance companies in the UK, which was also popular in South Africa. Five taxpayer companies were involved in the appeal for the period 31 December 1996 to 31 March 1999, involving sold products totalling

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[30] *Griffin (Inspector of Taxes) v Citibank Investments Ltd* (2000) STC 1010.
[31] *Griffin (Inspector of Taxes) v Citibank Investments Ltd* (2000) STC 1010, in a second appeal brought by Revenue at [49]; Hudson (n 10) 18-61 and n 123.
[32] *Lloyds & Scottish Finance v Cyril Lord Carpets Sales Ltd* [1992] BCLC 609.
[33] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 369.
[34] *HSBC Life (UK) Ltd v Stubbs* (2002) STC (SCD) 9.

some £4.5 billion. Fifty-three representative transactions were initially in evidence, with six of these used to reach a decision.[35]

Ordinarily, an investor might invest a lump sum (x) at an advertised rate of y per cent, which provides a simple arithmetic outcome (z) over 12 months. In the structured product, the life company uses z to instead purchase a call option on an equity index (FTSE 100). (x–z) = i is used to purchase a five-year bond. By the end of the investment term (five years), the investor has received his original capital (x) back due to the bond return (paid monthly or quarterly) and has participated in the equity upside via the call option, with no downside risk to the original capital, while enjoying an annuity type return akin to a bank deposit.

The policy contracts were not in dispute, but the underlying investment contracts were in dispute. The underlying contracts generally had the following components:[36]

1. an *equity forward transaction* (right to buy) for which the insurer pays (x + z) to a bank who agrees to return x and an amount equivalent to the market return in five years;
2. an *equity put option* (right to sell) granted by the bank in favour of the insurer to sell the shares at the delivery date back to the bank at their then market price; and
3. a *deposit transaction* whereby the bank pays interest on x paid over for the forward transaction, the interest on which is rolled up and the agreed interest return and frequency (monthly, quarterly etc) is paid to the investor.

The above are structured via an International Swap Dealers Association (ISDA)[37] Master Agreement. A netting agreement or clause with the Master Agreement will be in place to allow offset within the product terms.

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[35] Ibid [14].
[36] D Southern *Taxation of Loan Relationships and Derivative Contracts* (2012) 371.
[37] The International Swap Dealers Association (ISDA) draws up standard agreements for the derivatives market in the interests of standardisation.

Much emphasis was placed in the case on the ISDA agreements, which an expert witness testified to under extensive cross-examination. The Special Commissioner noted the judgment of the Privy Council in *Chow Yoong Hong v Choong Fah Rubber Manufactory*,[38] regarding whether transactions that could be described as having an economic effect comparable to that of a loan should be so regarded when the parties had nonetheless not entered into a loan transaction.[39] Lord Devlin stated: 'Even if the post-dated cheques did produce an excess [ie were worth more than the bills for which they were given], that is not "interest" within the definition unless there is a loan.'[40] An earlier case involving a hire purchase agreement, *McEntire v Crossley Bros Ltd*,[41] was cited, where Lord Herschell LC had said: 'But there is no such thing, as seems to have been argued here, as looking at the substance, apart from looking at the language which the parties have used. It is only by a study of the whole of the language that the substance can be ascertained ….'[42]

Lord Watson stated the following about the court's function:

> As is usual in cases of this kind, we have heard a great deal in the course of the appellants' argument of the necessity of attending to the substance of the agreement which we have to construe. My Lords, that is a canon of construction which is applicable to all agreements; but it must be borne in mind that the substance of the agreement must ultimately be found in the language of the contract itself ….[43]

In *Marren (Inspector of Taxes) v Ingles*,[44] Lord Wilberforce said:

> No case was cited, and I should be surprised if one could be found, in which a contingent right (which might never be realised) to receive an unascertainable amount of money at an unknown date has been considered to be a debt; and no meaning however untechnical of that could, to my satisfaction, include such a right.[45]

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[38] *Chow Yoong Hong v Choong Fah Rubber Manufactory* (1962) AC 209.
[39] *HSBC Life (UK) Ltd v Stubbs* (2002) STC (SCD) 9 at 27.
[40] *Chow Yoong Hong v Choong Fah Rubber Manufactory* (1962) AC 209 at 216–17.
[41] *McEntire v Crossley Bros Ltd* (1895) AC 457.
[42] Ibid 463.
[43] Ibid 467.
[44] *Marren (Inspector of Taxes) v Ingles* (1980) STC 500, (1980) 1 WLR 983.
[45] Ibid 503/986. *HSBC Life (UK) Ltd v Stubbs* (2002) STC (SCD) 9 at 29.

In *Westdeutsche Landesbank Girozentrale v Islington LBC*,[46] Lord Goff of Chieveley noted the following about swap transactions: 'The practical effect is to achieve a form of borrowing by, in this example, the floating rate payer through the medium of the interest rate swap',[47] which though designed to avoid borrowing restrictions in the LBC, were not in law classified as loans.

The court therefore found with respect to the nature of the payments that the economic equivalence of a transaction does not equate to tax equivalence:

> None of the many witnesses we heard, despite very thorough cross-examination, was prepared to recognise any of the derivatives purchase transactions as loans, whether or not they were assorted with put or call options or two way compensation agreements … In our judgment, it is impossible to conclude that any of the parties to these transactions thought that they were lenders or borrowers, or that they intended that to be the case. They plainly intended to enter into the legal relationships which the documentation showed that they had established, and indeed they took care to enter the relationship of buyer and seller of financial futures and not that of lender and borrower ….[48]

As VanderWolk concluded in his critique, '[t]he decisions in *Citibank Investments* and *HSBC Life* demonstrate that economic equivalence does not necessarily lead to tax equivalence'.[49]

8.6 CLARIFICATION OF CONTRACTUAL RIGHTS UNDER ISDA

The slew of cases that followed the Lehman Brothers' bankruptcy in September 2008 has provided helpful authority on contractual rights under ISDA.[50] The legal basis for ISDA is located in English and New York law.

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[46] *Westdeutsche Landesbank Girozentrale v Islington LBC* (1996) AC 669.
[47] Ibid 680.
[48] *HSBC Life (UK) Ltd v Stubbs* (2002) STC (SCD) 9 at 30 and 31.
[49] Vanderwolk (n 13) 76.
[50] 'At the time of its bankruptcy in September 2008, Lehman had total assets of more than $600 billion. The net worth of its total derivatives portfolio amounted to $21 billion, approximately 96% of which represented OTC positions. Lehman's OTC derivatives portfolio consisted of more than 6,000 contracts involving over 900,000 transactions with myriad counterparties.' See US Department of the Treasury *A Financial System that Creates Opportunities, Capital Markets* (2017) 115.

In England, the most significant cases are *Lomas v JFB Firth Rixson*[51] and *LBSF v Carlton*[52] (one of four appeals heard following the *Lomas* case). In *Carlton*, the judge referred to *Lomas* as 'essential pre-reading'.[53]

Briggs J stated the following in *Lomas v JFB Firth Rixson Inc*:

> It is necessary to begin with some preliminary observations about the correct approach to construction. The ISDA Master Agreement is one of the most widely used forms of agreement in the world. It is probably the most important standard market agreement used in the financial world. English law is one of the two systems of law most commonly chosen for the interpretation of the Master Agreement, the other being New York law. It is axiomatic that it should, as far as possible, be interpreted in a way that serves the objectives of clarity, certainty and predictability, so that the very large number of parties using it should know where they stand ….
>
> All personal things are either in possession or action. The law knows no *tertium quid* between the two. While the concept is broad, it includes 'rights to debts of all kinds … rights of action on a contract'; … it was extended to cover documents, such as bonds … This led to the inclusion in this class of things of such instruments as bills, notes, cheques, shares in companies, stock in public funds, … these choses in action have changed their original character, and become very much less like merely personal rights of action and very much more like rights of property.[54]

These cases turned on contractual rights under section 2(a)(iii)[55] of ISDA in the circumstances of the bankruptcy of Lehman Brothers. Derivative counterparties to Lehman's who were 'out of the money' on their positions withheld payment from Lehman's. At issue was whether section 2 permanently extinguishes an obligation to pay or merely suspends it.[56]

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[51] *Lomas v JFB Firth Rixson Inc* (2010) EWHC 3372, (2011) 2 BCLC 120.
[52] *Lehman Brothers Special Financing (LBSF) Inc v Carlton Communications Ltd* (2011) EWHC 718.
[53] In *Enron Australia v TXU Electricity*, a court in new South Wales permitted a non-debtor counterparty to withhold performance under s 2(a)(iii) of the ISDA Master Agreement. 'Based on an event of default triggered by a debtor-counterparty's insolvency filing … it has not been followed by the English court in *Lomas v FJB Firth Rixson*'. Ibid [317].
[54] Ibid [1029]. *Lomas* (n 51) paras 540, 998, 1029 [footnotes omitted].
[55] 'Section 2(a) … provides that it is a condition precedent of the formation of the contract under either the master agreement or the payment of any obligation under a confirmation that no event of default, actual or potential, has occurred and is continuing at the time any such payment is made (2(a)(iii)). This provision enables the parties to render the contract void ab initio in the event that there is any hidden defect in the capacity or credit worth of the counterparty.' See Hudson (n 10) 6-121.
[56] Ibid 6-122.

Longmore LJ, in the *Lomas v Firth Rixson Inc* appeal, referred to the 2011 *Belmont Park* case,[57] which addressed the anti-deprivation rule:[58]

> It would go well beyond the proper province of the judicial function to discard 200 years of authority, and to attempt to re-write the case law in the light of modern statutory developments. The anti-deprivation rule is too well-established to be discarded despite the detailed provisions set out in modern insolvency legislation, all of which must be taken to have been enacted against the background of the rule … The policy behind the anti-deprivation rule is clear, that the parties cannot, on bankruptcy, deprive the bankrupt of property which would otherwise be available for creditors … Except in the case of well-established categories such as leases and licences, it is the 'substance rather than the form which should be determinant'… this must now be taken as an authoritative statement of the anti-deprivation principle.[59]

Lord Collins, in his introduction, referred to the concept of property with reference to credit swaps by citing section 436 of the Insolvency Act 1986: ' includes money, goods, things in action, land and every description of property … and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property.'[60]

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[57] *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Securities Ltd* [2011] UKSC 38 [18]–[21]: 'Prior to the events which form the background to this appeal, the Lehman Brothers group was the fourth largest investment bank in the United States. On 15 September 2008, Lehman Brothers Holdings Inc (LBHI), the parent company of the Lehman Brothers group, applied to the US Bankruptcy Court for the Southern District of New York for protection under Chapter 11 of the United States Bankruptcy Code. … This appeal concerns the effect of the security arrangements in a complex series of credit swap transactions under which, in effect, investors gave credit protection to Lehman Brothers by reference to the performance of a basket of underlying obligations … At the time of the Lehman Brothers collapse in September 2008 there were 19 SPVs being used as Note issuers in the programme with a total of about 180 series of Notes with an aggregate principal amount of $12.5 billion. LBSF filed for Chapter 11 protection in the United States Bankruptcy Court for the Southern District of New York on 3 October 2008.'

[58] See Collins J at 1-3: 'What is now described as the anti-deprivation principle dates from the 18th century, although the expression "deprivation" has been in use in this context only since the decision of Neuberger J in *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd* (2002) 1 WLR 1150. In 1812 Lord Eldon LC confirmed that a term which is "adopted with the express object of taking the case out of reach of the Bankrupt Laws" is "a direct fraud upon the Bankrupt Laws" from which a party cannot benefit: *Higinbotham v Holme* (1812) 19 Ves Jun 88, 92. "… the law is too clearly settled to admit of a shadow of doubt that no person possessed of property can reserve that property to himself until he shall become bankrupt, and then provide that, in the event of his becoming bankrupt, it shall pass to another and not to his creditors" (*Whitmore v Mason* (1861) 2 J & H 204, 212, per Sir William Page Wood V-C).'

[59] *Belmont Park* (n 57) [102].

[60] Ibid [5].

In *Belmont Park*[61] (where the respondents were Australian) the Supreme Court protected the ISDA framework. Lord Collins referred to the concept of property with reference to credit swaps as including 'things in action … also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property'.[62] Lehman Brothers Special Financing (LBSF) argued that the rights under the Swap Agreement and the rights over the collateral to secure them were the property of LBSF within the meaning of the Insolvency Act 1986 and therefore formed part of the insolvent estate of LBSF. LBSF was insolvent, but 'in the money'. The notes issued by LBSF had been marketed and sold to Australian local authorities, pension funds, private investment companies and private individuals[63] with a Triple A credit rating. Attempts at arguing 'anti-deprivation' because counterparties ceased payment under the swaps at the date of bankruptcy of LBSF failed. Lord Collins preferred to consider each transaction on its merits to see whether a shift in interests could be justified as a genuine and justifiable commercial response to the consequences of insolvency. Longmore LJ, in *Lomas*, quoted[64] Lord Collins in *Belmont Park* and dismissed a number of arguments in dealing with title to property:

> 107. The answer is not to be found in the Noteholders' argument that
>
> (a) LBSF's property was a beneficial interest under a trust, …
>
> (b) LBSF retains its beneficial interest under the trust to this day. The fact that the security interests were held by the Trustee is not determinative. The court has to look to the substance of the matter, … Nor is it to be found in the fact that the potential for change in priority was in the documentation from the beginning, nor in the 'flawed asset' argument or variant of it, … The answer is to be found in the fact that this was a complex commercial transaction entered into in good faith …[65]

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[61] Ibid.
[62] Ibid.
[63] Ibid [113].
[64] Ibid [85].
[65] Ibid [108].

Rights before and after bankruptcy were then distinguished with reference to the anti-deprivation principle by asking whether what the court described as 'the chose in action'[66] represents the *quid pro quo* for something already done or is intended to provide the *quid pro quo* for services yet to be rendered. 'The availability of the anti-deprivation principle in insolvency law was accepted as correct.' As summarised by Longmore LJ, 'it was necessary to look at the substance of the agreement rather than its form and to consider whether the provision in question amounted to an illegitimate attempt to evade the relevant bankruptcy law or had some legitimate commercial basis.'[67]

Longmore LJ supported Lord Collins by looking to the substance of the contract, rather than a claim against property, given that the assets backing the contract held by LBSF were held in trust as security. The 'touchstone' was that this was a *chose in action* in the nature of a 'complex commercial transaction' that was not extinguished by the insolvency of Lehman, or claimable as property in isolation of the contractual terms even though the contracts were 'in the money'.

As Hudson put it, '[t]he decision of the Court of Appeal in *Lomas v AFB Firth Rixson* combined four different appeals which included an appeal from the judgment of Briggs J in *Lomas* itself.'[68] Although the construction of the ISDA Master Agreement was flawed, the courts confirmed the single provision agreement and the principle of netting between parties under the agreement. The relevant point for this thesis is that the contract is a valid one bestowing rights on the parties that have undergone the severest of tests through bankruptcy in the highest courts, confirming application to property as defined in the Insolvency Act 1986, which includes things in action. The corollary therefore must be that if financial derivative

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[66] Ibid [88].
[67] Hudson (n 10) 6-143.
[68] '*Lehman Brothers Special Financing Inc v Carlton Communications Ltd* on appeal from the judgment of Briggs J; *Pioneer Freight Futures Co Ltd (in liq) v Cosco Bulk Carrier Co Ltd* on appeal from Flax J; and *Britannia Bulk plc (in liq) v Bulk Trading SA*.' See Hudson (n 10) 6-136.

instruments bestow rights, those rights are to be considered property, bringing derivatives within the ambit of the logic as applied in *CIR v Pick 'n Pay*,[69] and do not differ from transactions in respect of any other property such as land and shares. Watermeyer CJ described 'property' as follows:

> [W]hat is meant by property is all rights vested in him which have a pecuniary or economic value. Such rights can conveniently be referred to as proprietary rights and they include *jura in rem*, real rights such as rights of ownership in both immovable and movable property, and also *jura in personam* such as debts and rights of action.[70]

8.7 SUMMARY

The UK provides valuable insights into the treatment of financial derivative instruments. The UK is a leading financial jurisdiction with policies that have promoted London as a financial centre in Europe. Its judicial tradition shares a common history with our own. It is therefore interesting that the HMRC interpretative statements on derivatives (Box 7.1 above) adopt a conceptual stance that is unknown to South Africa.

Rather than characterising derivative instruments in isolation, the HMRC considers the context of each taxpayer (badge of trade) when characterising income. An accounting approach has been adopted, yet the HMRC has developed its own language and framework for the taxation of these instruments. This approach is accompanied by developing anti-avoidance case law that directly confronts the pretensions associated with the sale of artificial derivative structures in *Ramsay* and confirms the need to keep faith with natural interpretation, according to *Barclays Mercantile Business Finance Ltd v Mawson.*

Questions as to whether derivative transactions should be disaggregated or viewed as a composite under the ISDA Master Agreement are addressed. In *Griffin (Inspector of Taxes) v*

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[69] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[70] *CIR v Estate CP Crewe and Another* 1943 AD 656, 12 SATC 344 at 352. See SARS *Comprehensive Guide to Capital Gains Tax* Issue 7 (2018) 42.

Citibank Investments Ltd, the court confirmed that there are limitations on its powers to reconstruct transactions that are 'indissolubly linked', thereby risking converting genuine transactions into 'something quite different'.[71] In *Scottish Provident*, the House of Lords ruling that the transaction should be 'considered as it was intended'[72] was essential to avoid a return to a 'world of artificial tax schemes, now equipped with anti-*Ramsay* devices'.[73] In *HSBC Life (UK) Ltd v Stubbs*, it was interestingly HMRC that made an economic equivalence argument to justify re-characterisation. The court held that the substance and the language of the agreement are both relevant to character determination. Importantly, economic equivalence achieved by combining instruments, as illustrated mathematically by Warren[74] above, cannot on its own lead to tax equivalence.

Finally, the bankruptcy cases involving Lehman Brothers in 2008 have provided authority on contractual rights under ISDA, confirming that those rights are in the nature of property and must be protected under insolvency law. The wide use of the contract template makes it an appropriate proxy for understanding the legal nature of financial derivative instruments, so that it serves the objectives of 'clarity, certainty and predictability, so that the very large number of parties using it should know where they stand'.[75] That clarity obtained through the Court of Appeal upheld the ISDA agreement as a *chose in action* in the nature of property. This establishes a causal link in helping to understand how these contracts should be framed in South African jurisprudence. Interestingly enough, this clarity is not provided by tax

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[71] *Griffin (Inspector of Taxes) v Citibank Investments Ltd* (2000) STC 1010 in a second appeal brought by Revenue at [49]. Hudson (n 10) 18-61 n 123.
[72] *Inland Revenue Commissioners v Scottish Provident Institution* [2004] UKHL 52; [2005] STC 15 at [23]; Hudson (n 10) 18-53.
[73] Ibid.
[74] AC Warren Jr 'Commentary: Financial contract innovation and income tax policy' (1993) 107 *Harvard Law Review* 460–92.
[75] Ibid.

law, but by the insolvency case law that resulted from the collapse of Lehman Brothers and its extensive use of derivative contracts.

CHAPTER 9

AUSTRALIA: LEGISLATIVE AND REGULATORY OUTLINE

9.1 INTRODUCTION

> Thus, modern borrowing of precedents between constitutional judges would be an expansion of a typical format of common law that evolved from a historically common practice among the judges of the ex-Commonwealth countries. Beginning in the 19th century these judges largely used precedents of foreign judges, generally British ones and in particular the Privy Council. The Privy Council was the court of final appeal for the colonies and dominions, a function that it still performs today in relation to a small group of Caribbean countries. Its function of ensuring the exact observation and interpretation of the law deeply influenced the development of law in countries such as New Zealand, Australia, India, South Africa, Hong Kong, Caribbean countries, and Canada (along with other countries in the colonial area of East and Southern Africa).[1]

Australia was included in this research because of its status, like South Africa, as a former colony of Britain sharing a common-law tradition. To my knowledge there has always existed a constructive and helpful relationship between SARS and the Australian Tax Office. The 1994 Tax Advisory Committee[2] document acknowledged extensive reliance on an Australian document of the same title, and sought to deal with the rapidly advancing, sophisticated and complex financial instruments.[3] Possible departures from the Australian approach included applying normal tax principles, whereas the Australian Tax Authorities were in favour of all gains and losses being recognised on revenue account.[4] The situation remains largely unchanged to date. The development over some 20 years of the Australian legislation referred

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[1] See P Nevill 'New Zealand: The Privy Council is replaced with a domestic Supreme Court' (2005) 3 *International Journal of Constitutional Law* 115 et seq. In some former Commonwealth countries, appealing to the Privy Council was formally annulled only recently, while in others, such as South Africa, it was abolished a long time ago. The case of Australia is worth noting: Australia eliminated this mechanism that put the national legal system in direct communication with the British one only in the 1980s, which, as stressed by Australian doctrine, produced a deep legal influence. The mechanism of the Privy Council is also analysed by PK Tripathi 'Foreign precedents and constitutional law' (1957) 57 *Columbia Law Review* 319 et seq. See also the study of S Gardbaum 'Japanese Law Symposium: The new Commonwealth model of constitutionalism' (2001) 49 *American Journal of Comparative Law* 707–60; A Lollini 'Legal argumentation based on foreign law: An example from case law of the South African Constitutional Court' (2007) 3(1) *Utrecht Law Review* 61.

[2] Tax Advisory Committee *Consultative Document on the Tax Treatment of Financial Arrangements* (1994). This committee was appointed to advise the Minister of Finance on tax matters. It no longer exists. I am grateful to Dr Jan Graaff who served on the committee and who provided me with this document and related work papers.

[3] Ibid 1.

[4] Ibid 2.

to as the Taxation of Financial Arrangements, which was introduced in 2008, therefore requires attention.

9.2 FINANCIAL REGULATORY FRAMEWORK WITHIN AUSTRALIA

The Australian Securities and Investment Commission (ASIC) is the regulator responsible for regulating asset managers in Australia under the Corporations Act 2001.

Essentially, four management structures are used by managers in this jurisdiction:

(a) Fixed unit trusts, managed by a trustee manager via a contractual relationship under a trust deed, operate as a conduit for taxation purposes, with income, gains and losses taxed in the hands of the investor.

(b) The Management Investment Trust (MIT) regime was introduced in 2010, given the uncertainty around the characterisation of gains made by funds. In consequence, an MIT must comply with certain criteria, including that it may not be a trading trust, and the assets must be widely held.

(c) Venture capital limited partnerships (VCLPs) and early stage venture capital limited partnerships (ESVCLPs).

(d) Linked investment companies – closed-end listed trusts.[5]

9.2 TAX LEGISLATIVE FRAMEWORK

9.2.1 Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009

The Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 (the Bill) was introduced into Parliament on 4 December 2008. The Bill contained Division 230, which comprised stages 3 and 4 of the reforms to the taxation of 'financial arrangements' and received Royal Assent on 26 March 2009. The Tax Laws Amendment Act 2009 (the TOFA Act) was enacted to address the lack of statutory mechanisms for dealing with financial innovation. First

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[5] P Dickson *The Asset Management Review* (2012) 42–55.

mentioned in the 1992 Budget, the taxation of financial arrangements (TOFA) was implemented in three stages from 2001. The Australian Tax Office (ATO) stated that prior measures had been of a limited and piecemeal nature in response to specific issues:

> What has been lacking is an overarching framework which seeks to systematically address the functional purposes of different financial arrangements and the ways in which they are used. As a consequence, current tax laws, which have continued to rely significantly on legal form, represent an increasingly complex amalgam of both general and specific provisions … Current tax laws have resulted in tax-based timing and character mismatches and lack the tax design architecture needed to facilitate efficient hedging activity and market-making. In a number of areas, gaps have appeared in the law, determinacy has been lacking, tax anomalies and distortions have emerged, neutrality has not been achieved, and uncertainty has developed about the appropriate treatment of some basic financial arrangements.[6]

The ATO sets out the chronology of the development of TOFA as follows:[7]

> Division 974 of the ITAA 1997 was introduced in the *New Business Tax System (Debt and Equity) Act 2001* and the *New Business Tax System (Thin Capitalisation) Act 2001*. It introduced rules for classifying financial instruments as debt interests or equity interests according to the economic substance of the instrument rather than its legal form.
>
> Division 775 and Subdivisions 960-C and 960-D of the ITAA 1997 were introduced in the *New Business Tax System (Taxation of Financial Arrangements) Act (No. 1) 2003*. Under Division 775, forex realisation gains and forex realisation losses, attributable to fluctuations in foreign currency exchange rates, are made when a forex realisation event occurs.
>
> Division 230 was introduced by the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009* (the TOFA Act). The TOFA Act implements Stages 3 and 4 of the TOFA reforms and are the final set of TOFA reforms recommended by the Ralph report. Stage 3 addresses hedging financial arrangements, allowing for the matching of the tax classification and tax timing of gains or losses from certain hedging financial arrangements with the gains and losses from a hedged item. Stage 4 deals with the tax treatment of all other financial arrangements by providing a framework for calculating and taxing gains and losses from financial arrangements.

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[6] See http://law.ato.gov.au/atolaw/ (accessed 17 July 2014) at 1.4 and 1.6.
[7] See https://www.ato.gov.au/Business/Taxation-of-financial-arrangements-%28TOFA%29/In-detail/Guide-to-the-taxation-of-financial-arrangements-%28TOFA%29/ (accessed 8 January 2018).

On 29 June 2010, a number of amendments to the provisions were announced to improve certainty under TOFA hedging rules. On 29 November, further announcements were made as well as further changes in the 2011 to 2012 budget.

At a 2014 conference, which focused on the symmetrical treatment of TOFA provisions for liabilities, the following statement was made with regard to the introduction of the original legislation in the conference paper that was co-authored by an Assistant Commissioner at the ATO:

> The size of both the amount of foreign currency debt and derivative positions held by large and medium sized Australian entities (including financial institutions, mining companies, general corporates, listed and unlisted trusts, etc.) was unquestionably one of the key reasons for the introduction of TOFA. In this regard, there was a recognition within Treasury, the ATO and the taxpaying community that there needed to be clearer and more comprehensive income tax provisions dealing with such instruments. The introduction of the Division 230 elective methods (plus also FRE9) was also driven by a desire to allow taxpayers to obtain greater book/tax symmetry in relation to these types of transactions.
>
> In other words, it was the very size and importance of both foreign currency debt positions and derivative transactions (which now represent billions of dollars of transactions every year) which was one of the key drivers of the TOFA regime. As part of this, ensuring a consistent treatment for both assets and liabilities was fundamental. This was particularly the case in relation to derivatives which are typically entered into by taxpayers in order to provide an economic hedge in relation to another transaction (for instance, foreign currency debt). As derivatives will typically be entered into 'on-the-money' with movements in value then causing the derivative to either become an asset (an in-the-money derivative) or a liability (an out-of-the money derivative) it was imperative that Division 230 provided for symmetrical treatment in relation to the recognition of gains and losses on assets and liabilities.[8]

It is also evident from the ATO explanation that accounting standards were used to inform legislative design:

> The Division 230 tax framework explicitly takes into account a number of Australian accounting standards. These standards reflect the adoption of the international financial reporting standards in

[8] See E Campbell & A Hirst 'Financial Services Conference, Liabilities – A changing world post TOFA' (2014) *The Tax Institute* 19. Campbell is Assistant Commissioner at the ATO.

> Australia, with effect from 1 January 2005. However, Division 230 does not mandate that taxpayers use accounting standards as the basis for taxation.[9]

The Explanatory Memorandum to the Bill provides helpful clarification on the legislative approach, which now deems all gains and losses from financial arrangements subject to Division 230 to be on revenue account,[10] other than for hedges. A first-time reader of the provisions may face the difficulty of definition, for example, what an arrangement constitutes:

> 2.36 Typically, an arrangement will be constituted by a contract. Generally, this would be the case for ordinary financial instruments, common hybrid instruments and derivatives. However, the concept of arrangement as used in Division 230 recognises that a contractual basis may be insufficient to reflect the substance of an arrangement in all circumstances. It is recognised that modern arrangements can be put together in very complex ways and that their substance may be different from their form …
> 2.44 An *arrangement*, as defined in the ITAA 1997, is a broad concept. It includes any arrangement, agreement, understanding, promise or undertaking, whether express or implied. Moreover, it does not need to be enforceable, or intended to be enforceable, by legal proceedings.[11]

Reference to the legislation, namely section 230-5, identifies the TOFA provisions as applying to financial arrangements that are settled in cash or 'equitable rights and/or obligations' to receive or provide a financial benefit. The concept of a 'benefit'[12] is simply a net gain or loss.[13] A 'financial arrangement' is defined as follows:

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[9] See http://law.ato.gov.au/atolaw/ (accessed 18 July 2014) 1.17. The Australian Accounting Standards Board (AASB) is responsible for developing and issuing Accounting Standards applicable to Australian entities. In 2002, work commenced towards adopting standards that are the same as those issued by the International Accounting Standards Board, for application under the *Corporations Act 2001* for accounting periods beginning on or after 1 January 2005.

[10] See http://law.ato.gov.au/atolaw/ (accessed 18 July 2014) 3.16. Under Division 230 the general rule is that gains and losses from financial arrangements will be on revenue account. This treatment will simplify the law by removing the need to determine the revenue or capital nature of such gains and losses.

[11] See http://law.ato.gov.au/atolaw/ (accessed 18 July 2014); Explanatory Memorandum to Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.

[12] Division 230 focuses on net concepts of gains and losses rather than gross receipts and outgoings (flows), at least under the Subdivision 230-B accruals/realisation and Subdivision 230-G balancing adjustment provisions. Although 'gains' and 'losses' are not specifically defined in Division 230, as a general rule the concept of net gains and losses involves a comparison of the financial benefits provided and received under a Financial Arrangement. See Campbell & Hirst (n 8) 14.

[13] 230-5 Scope of this Division: (1) You have a financial arrangement if you have one or more cash settleable legal or equitable rights and/or obligations to receive or provide a financial benefit.
230-15 Gains are assessable and losses deductible:
Gains
(1) Your assessable income includes a gain you make from a financial arrangement.
Note: This Division does not apply to gains that are subject to exceptions under Subdivision 230-H.

230-50 Financial arrangement (equity interest or right or obligation in relation to equity interest)

(1) You also have a ***financial arrangement*** if you have an equity interest. The equity interest constitutes the financial arrangement.

(2) You also have a ***financial arrangement*** if:

(a) you have, under an arrangement:

(i) a legal or equitable right to receive something that is a financial arrangement under this section; or

(ii) a legal or equitable obligation to provide something that is a financial arrangement under this section; or

(iii) a combination of one or more such rights and/or obligations; and

(b) the right, obligation or combination does not constitute, or form part of, a financial arrangement under subsection 230-45(1).

The right, obligation or combination referred to in paragraph (a) constitutes the financial arrangement.[14]

The Act deliberately seems to use very general language to capture the potential obscurity of what might be constructed by financial innovation. Financial derivatives are generally not mentioned or given naming conventions, undoubtedly to avoid inventive avoidance by way of definition. The statutory definition of a derivative follows this rule of construction:

230-350 *Derivative financial arrangement* and *foreign currency hedge*

Derivative financial arrangement

(1) A ***derivative financial arrangement*** is a financial arrangement that you have where:

(a) its value changes in response to changes in a specified variable or variables; and

(b) there is no requirement for a net investment, or there is such a requirement but the net investment is smaller than would be required for other types of financial arrangement that would be expected to have a similar response to changes in market factors.

Note: Paragraph (a) — a specified variable includes an interest rate, foreign exchange rate, credit rating, index or commodity or financial instrument price.

Losses
(2) You can deduct a loss you make from a financial arrangement, but only to the extent that:
(a) you make it in gaining or producing your assessable income; or
(b) you necessarily make it in carrying on a business for the purpose of gaining or producing your assessable income. Ibid at n 85.

[14] Ibid at n 85.

9.2.2 Character of gains and losses from financial arrangements

The character of gains and losses from financial arrangements follows from the international accounting standards (IFRS) discussed in chapter 4. The Explanatory Memorandum indicates that the designation on character was a matter of policy convenience:

> The revenue/capital distinction in the income tax law is often a very difficult distinction to make, relying on factors such as purpose, the degree of periodicity, and the circumstances in which the relevant amount is found in the hands of the particular taxpayer. Determining the character of the gains and losses against factors such as these can be very demanding and complex and the outcome may be uncertain ….[15]

Consequently, a mixture of approaches is used, by combining specific statutory provisions (for example, 3.22 below), a catch-all Division 230, exemptions (for exempt income) and recognition of hedging, where character follows the object asset of the hedge:

> 3.22 In this regard, certainty as to the character of some gains and losses from financial arrangements has been provided by a number of existing specific provisions. Specifically, revenue treatment has been provided by:
> Sections 26BB and 70B of the ITAA 1936, in relation to the disposal of traditional securities;
> Division 3B of Part III of the ITAA 1936, in relation to foreign currency gains and losses; and
> Division 775 of the ITAA 1997, in relation to foreign currency denominated arrangements (with limited exceptions).
> 3.23 Complexity will be further reduced by removing the capital/revenue distinction in respect of financial arrangements by taxing all gains and losses on revenue account under Division 230. An exception to the requirement that a gain or loss from a financial arrangement will always be on revenue account is contained within the hedging financial arrangements election, and is applicable to certain hedging financial arrangements. Under this exception, the tax characterisation of a hedging financial arrangement may be based on the characterisation already given to the hedged item under the taxation law, and to that extent will not of itself increase complexity to any significant extent.
> 3.24 In addition, any gains and losses to which Division 230 expressly does not apply (such as through an exception as set out in Subdivision 230-H as explained in Chapter 2) will fall for consideration under the existing tax law. This means their tax treatment, including their character, is to be determined by any residual operation of the ITAA 1936 and the ITAA 1997.
> Nexus test for losses

[15] Ibid. See Explanatory Memorandum at 3.21.

> 3.25 To be deductible, the current income tax law requires a sufficient nexus between losses and the gaining or producing of assessable income. This concept is preserved under Division 230.[16]

In 2015 I visited Australia with representatives from the South African Reserve Bank (SARB) and the National Treasury on matters related to macro prudential policy. Several of the meetings also provided an opportunity to inquire about the taxation of financial derivatives. In a meeting with a representative of the Australian Treasury on 29 July 2015, it was mentioned that a review of TOFA had become necessary.

In the 2016 to 2017 budget, the Australian Government announced that TOFA would undergo further reforms, effective 1 January 2018, to 'reduce the scope, decrease compliance costs and increase certainty'. This would include four key components:[17]

1. a 'closer link to accounting' to strengthen and simplify the existing link between tax and accounting in the TOFA rules;
2. simplified accruals and realisation rules;
3. a new tax hedging regime which is easier to access, encompasses more types of risk management arrangements (including risk management of a portfolio of assets) and removes the direct link to financial accounting;
4. simplified rules for the taxation of gains and losses on foreign currency to preserve the current tax outcomes but streamline the legislation.

[16] Explanatory Memorandum.
[17] See https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Incometax-for-businesses/Taxation-of-financial-arrangements---regulation-reform/ (accessed 8 January 2018).

CHAPTER 10

AUSTRALIA: TREATMENT OF INCOME CHARACTER

10.1 INTRODUCTION

> [T]he words income and capital are ordinary English words, in the sense that they each appear in the dictionary …. There is no reason to suppose that either word is used in some technical or trade way. Hence it would seem to follow that it will be the task of the judge to determine, without evidence, their meaning. To the extent that business people or accountants attribute some special or different meaning to the words, those meanings would be disregarded and, in particular, evidence could not be advanced as to such usages.[1]

As mentioned above, case law on income character determination for derivatives in Australia is limited. The main cases are *FC of T v Visy Industries*[2] and *Commissioner of Taxation v Woolcombers*.[3]

The main derivative-related ATO rulings, which are not all relevant to the narrower confines of this research, are the following:

TR 2014/7 – foreign currency hedging transactions

TR 2012/13 – gains/losses on financial arrangements connected to earning NANE or exempt income

IT 2228 – futures transactions

IT 2050 – interest rate swaps – character

IT 2682 – interest rate swaps – timing

TR 1996/D13 and TR 99/D13 (withdrawn) – payments under swap contracts.

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[1] Justice DG Hill 'Income and capital: Have the goal posts been moved?' (1995) 4 *Taxation in Australia: Red Edition* 8 at 10.
[2] *FC of T v Visy Industries USA Pty Ltd* (2012) ATC 20-340.
[3] *Commissioner of Taxation v Woolcombers Pty Ltd* (1993) 93 ATC 5170. This case involves deductibility for forward agreements related to commodities and does not apply to this research.

As a jurisdiction, case law is therefore largely instructive on general principles associated with share dealing, rather than derivatives as a class of instrument within that body of case law.

Rulings by the ATO were found to be very helpful in establishing a perspective on case law development. In this section, key elements of Tax Ruling 92/3 are highlighted, 'whether profits on isolated transactions are income',[4] which is the most complete treatment by the ATO on the subject of general income character.

10.2 PROFIT-MAKING PURPOSE

Californian Copper Syndicate v Harris[5] is cited by the ATO as 'the starting point in this area of the law',[6] citing Lord Justice Clerk (the Right Honourable JHA Macdonald) as follows:

> It is quite a well settled principle, in dealings with questions of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit ... assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. ... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of values by realising a security, or is it a gain made in an operation of business in carrying out a scheme of profit-making?[7]

In this case, the taxpayer had made an $80 million interest-bearing loan over seven years at 12,5 per cent per annum to a subsidiary and then, three days later, as predetermined, assigned the right to the interest income in exchange for a lump sum, discounted to a net present value at a rate of 16 per cent per annum. The court found that the amount ($45.37 million) was income. On appeal, the amount was held to be capital by both the Supreme Court of Victoria

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[4] The ATO was responding to the decision in *FC of T v The Myer Emporium Ltd* (1987).
[5] *Californian Copper Syndicate v Harris* (1904) 5 TC 159 at 165–6.
[6] TR 92/3, page 6 at 27.
[7] This passage from Californian Copper has been approved by the House of Lords on numerous occasions – see eg *Commissioner of Taxes v Melbourne Trust Ltd* (1914) AC 1001 at 1010; *Ducker v Rees Roturbo Development Syndicate Ltd* (1928) AC 132 at 140, and *Punjab Cooperative Bank Ltd, Amritsar v Income Tax Commissioner*, Lahore (1940) AC 1055 at 1072. J Manyam 'Taxation of gains from banking and insurance businesses in New Zealand (2010) 20(1) *Revenue Law Journal* article 6 at 2 n 3.

and the full bench of the Federal Court of Australia. Successful appeal to the full High Court relied upon the following two alternatives for its reasoning:

(a) The amount in issue was a profit from a transaction which, although not within the ordinary course of the taxpayer's business, was entered into with the purpose of making a profit and in the course of the taxpayer's business.

(b) The taxpayer sold its mere right to interest for a lump sum, that lump sum being received in exchange for, and as the present value of, the future interest it would have received. The taxpayer simply converted future income into present income.[8]

Such purpose need not be in the ordinary course of business as understood in the context of a continuum of activities. In *Blockey v FC of T*, the judge stated:[9] 'But if a man, even in a single instance, risks capital in a commercial venture – say, in the purchase of a cargo of sugar or a flock of sheep – for the purpose of profit making by resale and makes profit accordingly, I do not for a moment mean to say he has not received "income" which is taxable.'

This view was further discussed in *FC of T v Whitfords Beach Pty Ltd*[10] and confirmed by Mason J.

10.3 PROFIT OR GAINS IN THE ORDINARY COURSE OF BUSINESS

The consequence of business is hopefully income and the nature of certain businesses implies income in the ordinary course. The ATO cites banks and insurance companies as examples of businesses where the sale of investments typically represents income.[11] This might be regarded as glossing over the complex nature of the activities of these entities. However, banks, as an example, are often willing to take this view on the sale of investments, given the trading that is done on proprietary desks, allowing losses and profits to be netted. Alternatively, income may

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[8] See TR 92/3, page 6 at 26.
[9] *Blockey v FC of T* (1923) 31 CLR 503 at 508–9.
[10] *FC of T v Whitfords Beach Pty Ltd* (1982) 150 CLR 355 at 376, 82 ATC 4031 at 4042, 12 ATR 692. A company which owned beachfront land suffered a change in ownership and then procured changes of zoning, developed the land as a residential subdivision, and sold the vacant subdivided lots for a profit of several million dollars.
[11] *Chamber of Manufactures Insurance Ltd v FC of T* (1984) 2 FCR 455, 84 ATC 4315, 15 ATR 599 and *C of T v Commercial Banking Co. of Sydney* (1927) 27 SR (NSW) 231.

be generated in the ordinary course of a business, where the proceeds of a specific transaction lack the character or qualities of income.[12]

10.4 PROFIT OR GAINS IN ISOLATED TRANSACTIONS

In *Myer*,[13] the full High Court made the following remarks about isolated transactions:

> It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profitmaking by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realisation. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction. … The courts have often said that a profit on the mere realization of an investment is not income, even if the taxpayer goes about the realization in an enterprising way.[14]

The ATO regards a profit from an isolated transaction as being taxable as income when there was both an intention present when entering the transaction to make a profit, and that intention was accompanied by a business context.[15]

The taxpayer's intention might be that associated with those who control it, in the case of a company.[16] However, intention is not a subjective notion, but is borne out by objective facts. The ATO speaks to *degree* by saying that dominance of intention is not needed either,[17] because '[i]t is sufficient if profit-making is a significant purpose'.[18]

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[12] *Commercial and General Acceptance Ltd v FC of T* (1977) 137 CLR 373 at 381, 77 ATC 4375 at 4380, 7 ATR 716 at 722, per TR 92/3 at pages 7 and 8, para 32.
[13] 163 CLR 213, 87 ATC 4369, 18 ATR 699–700. See TR 92/3 at para 34.
[14] TR 92/3 at para 36.
[15] See TR 92/3 at para 35.
[16] *Whitfords Beach* 150 CLR 370, 82 ATC 4039, 12 ATR 701.
[17] At para 40.
[18] *FC of T v Cooling* 90 ATC 4472 at 4484, 21 ATR 13 at 26; *Moana Sand Pty Ltd v FC of T* 88 ATC 4897, 19 ATR 1853; *AGC Investments Ltd v FC of T* 91 ATC 4180, 21 ATR 1379. See also *Forwood Down and Co Ltd v Commissioner of Taxation* (WA) (1935) 53 CLR 403 (especially Evatt J) and Jacobs J in *London Australia Investment Co Ltd v FC of T* 77 ATC 4398 at 4409–11, 7 ATR 757 at 770–2. TR92/3 at page 10 para 40.

Ideally, intention must be present at the time of entering into the transaction. However, intentions might change and so would the status of the asset when it is committed to a business venture, scheme or transaction.[19]

It is possible within the context of a business operation that a transaction is not profit-making and then the intention of the taxpayer will be important in substantiating purpose:

> It is not our view, nor has it ever been, that all receipts or profits of a business are income. For example, when a taxpayer derives a profit from a transaction outside the ordinary course of carrying on its business and the taxpayer did not enter that transaction with the purpose of making a profit, the profit is not assessable income.[20]

Factors that might assist with discerning the character of isolated transactions include the following:

1. the self-defining nature of the entity undertaking the transaction (a company versus a family trust);[21]
2. its relative scale to other activities undertaken by the entity;[22]
3. the amount of money involved in the transaction and the magnitude of profit sought or gained;
4. the nature, scale and complexity of the operation;
5. the manner in which the transaction was executed, including professional advisers involved in structuring the transaction;
6. the arm's length nature of the transaction;
7. the nature of the property (is the property only for commercial use – this points to

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[19] *White v FC of T* (1968) 120 CLR 191, 15 ATD 173 and *Whitfords Beach v FC of T* (FC) 79 ATC 4648. (See also Menzies J in *FC of T v NF Williams* (1972) 127 CLR 226 at 245, 72 ATC 4188 at 4192–3, 3 ATR 283 at 289 and *Whitfords Beach Pty Ltd v FC of T* (FC) 79 ATC 4648 at 4659, 10 ATR 549 at 567.) TR92/3 at page 10 para 41.
[20] ATO opinion. TR92/3 at page 10 para 44.
[21] *Ruhamah Property Co Ltd v F C of T* (1928) 41 CLR 148 at 154; *Hobart Bridge Co. Ltd. v FC of T* (1951) 82 CLR 372 at 383; *FC of T v Radnor Pty Ltd* 91 ATC 4689; 22 ATR 344). See TR 92/3 at paragraph 49(a), at page 12.
[22] *Western Gold Mines NL v C of T* (WA) (1938) 59 CLR 729 at 740.

intention);[23]

8. the timing (asset held for a long time) or frequency of the operation.[24]

Westfield Ltd v Commissioner of Taxation[25] followed the *Myer*[26] case on isolated transactions.[27] Westfield was in the business of designing, constructing, letting and managing shopping centres.[28] In 1978, the taxpayer acquired an option to buy a block of land with the potential of developing a shopping centre in an advantageous location. The taxpayer's initial plans were to develop the land. The option was exercised and the land was later sold at a profit on the agreement that Westfield would be given the contract to design and build a shopping centre on the land. The Commissioner took the view that the transaction was one of a scheme of profit-making, given that a profit was made using the opportunistic foresight of its management. Sheppard J stated as follows:

> There are statements in memoranda and letters which indicate that he was not interested in the sale of the land unless the applicant were retained as the developer and builder – he realised that he could not obtain the leasing or management rights as well. He did not hold out for a top price let alone an excessive one. Once he had secured the agreement of the A.M.P. that the applicant could design and build the shopping centre, the sale of the land was very much a collateral or consequential matter. He sold for a reasonable price and no more … It was not its business to buy and sell vacant land. Hence the

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[23] *Edwards v Bairstow*; *Hobart Bridge* 82 CLR at 383.
[24] *Ruhamah Property* 41 CLR at 154. See TR 92/3 at page 13 para 49(h).
[25] *Westfield Ltd v Commissioner of Taxation* (1990) 90 ATC 4428.
[26] Sheppard J, quoting from the *Myer* case at 4807: 'Later their Honours said (ATC p. 4367; CLR p. 211): "The important proposition to be derived from *Californian Copper* and *Ducker* is that a receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction". The references to *Californian Copper* and *Ducker* are references respectively to *Californian Copper Syndicate* v *Harris* (1904) 5 TC 159 and to *Ducker* v *Rees Roturbo Development Syndicate Ltd.* (1928) AC 132.'
[27] Sheppard J, quoting from the *Myer* case at 4807: 'The final passage to be quoted from the judgment in the *Myer case* is the following (ATC pp. 4368–4369; CLR p. 213): "... profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the profit arising from their expected increase in value" — see the discussion by Gibbs J. in *London Australia* [*London Australia Investment Co. Ltd.* v *F.C. of T.* 77 ATC 4398 at pp. 4403-4404; (1976-1977) 138 CLR 106 at pp. 116–118].'
[28] At that stage the applicant, or the companies associated with it, had built and then owned seven major shopping centres in New South Wales, Victoria and Queensland. The applicant was also managing three shopping centres built by it for financial institutions and leased back from them under long-term leases. The only other significant developments that were undertaken and owned were an office and hotel block and a motel complex in Sydney. See *Westfield* (n 25) 4803.

> profit was not income according to ordinary concepts. No more was involved than the realisation of one of its capital assets.[29]

A full Federal Court therefore found that the purchase and sale were in the ordinary course of the business of the taxpayer and should be taxed, not as an isolated profit-making venture, but as a transaction in congruence with its ordinary modus and therefore as capital (the taxpayer was not speculating on a piece of land):

> That having been said, it seems to me, however, that the whole of the transaction, including the sale of the land, was one carried out in the ordinary course of the applicant's business and was part of an overall profit-making venture. I do not feel able to separate out the sale of the land from the totality of the transaction. The sale of the land was a necessary step in the carrying out of the entirety of what was involved … Critical to be taken into account are the applicant's intentions and purposes at that time. The evidence establishes, as I have said, that the applicant intended, when it acquired the land, to use it in a way which, although not then precisely foreseen, would achieve for it participation in the development of it and other adjacent land into a shopping centre whether integrated with Garden City or not. It did not envisage sale as a necessary consequence. But it was certainly a possibility. As events turned out the land was sold … In my opinion, it must follow that the amount of the profit was properly included in the applicant's assessable income.[30]

In *FC of T v Visy Industries,*[31] the taxpayer was a member of the Pratt Group (family-owned since 1948) whose businesses included waste collection, paper manufacturing, packaging and property and share investments. The Australian taxpayer was the holding company for the group's manufacturing division operating in the USA. The matter involved a hedging of USD liability on the restructuring of its debt through the issuance of corporate bonds. The board of Pratt Finance resolved on 19 March 1997 that the placement of senior unsecured notes in the amount of USD400 million would be placed with institutional investors resident in the USA, repayable in 15 to 18 years.[32] The Group Finance Director of Pratt Holding

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[29] Ibid 4805–7.
[30] Ibid 4808.
[31] *FC of T v Visy Industries USA Pty Ltd* (2012) ATC 20-340.
[32] Ibid 10.

Pty Ltd described the transaction as 'the likes of which [they had] never entered into before'.[33] The stated intention was to secure both the benefits of a hedge and the benefit of profit within the considerable 20-year term of the forward exchange contract, secured internally at open market rates. The group felt that rather than pay fees to external parties (such as a bank), the group could transact within its ranks to similar effect more economically, after taking professional advice. The relevant exchange rate of USD0.775 was described as a historically 'reasonable amount'.[34] Visy USA therefore agreed to sell to Pratt Finance five amounts of USD, being amounts that matched Pratt Finance's USD liability under half of the bonds. In exchange, Pratt Finance agreed to deliver to Visy USA equivalent amounts of AUD at the agreed exchange rate of USD0.775. Then, from mid-May 1997, the Asian economic crisis caused the AUD to fall sharply against the USD. By the middle of 1998 the AUD had fallen below USD0.59 and Visy USA had an unrealised loss of AUD80 million.[35] The auditors called the nature of the hedge into question if Visy USA could not afford to settle the amount. When the rate recovered somewhat to USD0.645, a forward agreement was decided upon to protect Visy Industries. This indemnity provided by Pratt Investments involved the payment of a one-off, non-refundable fee of USD17,801,325, upon execution of the agreement.[36] The Commissioner contended that this amount was of a lump sum capital nature in the interests of protecting the business structure of the organisation. The primary judge rejected the Commissioner's view that the forward exchange contract was not commercial and was not an adventure in the nature of trade. She also concluded that the subsequent indemnity fee was an allowable deduction to Visy USA, either as being incurred in 'gaining or producing its assessable income or as being necessarily incurred on a business for that purpose'.[37]

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[33] Ibid 11.
[34] Ibid 23.
[35] Ibid 32.
[36] Ibid 41 and 42.
[37] Ibid 45 and 46.

On appeal, the judgment was upheld. A number of interesting statements were made by the court, quoted here selectively:

> References to 'profit-making undertaking', 'profit-making scheme' or 'adventure in the nature of trade' were found to be 'muffled echoes of old arguments' concerning old legislation.[38]
>
> *Myer Emporium* was referenced, where 'it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income'.[39]
>
> The extraordinary nature, albeit it subject to the facts of the case, cannot detract from its income nature if the taxpayer's intention or purpose was profit or gain.[40]
>
> The appeal rejected the approach that the fact that 'the outcome of a particular activity may be dependent, in part, on chance does not negate a business activity being carried on' and did therefore not constitute a wager.[41]
>
> The Commissioner contended that the indemnity fee was not incidental or relevant to the purpose of profit-making, but to the maintenance of an internal hedge. The court agreed that basing the nature of receipts and outgoings or profits and losses on analogies can be dangerous. 'They can mislead by leading to taxation by reference to economic equivalence, in other words, by reference to the same commercial result. The courts of this country have said on many occasions in the past that this is neither helpful nor, indeed, permissible …'.[42]
>
> The court found that the forward agreement was in form and substance an insurance contract.[43]
>
> The non-recurrent nature of the indemnity payment alone will not characterise the outgoing as being of a capital nature.[44]
>
> The company did these things, in the course of its business, albeit not in the ordinary course of that business. Furthermore, the indemnity fee did not secure any enduring benefit of a capital nature.[45]

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[38] Ibid 52 and in contrast to judicial thinking in South Africa as espoused in *Pick 'n Pay*.
[39] Ibid 52.
[40] The court cited *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd*.
[41] *FC of T v Visy Industries USA Pty Ltd* (2012) ATC 20-340 at 58.
[42] Ibid 68.
[43] Ibid 69.
[44] Ibid 74.
[45] Ibid 75 and 76.

10.5 PROFIT OR GAINS ON SHARES

Tax Ruling 2005/23[46] (TR 2005/23) provides an exhaustive statement on the subject of equity income character, issued with respect to the listed investment companies (LIC) regime in Australia.[47] The LIC regime allows certain 'permitted investments':

> (a) shares, units, options, rights or similar interests to the extent permitted by subsections (5), (6), (7) and (8); or
>
> (b) financial instruments (such as loans, debts, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract); or …[48]

and subject to a number of conditions, allows investors a discount on capital gains tax.

In the ruling, on the subject of the characterisation of gains, the ATO relies substantively and almost exclusively on *London Australia Investment Co Ltd*[49] as significant authority on the matter. Gibbs J summarised the facts of the case as follows:

> The taxpayer is an investment company … Its principal object was to invest mainly or wholly in Australian securities, for the purpose of producing dividend income … During the years in question the directors of the taxpayer met each month to decide whether shares should be bought or sold, and during that period, as Helsham J. found, the taxpayer engaged in a continuous large scale activity in the buying and selling of shares. In deciding what shares should be bought, sold or retained the taxpayer was guided by a number of principles, but one important consideration in buying shares was that the shareholding should immediately or within a reasonable time produce a dividend yield of four percent or better ... In buying shares the taxpayer was influenced by their 'growth potential', that is, the expectation that they would produce a greater dividend yield. … In the years in question there was a steady rise in share prices and in consequence the dividend yield of many shares held by the taxpayer

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[46] Issued on 21 December 2005. References are to the consolidated version issued on 6 March 2013. This Ruling is concerned with the operation of Subdivision 115-D (Tax relief for shareholders in listed investment companies) that is contained in Part 3-1 of the Income Tax Assessment Act 1997 (ITAA 1997). All legislative references are to the ITAA 1997 unless otherwise stated.

[47] 'A capital gain made by a company is not reduced by the CGT discount, a concession that is available to other entities making a capital gain. Similarly, a shareholder receiving a distribution of a capital gain as a dividend does not benefit from the CGT discount that may have been available if the shareholder had made the capital gain directly. The amendments in Schedule 4 to this bill amend Division 115 of the ITAA (1997) by introducing Subdivision 115-D. These amendments enable certain shareholders in LICs to effectively reduce the eligible capital gain component of a dividend by the CGT discount'. See http://law.ato.gov.au/atolaw (accessed 8 July 2014).

[48] See http://law.ato.gov.au/atolaw (accessed 8 July 2014).

[49] *London Australia Investment Co Ltd* (1977) 138 CLR 106, 7 ATR 757, 77 ATC 4398.

> fell and many shares were sold. The shares sold in each of the years in question exceeded a million dollars in value and amounted to at least one-tenth of the total value of the shares held in that year. The moneys realized on the sale of the shares were not under the articles of the taxpayer available for dividend but could be used to buy further shares or to make up a future capital loss … The principal question for decision in these three appeals is whether the Commissioner was right in including in the taxpayer's assessable income for the years 1967, 1968 and 1969 the respective amounts of $816,651, $140,166 and $413,263 which represent the difference between the net proceeds of the sale of shares sold by the taxpayer in each of those years and the average cost to the taxpayer of the shares.[50]

TR 2005/23 highlights certain qualitative indicators that point to character determination. Much seems to be made of the investment process envisaging an 'exit point': 'Nonetheless, the fact that the investment process envisaged an "exit point" for some shares appeared to be critical to the finding that the taxpayer held shares on revenue account.'[51] This assessment is then expanded with reference to investment styles in general, such as 'value investing' – a technique that typically uses a price-to-book ratio to purchase undervalued stocks, but similarly sells if the shares become over-valued by the market (an exit price). In value investing, the shares are not typically bought with an intention to sell, but simply with the identification of a valuation threshold beyond which the investment manager would not consider the investment to be prudentially justifiable (they are too expensive relative to their earnings). However, the ATO explains:

> Similar reasoning would apply to any investment process which implicitly or explicitly envisages an exit point. For example, portfolios managed according to a 'value style' normally envisage the purchase of undervalued stocks and subsequent sale of the stocks once they become 'fully valued' by the market. It would normally follow that such portfolios would be held on revenue account. Similar conclusions may be reached about other investment styles ... The absence of an investment style which envisages an exit point is one indicator that the portfolio would be held on capital account, so that any disposals from that portfolio would be mere realisations of investments. The 'buy and hold' philosophy is an example of such a style.[52]

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[50] Ibid 114–15.
[51] TR2005/23 para 76.
[52] Ibid paras 77 and 80.

Focus is then given to what seems to be a requirement for an 'incidental' quality to the sale transaction, which 'is no more than a mere realization', which might refer to the degree or scale of activity. *Myer Emporium* is used by the ATO to explain this in more detail:

> On the other hand, where the sale of stocks is no more than a mere realisation or change of investment, the proceeds are not recognised as income according to ordinary concepts but as capital gains or losses. The Full High Court set out this principle in *FC of T v Myer Emporium Ltd* (1986-1987) 163 CLR 199 at 213 as follows:
>
> > '… over the years this Court, as well as the Privy Council, has accepted that profits derived in a business operation or commercial transaction carrying out any profit-making scheme are income, whereas the proceeds of a mere realisation or change of investment or from an enhancement of capital are not income ….'
>
> The proposition that a mere realization or change of investment is not income requires some elaboration. First, the emphasis is on the adjective 'mere': *Whitfords Beach* ((1982) 150 CLR at p 383). Secondly, profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the profit arising from their expected increase in value: see the discussion by Gibbs J in *London Australia* ((1977) 138 CLR, at pp 116–118). It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realization. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.[53]

In *London Australia Investment Company*,[54] Gibbs J, in finding that the relevant gains were on revenue account, stated that '[t]he sale of shares was a normal operation in the course of carrying on the business of investing for a profit.'

It is likely that all LICs would be considered to be carrying on an investment business. On principle, the same could be said of any investment management structure used by professional portfolio managers to manage client monies (such as an MIT or other trust structure).

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[53] Ibid para 78.
[54] *London Australia Investment Company* CLR 117, ATR 763, ATC 4403–4404.

TR 2005/23 summarises a list of criteria that are indicative of an income character:

(a) a low average annual turnover (that is, less than *London Australia*, where the average turnover had been in the order of 10%);
(b) a lack of regularity in sale activity (*AGC (Investments) Limited v FC of T* 92 ATC 4239 (*AGC (Investments*)); *Trent Investments Pty Ltd v FC of T* 76 ATC 4105);
(c) a high proportion of stocks sold have been held for a significant number of years (see *AGC (Investments)* — 75% of stocks sold held more than 5 years). However, if a high proportion of the remainder are turned over, this tends to the opposite conclusion;
(d) a low level of sales transactions compared to the number of stocks in the portfolio (see *Milton Corporation v FCT* 85 ATC 4243);
(e) profits on sale normally constitute a small percentage of total income; and significant percentage of 'aged' stocks remain in the portfolio (*AGC (Investments)* — nearly 60% of stocks held more than 10 years)'.[55]

In a joint submission by the Taxation Institute of Australia, CPA Australia, the Institute of Chartered Accountants in Australia, and the National Institute of Accountants and Taxpayers Australia,[56] they take strong exception to what seems to be a stance of over-reliance on *London Australia Investment Co Ltd* to the effect that it seems to nullify the policy objectives of the LIC regime.

10.6 PROFIT OR GAINS ON SHARES — ALTERNATIVE GENERAL FINDINGS

In contrast to *London Australia Investment Co. Ltd, Charles v FC of T*[57] involved the characterisation of a receipt by a unit holder in a unit trust, where almost 50 per cent of the proceeds of a distribution (£390) constituted capital profits from rights issues and realisations within the portfolio for the year ended 30 June 1949. The Commissioner contended that this portion constituted proceeds from a profit-making undertaking or scheme that had, from the beginning, the character of income produced from 'personal exertion'.[58] The trust deed allowed

[55] TR2005/23 para 80.
[56] Joint Submission by Taxation Institute of Australia, CPA Australia, Institute of Chartered Accounts in Australia, National Institute of Accountants and Taxpayers Australia, Draft Taxation Ruling TR 2005/D2, dated 14 March 2005.
[57] (1954) 90 CLR 598.
[58] At 598.

for the variation of securities. Counsel for the Commissioner was at pains to explain the dealings in securities which were 'considerable; they occurred frequently and produced substantial profits'.[59] The High Court found that the actions of the investment manager were 'transactions effected in the course of performing a fiduciary duty to preserve for beneficiaries as far as practicable the assets comprising the trust fund and any increments in the value of those assets which might appear from time to time to be in jeopardy.'[60]

In TD 2011-D1, the ATO stated that some commentators had taken the decisions in *London Australia* and *Charles* as indicative of the fact that the actions of trustees will always constitute 'a necessary incident of the trustee's fiduciary duty to preserve for beneficiaries as far as practicable the assets comprising the trust fund and any increments in the value of those assets.'[61]

However, the decision in *Charles*, stated the ATO (with which I concur), 'was based largely on the unchallenged evidence from the manager of the trust that at no time were securities acquired for the express purpose of re-sale at a profit and that sales were normally made when the managers anticipated a fall in the value of shares.'[62]

Radnor[63] involved an investment vehicle for three trusts set up to support a disabled person for the rest of his life. In *Radnor,* Hill J referred to the decision in *Charles* as follows:

> The trust deed provided that, except for the purposes of the deed, the trustees should not sell any investments until the determination of the trust. Nevertheless the deed did give the trustees a wide power to vary investments. The court, on the evidence before it which included the provisions of the trust deed, saw the case as one where the transactions were effected in the course of the trustee's fiduciary obligations to the beneficiaries to preserve for them the trust assets and increments thereto, rather than as a case where the trustees were carrying on a business of 'stock jobbing'. Nevertheless, Dixon CJ, Kitto and Taylor JJ said (at ATD 331; CLR 610):

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[59] Ibid 609.
[60] Ibid 612.
[61] TD 2011-D1 at 6 para 42.
[62] Ibid para 43.
[63] *FC of T v Radnor Pty Ltd* 91 ATC 4689, (1991) 22 ATR 344.

> '[I]f the proper conclusion from the evidence were that the managers and the trustees co-operated in pursuing a systematic course of buying and selling securities for the purpose of producing profits and thereby swelling the half-yearly amounts of 'cash produce' available for distribution to certificate-holders, the Commissioner's opinion that such profits should be treated as assessable income of the certificate-holders when paid over to them would be clearly correct.'[64]

TD 2011-D1 summarises what the ATO would regard as factors that would contribute to a capital determination for trust actions:

1. the absence of an investment style that envisages an exit point;
2. a low average annual turnover – that is, less than in *London Australia* where turnover had been in the order of 10 per cent;
3. a lack of regularity in the particular sale activity – *AGC (Investments) Limited v FC of T* (1992) 23 ATR 287, 92 ATC 4239; *Trent Investments Pty Ltd v FC of T* 76 ATC 4105, (1976) 6 ATR 201;
4. a high proportion of stocks sold have been held for a significant number of years (see *AGC (Investments)* – 75 per cent of stocks sold held more than 5 years). However, if a high proportion of the remainder are turned over, this tends to support the opposite conclusion;
5. a low level of sales transactions compared to the number of stocks in the portfolio – see *Milton Corporation Ltd v FC of T* 85 ATC 4243, (1985) 16 ATR 437;
6. profits on sale normally constitute a small percentage of total income;
7. significant percentage of 'aged' stocks remain in the portfolio (*AGC (Investments)* – nearly 60 per cent of stocks held for more than ten years); and
8. the existence of a family as distinct from a commercial explanation for the dealing.[65]

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[64] At ATC 4698 and 4699.
[65] TD 2011-D1 para 55.

AGC (Investments) Ltd[66] presents an interesting co-mingling of issues, often at the centre of cases involving income character determination. It is doubtful whether Commissioners bring cases against taxpayers when capital losses are claimed in declining markets, arguing that they are business income. If so, this would provide a proper balance of argument. AGC sold a significant portion of its investment book at the height of the 1987 bull-run, had a group structure that was open to challenge with respect to separation of functions, had both long-term investments and significant realisations, coupled with internal communications that were conflicting at times and certainly cognisant of the case law implications of trading.

AGC was part of an insurance group, and amounts were advanced to the investment arm to invest on behalf of the group. By March 1983, the amount owed by the appellant to *AGC (Insurances)* on this account was $23,250,000. By September 1987, the account stood at $91,683,103.55. In the 12 months to 30 September 1987, the appellant sold its holdings in 33 companies, realising the sum of $79,413,638. The sales represented approximately one-half of the value of the portfolio. The surplus achieved on realisation was $45,068,043 in total.

In a letter to the fund managers, 'Westpac Management', on 26 January 1978, the General Manager commented on the investment policy for the portfolio. Tax advice was sought on the *London Australia* investment case. The following comments were made to Westpac:

> If we are to be taxed on the principles set out in the judgment we may as well face these issues and exploit all forms of gain from our equity operation. We shall inform you of their advice and the policy we should like to follow.
>
> Notwithstanding the above we feel it is important that you should fully exploit the cyclical fluctuations in the share market by capitalising on market highs for sales and repurchasing at the bottom of any depressed period.[67]

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[66] *AGC (Investments) Limited v FC of T* (1992) 23 ATR 287, 92 ATC 4239.
[67] At 4242.

The Commissioner based the contention of profit-making on this correspondence in particular. More moderated subsequent correspondence is referred to in the judgment concerning, in particular, the *London Australia* case, by Beaumont, Gummow and French JJ:[68]

> It will be recalled that, by its letter dated 26 January 1978, the appellant informed Westpac Management that the appellant was seeking advice as to the effect of the *London Australia* decision; and that, if the appellant were to be taxed accordingly, the appellant should 'exploit all forms of gain from our equity operation'. The letter added that, notwithstanding this, Westpac Management 'should fully exploit the cyclical fluctuations in the share market by capitalising on market highs for sales and repurchasing at the bottom of any depressed period.' On behalf of the Commissioner, much reliance is placed upon this passage to justify the inference, at the time of acquisition, of a purpose or intention on the part of the appellant, of profit making by subsequent sale.[69]

It seems as if advantage was deliberately sought from a rising market in quite an aggressive manner for an insurer managing reserves. The reference to *London Australia* when deciding investment strategy in itself seems to point to concern with management's own intent. The timing of the exit point just before the stock market crash in October 1987 appears to further endorse the opening motivation, 'should fully exploit the cyclical fluctuations', as expressed in the letter of 26 January 1978. Subsequent correspondence referred to seems almost to manage down the impact of the 1978 letter, as if guided by advice. However, records of transactions dating back to 1970 were examined. Evidence given and accepted by the full Federal Court was that, of a total of 81 equity acquisitions, 26 had been held for a period exceeding 15 years, 20 had been held for a period of between ten and 15 years, and an additional 14 had been held for between five and ten years. This is not synonymous with the management of working capital (or circulating capital as the Australians seem to refer to it) or with a trading motive.

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[68] A full Federal Court opinion.
[69] *AGC (Investments) Limited v FC of T* (1992) 23 ATR 287 [58] and [59].

In the final weighing of the matter, the appeal was not so much about primary facts or the credibility of testimony, but about inferences that could be drawn from correspondence:

> There is little, if any difference in the submissions put by the parties with respect to the legal principles applicable here. The central issue in the litigation at first instance and before us, was the true characterisation of the appellant's purpose in acquiring its share portfolio. This is a question of fact, albeit of secondary fact. There is no real dispute about the primary facts, and little appears to turn on the credit of the individual witnesses called on behalf of the appellant. But the proper inferences to be drawn from the primary facts are contentious.[70]

While this is not helpful with respect to legal principle (the principles were not in dispute), it proves the point that, given no difference of opinion on fact or principle, in the final instance, a judgment will have to be made on what the court believes are the true intentions of the taxpayer. Where this is not subject to disagreement on objective facts, it leaves assessment of subjective intent as the final arbiter of income character, which is a consequence more suited to adjudicating matters for individual taxpayers rather than corporate or collective entities.

In *FCT v Equitable Life & General Insurance Co Ltd*,[71] the taxpayer was a company belonging to insurance group QBE Insurance (International) Ltd. For several years, until the 1983 and 1984 tax years, the taxpayer was assessed for tax as a share investor, after ceasing its insurance business in 1977 and operating as an investment company within the group. The taxpayer also engaged in intra-group loans. At least one other company in the group, QBE Securities (Pty) Ltd, also appears to have been taxed in this manner.

Equitable Life contended that the investment portfolio did not constitute 'circulating capital' for the business of insuring risk within the group:

> The taxpayer's investments have never been viewed by its directors or shareholders as a potential reserve fund to meet the liquidity requirements of QBE's group insurance operations. Proceeds from the disposal of the taxpayer's investments have, in fact, never been used for this purpose. To cover any major catastrophe QBE Insurance (International) Limited has entered into reinsurance treaties. Further,

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[70] Ibid [45].
[71] *FCT v Equitable Life & General Insurance Co Ltd* (1990) 21 ATR 364, 90 ATC 4438.

> proceeds from the disposal of the taxpayer's investments are never taken into account in QBE's group insurance operations' cash flow forecasts or budgets.[72]

In the years of income that ended 30 June 1979, 1980, 1981 and 1982, three acquisitions were made that were not associated with new issues and take-over offers relating to an existing investment. In 1981, as can be seen below, substantial sales were made. The company expected the market to correct, and sold $9,8 million worth of shares over the next two years.[73] In 1983 and 1984 the company purchased $7,2 million in an apparent reversal of that sentiment,[74] but then cleared out the portfolio in the latter year in the amount of $12,7 million. Yet Davies J, with a full bench, commented that:

> Such a course was not inconsistent with long-term investing, though it tends towards profit-making and profit-taking … Overall, the portfolio appears to have been a widespread, secure portfolio which was managed in a conservative manner, though managed so as to enhance its overall capital value.[75]

Table 10.1: Yearly purchases and sales (inception to liquidation)[76]

DATE	PURCHASES	SALES
	AUD	AUD
1978	4 195 071,54	703 417,00
1979	570 306,17	1 813 170,00
1980	332 041,81	1 945 825,00
1981	341 452,34	7 251 367,00
1982	244 362,44	2 313 869,00
1983	3 741 517,78	745 745,24
1984	3 447 211,20	12 701 281,00
TOTAL	**12 871 963,28**	**27 474 674,24**

[72] *FCT v Equitable Life & General Insurance Co Ltd* (1990) 21 ATR 364, 90 ATC 4438 at 4440.
[73] Davies J, quoting the trial judge: 'After March 1980 there was an instruction requiring the investment committee "to continue to rationalise the share portfolios and improve their performance". The September 1980 resolution was not directed to advantageous disposal of shares. Although the evidence does not establish the constant "fine tuning" found in *London Australia*, it must be assumed that the investment manager had regard to these directions in making decisions as to the acquisition and disposal of shares.' See *FCT v Equitable Life & General Insurance Co Ltd* (n 72) 4442.
[74] '*Pincus* J. has set out the memorandum of a Mr Moody dealing with the policy for the last six months of 1983. This shows that, as there were excellent long-term investment opportunities in both the resources and industrial sectors "$10 million should be made available for long-term share investment" and that as "excellent short-term situation opportunities are expected to become available in both the resource and industrial sectors ... an additional $1 million be allocated for trading investment in mining, oil and industrial shares".' See *FCT v Equitable Life & General Insurance Co Ltd* (n 72) 4442.
[75] Ibid 4441.
[76] Extracted from *FCT v Equitable Life & General Insurance Co Ltd* (n 72) 4442 and tabulated.

Of interest to this case is the attitude of the Commissioner to the activity of professional portfolio management:

> As I have said, the Commissioner accepted that the taxpayer was not engaged in the business of share trading at any relevant time, and that this part of the case is to be dealt with upon the basis that the taxpayer's activities were dictated by 'the portfolio management principles' to which I have referred. The Commissioner's argument was, however, first, that a taxpayer who acquires and disposes of assets according to such principles, is liable to tax upon the surpluses generated by such business, whether by way of receipt of dividends or surplus on disposal; and, second, that (whether this be so or not) the way in which the portfolio management principles were applied by the taxpayer had such a result.[77]

The view was not confirmed though, with Davies J, quoting the trial judge as follows:

> At pp. 4108-4109, his Honour said:
> In my opinion, this general principle should not be accepted. The term 'portfolio management' covers a number of different kinds of business activities and I do not think that the activities, systematic and concerted though they may be, have the income tax results which the Commissioner claims. The term, as perhaps it would more usually be understood, denotes merely the systematic investment of assets. I do not think that, notwithstanding Mr Priestley's careful argument, such investment activities have the tax consequences he suggests because they are systematic or are directed to matters other than the derivation of income.
> Those who have large sums of money have normally not held such money in globo but have turned it to account. Where this has been done not by way of trading or in the making of profits by ventures in the nature of trade, but by the purchase of assets to be held, it has generally been accepted that an increase in the value of the assets, whether realised or unrealised, is not of the nature of income. The distinction between investment, in this sense, on the one hand, and the use of capital in trade is well established.[78]

Davies J went on to express the court's own view of the matter:

> It is, in my opinion, consistent with investment principles, e.g., that an asset will be sold and the proceeds invested in another asset because, inter alia, it is seen that the asset purchased is likely to be more valuable than that sold. I do not think that the principles which have been established require that the investor, in considering whether to hold or dispose of an investment, should not have regard to the fact that a prospective investment will become of a greater capital value than the one presently held. The difficulty of drawing the line between a sale and purchase for that purpose and one for the purpose of realisation at a profit does not, in my opinion, mean that the investor must ignore the opportunity to improve as well as maintain the value of his capital.

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[77] Ibid 4442.
[78] Ibid.

> At p. 4108, his Honour commented:
> Investment, in the sense to which I have referred, does not cease to be such merely because it is done systematically and skilfully ... But, upon the present facts, I do not think that it was so. Except in the sense to which I have referred, the Commissioner did not contend that what the taxpayer was doing was a trade.[79]

The court therefore concluded that the activities of the taxpayer were 'consistent with long-term investment'. The profits that it derived were profits from ordinary investing, rather than ordinary income from profit-making.[80]

In *Investment and Merchant Finance Corporation Ltd v FCT*, [81] the Commissioner sought to have a specific share transaction that resulted in a loss for the taxpayer, who was a share dealer, identified and assessed as capital under section 51 of the Income Tax Assessment Act 1936–1969 (Cth) (the Act). Barwick CJ stated that trying to isolate a transaction on this basis within a running business was flawed and that the business should be regarded as a whole.

The Commissioner used the argument in *Milton*[82] that the taxpayer's business taken as a whole[83] was akin to that of a merchant bank and that its investment portfolio was consequently part of that consideration and should be taxed accordingly – outside of the general framework of consideration on income characterisation and viewed through the lens applicable to banks and general insurance companies who often have share portfolios. The activities of the company included the following:

1. lending money on the security of mortgages over real property, conducted partly by the company directly and partly by wholly-owned subsidiaries;
2. accepting money on deposit from investors for reinvestment;

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[79] Ibid 4447.
[80] Ibid 4448.
[81] *Investment and Merchant Finance Corporation Ltd v FCT* 71 ATC 4140.
[82] *Milton Corporation v FCT* 85 ATC 4243. The company was a public company listed on the Sydney Stock Exchange.
[83] The Commissioner did not rely on section 26a, or on the fact that the shares in question were bought for resale, or on the fact that the taxpayer was a share trader.

3. investing in the short-term money market;
4. investment in real estate (minor); and
5. management of the investment portfolios of superannuation funds and some client investors.

The court found the Commissioner's contention to be unlikely. The guidelines used in arriving at this conclusion were the following:

> In reaching these findings I accept and rely upon the supportive evidentiary material particularly being the extremely small scale and intermittent nature of the sales, the reasons advanced for the sales, the very small amount involved in relation to the overall value of the total portfolio, the history of the taxpayer, and the fact that its portfolio management was the sole and exclusive responsibility of one man. He was experienced, knowledgeable and trusted in the field of investment, not only with this company, but with other substantial and public companies, and his association with the taxpayer spanned virtually a professional lifetime, and whose constant policies, guidelines approach and determinations were directed to investment as capital and assets in no way were related to or part of the business activities carried on by the taxpayer.[84]

The court's reasoning points to a clearly demarcated investment operation, but also to one of degree:

> This is a vastly different situation … different as to scale, systematic conduct, policy and above all, the nature of the business and the relationship of the source of the gains to the business. Further, the company was an investment company dealing solely in shares, quite unlike the taxpayer.[85]

In *National Bank of Australasia Limited v FC of T*,[86] the appellant sold all the shares it owned in the capital of Queensland National Pastoral Company Limited during the year of income ended 30 June 1963, at a profit of £527,625. In assessing the National Bank's income tax, the Commissioner treated this amount of profit as assessable income. The Pastoral Company had been purchased from the Queensland National Bank at the time of its liquidation in favour of a merger. The Pastoral Company was formed to hold properties that had been

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[84] *Milton Corporation v FCT* 85 ATC 4243 at 4250.
[85] Ibid 4251.
[86] *National Bank of Australasia Limited v FC of T* 69 ATC 4042.

mortgaged to the bank, but had defaulted due to difficult economic circumstances. Shares were issued in the company to offset against the outstanding debts.

> But it does not at all follow that the National Bank should be considered to have taken over the Queensland National Bank's assets in the same character as that in which the Queensland National Bank had held them. Their character in the hands of the National Bank must depend on the nature of the purchase transaction: was it a transaction on capital account – for the purpose of adding to the profit-making structure of the National Bank – or was it a transaction forming part of the profit-earning activities within the structure. I have no doubt that it was the former … The purchase of the shares bore no resemblance to an investment of banking funds, made to earn income pending a need for their deployment in the making of advances and the like; it bore no resemblance to an investment by way of erecting a second or third line of defence against a time of stringency or emergency.[87]

The National Bank of Australia, notwithstanding the dividends that the Pastoral Company would yield, had convincingly testified to the fact that the nature of rural and pastoral assets in the portfolio gave it a significant profile in those communities, enabling it to leverage that profile for additional or related business. The court concluded on this testimony that the motive at the time of purchase, holding and sales had always been the goodwill nature of the asset, notwithstanding any other economic benefits. The profit upon sale of the shares was therefore capital.

In *GRE v FC of T*[88] an example to the contrary is found, where shares were held as part of the funding structure of a general insurer, and its wholly owned subsidiary, Unitraders Investments Pty Ltd. The court further held that certain profits derived by GRE from bonds, some of which were sold at a profit and others of which were redeemed at maturity, were not exempted from assessable income by the provisions of section 23J of the Income Tax Assessment Act 1936 (Cth). Regardless of instrument type (equity, bonds, property), the portfolio was part of the insurance business. The investment strategy was to hold a proportion in equities, and varying that proportion was within the requirements of prudent management:

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[87] Ibid 4047–8.
[88] *GRE Insurance Limited v FC of T* 92 ATC 4089.

> In our respectful opinion, however, the activities of Unitraders were an integral part of the insurance business conducted by GRE. Although the equities were held by the wholly owned subsidiary rather than by GRE directly, the equities indirectly formed part of the funds representing the insurance reserves and part of the circulating capital of the business. Just as the prudent management of the investment portfolio of an insurance company ordinarily requires that some proportion of equities be held as well as government securities, mortgages and debentures, so in this present case, it was always an element of the investment strategy that a proportion of equities be held. And that strategy continued, the proportion varying whenever it seemed prudent from an investment point of view to vary the mix.[89]

10.7 SUMMARY

The findings of the Australian courts are consistent with the broad principles that apply in the UK and the USA. *Visy Industries* provides recent jurisprudence that confirms that derivative contracts can be used as a business hedge that in form and substance amounts to an insurance contract. The court held that, notwithstanding the element of chance, the forward agreement did not amount to a wager. The court also addressed the principle of economic equivalence discussed in this thesis and the legal error of characterising based on referencing another transaction or asse. This supports the need for the separate characterisation of each derivative contract and the relevance of the legal structure and context of the contract.

The very limited case law on characterising derivative gains and losses will probably never be developed further, given the legislated TOFA regime.[90] Intervening legislation has effectively sterilised the ability to trace how judicial reasoning would have developed, based on purely common-law principles:

> The question – revenue expenditure or capital expenditure – is a question which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy; but in others it is difficult. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other; but this is simply not possible. Some cases lie on the border between the two; and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions

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[89] Ibid 4093.
[90] View expressed to me telephonically on 29 July 2015 by Professor Graeme Cooper, Professor of Taxation Law, University of Sydney.

with equal propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in the marginal cases; and then everyone is in doubt. Each can come down either way. When these marginal cases arise, then the practitioners – be they accountants or lawyers – must of necessity put them into one category or the other; and then, by custom or by law, by practice or by precept, the border is staked out with more certainty. In this area, at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is to search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find.[91]

[91] Lusher J in *Milton Corporation Ltd v Federal Commissioner of Taxation* 85 ATC 4244.

CHAPTER 11

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

11.1 INTRODUCTION

> The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.[1]

It may be asked how the jurisdictional analysis above is relevant in the South African context. I have avoided conducting a comparative analysis because of the questionable value of such an exercise, due to the vastly different legal and regulatory contexts. This review of the jurisdictions has provided a working hypothesis that harmonisation is not a research objective. I am not seeking to overhaul our case law or harmonise our tax policy with the US, the UK or Australia, which are three related, but very different, jurisdictional contexts. Clarity was sought by researching three jurisdictions within Commonwealth and US authority. While the USA has the most detailed legislation on the subject, its system lacks structural commonality with South Africa. The UK is the closest legal relative, but has opted, like Australia, for what might be considered 'policy convenience', by adopting accounting standards. This review did not include civil-law jurisdictions as this would have further complicated any attempt to simplify the analysis. A similar sentiment was expressed by Lord Steyn in *White et al v Jones et al*:[2]

> Strongly though I support the study of comparative law, I hesitate to embark in an opinion such as this upon a comparison, however brief, with a civil law system; because experience has taught me how very difficult, and indeed potentially misleading, such an exercise can be.[3]

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[1] Second canon of taxation laid down by Adam Smith: Adam Smith *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776, 1849 ed) 371. See GT Pagone 'Tax uncertainty' (2009) 33 *Melbourne University Law Review* 886.
[2] *White et al v Jones et al* [1995] 2 AC 207.
[3] Law Library of Congress *The Impact of Foreign Law on Domestic Judgments* (2010) 29.

This research also cannot be a survey of what might work for South Africa. Improved clarity might be achieved by analysing a foreign jurisdiction's own policy journey, correctly situated within its own legal system. While the stated problem is universal, the responses are not, complicated further by the doctrine of interpretation applied by national courts. However, where appropriate, foreign case law has provided helpful insights, even though our courts are not bound by it. An example of this are the insights gained on the nature of derivative contracts, analysed in the *Lehman Brothers* cases above. It is therefore proposed that the reasoning of the courts referred to in sectionh 8.6 above will be useful in pursuing clarity and congruency within our own case law, rather than trying to determine legal correlates. This is especially relevant where insufficient local precedents exist, as is the case in South Africa. The Constitution of the Republic of South Africa, 1996, in the Bill of Rights,[4] which applies to all law,[5] provides in section 39 that interpretation must be informed by international law and may be informed by foreign law. It therefore allows for insight gained from foreign jurisprudence. From a commercial viewpoint, derivatives are instruments that should be understood within a global context and our common law should be informed and developed by modern international perspectives, so as to avoid a disintegrative impact associated with ingrown domestic tax policy.

The preceding jurisdictional analysis has considered three policy approaches adopted by four jurisdictions:

1. a definition by exclusion of a capital asset set in legislation, buttressed by an anti-avoidance tax code (the USA);
2. an accounting approach that follows IFRS, in the UK and Australia;

[4] Chapter 2.
[5] Section 8(1): 'The Bill of Rights applies to all law, and binds the legislature, the executive, the judiciary and all organs of state.'

3. a hybrid tax policy in South Africa that in part adopts an accounting approach, but in remainder relies on a facts and circumstances common-law determination informed by the presence of a 'scheme of profit-making'.

In considering the possible importation of lessons from foreign jurisdictions, the following aspects will be discussed below: (1) relevance to our case law; (2) suggested interpretative approach of our courts; and (3) recommended tax policy.

11.2 RELEVANCE TO OUR CASE LAW

The *Lehmans* cases in the UK present two corollaries for consideration: (1) If derivative contracts are by virtue of the rights they confer in the nature of 'property', they should therefore be included for consideration, according to the leading authority of *Pick 'n Pay*;[6] and (2) they should consequently be treated like any other property in the determination of a 'scheme of profit-making'. As Smalberger stated, '[t]ransactions involving shares do not differ from transactions in respect of any other property'.[7] As a result, the ordinary tests applied by our courts that were outlined above must then be followed to determine to the character of receipts or accruals.

11.2.1 Nature of derivative contracts

A right '*in rem*' originally meant a right 'in a thing'.[8] This need for a 'thing' or an 'underlying' often complicates the assessment of the nature of a derivative. Instinctively, a student of tax might see a derivative as 'revenue derived from [what would have been] capital productively employed [via the underlying reference asset]'.[9] Or, to return to *Wisdom v*

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[6] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[7] Ibid 56.
[8] Y Chang & HE Smith 'An economic analysis of civil versus common law property' (2012) 88(1) *Notre Dame Law Review* 33. They commented that in German law the concept is very prominent: 'it means that the right is good against the world – usually called "the principle of absoluteness (*Absolutheitsprinzip*)"'.
[9] See *Berea West Estate (Pty) Ltd v SIR* 1976 (2) SA 614 (A), (1976) 38 SATC 43 at 628.

Chamberlain (Inspector of Taxes)',[10] the implication is that if the share type produces 'nil' dividends it is unlikely to be considered capital in nature, regardless of its purpose. This approach references the metaphor of a tree (capital asset) needing to bear fruit (income).[11] The difficulty with this metaphor is that it is useful, but not necessarily absolute: 'This economic distinction [of a tree and fruit] is a useful guide in matters of income tax, but its application is very often a matter of great difficulty'.[12] In *Berkey v Third Avenue Railway Co*, Cardozo J warned that '[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.'[13] Any analysis as to character should therefore be vigilant about unilaterally imposing the tree metaphor on all determinations.

In common law, 'property' is conceived of as a 'bundle of rights'.[14] The rights, rather than the contract or the physical item, evidence the 'property'. Smith[15] felt that the metaphor of a 'bundle' is deficient or obscure: 'John Austin said of property that "indefiniteness is at the very essence of the right; and implies that the right … cannot be determined by exact and positive circumscription" … the result is that an owner has control over an indefinite reservoir of uses'.[16] In *Standard Bank of South Africa Ltd and Another v Ocean Commodities Incorporated and Others*,[17] Corbett JA made a similar statement about shares: 'A share in a

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[10] (1969) 1 All ER 332 (CA). The case referred to silver ingots held in a safe as a hedge, regarded by the court as a trading venture. SARS states that '[t]he proceeds are more likely to be of a revenue nature when the type of share purchased does not produce dividends'.

[11] *Eisner v Macomber* 252 US 189 (1920); *Visser v CIR* SATC 271 in which it was held at 276 that ' "Income" is what "capital" produces, or is something in the nature of interest or fruit as opposed to principal or tree.'

[12] Ibid 276.

[13] 155 NE 58 at 61 (Cardozo J for Hiseock CJ, Cardozo, McLaughlin, Andrews and Lehmann JJ) (NY, 1926). See GT Pagone 'Tax uncertainty' (2009) 33 *Melbourne University Law Review* 886 at 895.

[14] This conception of property was suggested by Hohfeld and Honoré and dominated legal thinking for most of the twentieth century. See WN Hohfeld 'Some fundamental legal conceptions as applied in judicial reasoning' (1913) 23 *Yale Law Journal* 16; WN Hohfeld 'Fundamental legal conceptions as applied in judicial reasoning' (1917) 26 *Yale Law Journal* 710, cited in MW Lau 'The nature of the beneficial interest, historical and economic perspectives' (ms. 2013) notes 1 and 24.

[15] HE Smith 'Property as the law of things' (2012) 125 *Harvard Law Review* 1691.

[16] Chang & Smith (n 8) 32.

[17] *Standard Bank of South Africa Ltd and Another v Ocean Commodities Incorporated and Others* 1983 (1) SA 276 (A) 288. See SARS *Comprehensive Guide to Capital Gains Tax* Issue 7 (2018) 86.

company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends.'

It is argued that this same 'bundle of rights' that the ISDA master agreement represents brings it within the logic of *Pick 'n Pay*[18] as 'property, 'whether one is dealing with land or shares'. In the case of exchange traded derivatives, the matter seems much simpler as these instruments are freely transferable in the same manner as a share or a listed bond. They are characterised by a volume of similar units being available at a published market price and transferability between buyers and sellers.

A similar interpretative view is held by HMRC:[19]

> An individual may contend that his dealings in derivative contracts constitute a trade in itself. He may claim that derivative contracts are more sophisticated than dealing in shares and that this is evidence that the activity amounts to a trade. Or he may say that such assets, not being income-producing, are usually dealt with by way of trade. We disagree. Our view is that you approach the question of whether a trade is being carried on in the same way as you would with somebody claiming to carry on a trade of buying and selling shares. This means finding the facts and coming to a decision taking an overall view of all the circumstances … Where a derivative contract is entered into in the course of activities which amount to an investing activity then the profits and losses arising from the derivative contract will be regarded as entered into as part of that activity.

The case law and literature reviewed above therefore suggest a characterisation of derivatives that may be defined as follows:

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[18] *CIR v Pick 'n Pay* (n 6).
[19] BIM56830, available at https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim56880 (accessed 23 August 2020).

1. an agreement or contract[20] of commercial value[21] between two parties,[22] involving the sale of a promise,[23] of an aleatory[24] and permanent nature,[25] representing a *chose* in action;[26]
2. in identity a contract *sui generis*;[27]
3. constituting a module or bundle of rights,[28] in the nature of property,[29] which although having elements of indefiniteness;[30]
4. will have to have crystallised;[31]
5. the metrics of which might reference another asset, but whose intrinsic nature exists independently[32] of the referenced asset;

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[20] See TE Lynch 'Derivatives: A twenty-first century understanding' (2011) 43 *Loyola University Chicago Law Journal* 16 n 57, where enforceability by a court of law is essential to the term 'contract'.
[21] 'The answer is to be found in the fact that this was a complex commercial transaction entered into in good faith … If this is the touchstone …' Longmore LJ in *Lomas v JFB Firth Rixson Inc* (2010) EWHC 3372, (2011) 2 BCLC 120 at 87.
[22] *Inland Revenue Commissioners v Scottish Provident Institution* (2003) STC 1035. Ibid at 116.
[23] D Southern & PricewaterhouseCoopers *Tolley's Taxation of Corporate Debt, Foreign Exchange and Derivative Contracts* (2001) 317, 318; EJ Swan *Building the Global Market: A 4000 Year History of Derivatives* (2000) 17.
[24] 'Contract in which at least one party's performance depends on some uncertain event that is beyond the control of the parties involved'. Lynch (n 20), quoting Black's Law Dictionary. See n 51 on page 10 where he gives the Latin root *aleatory*, 'gambler', which stems from *alea*, meaning 'the throwing of dice'.
[25] *Pioneer Freight Futures Co Ltd v TMT Asia Limited* [2011] 2 Lloyd's Rep 96.
[26] Longmore LJ in *Lomas* (n 21) supported Lord Collins in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Securities Ltd* [2011] UKSC 38. A Hudson *The Law on Financial Derivatives* 6 ed (2018) 998 and 1029; *Colonial Bank v Whinney* 30 Ch D 261 at 285 (1885), per Fry LJ. See WS Holdsworth 'The history of the treatment of choses in action by the common law' (1920) 33(8) *Harvard Law Review* 997, 998 and 1029. 'All personal things are either in possession or action. The law knows no *tertium quid* between the two'. While the concept is broad, it includes 'rights to debts of all kinds … rights of action on a contract; … it was extended to cover documents, such as bonds … This led to the inclusion in this class of things of such instruments as bills, notes, cheques, shares in companies, stock in public funds, … these choses in action have changed their original character, and become very much less like merely personal rights of action and very much more like rights of property'. Financial Law Panel *Transactions in Derivatives Legal Obligations of Banks to Customers: A Discussion Paper* (1995) 9, cited in Swan EJ Swan *Building the Global Market: A 4000 Year History of Derivatives* (2000) n 59.
[27] *Spiro v Glencrown Properties Ltd* (1991) All ER, per Hoffmann J at [606].
[28] Preferred according to Smith's description of property.
[29] *Belmont Park* (n 26) [5].
[30] Chang & Smith (n 8) 32.
[31] To be 'in rem'. A 'mere expectancy' cannot be separated from the rights property ownership assigns. Krizek refers to Harris 'Property – Rights in rem or wealth?' to distinguish between wealth coming from property and other sources of wealth, such as contracts. The transferability of property, he argued, arises out of the main rights in rem, '*ius utendi, fruendi, abutendi, alienandi, vindicandi et al* – i.e. what a man owns he can also transfer'. See T Krizek *Legal Nature and Definition of Financial derivatives* (dissertation, University of Glasgow, 2011).
[32] Lynch (n 20); Longmore LJ in *Lomas* (n 21) [2]; D Southern 'The taxation of derivatives' (1998) 4 *British Tax Review* 348–63.

6. whether involving the delivery of the asset or the payment of an amount calculated by reference to its value or the value of an index;[33]
7. which might be of a capital or revenue nature.[34]

In the next section the application of this logic, using an example within an investment portfolio, is illustrated.

11.2.2 Practical application with reference to our case law

If derivatives are indeed 'property' they should then be subject to the same principles as any other asset.

In Chapter 2 a general explanation of derivatives was offered, and it was also explained why they might be used in an investment portfolio. For the purposes of this illustration, two equity derivative instruments are considered, namely, a forward and an option.

An equity future: an equity derivative might reference a single share, a basket of shares, a single index or a basket of indices. In this example, an equity future is purchased referencing a single share. The share is ABC Ltd. The seller, Bank Z, will make physical delivery of 100 ABC shares on 29 March 2019 in terms of the agreement entered into on the trade date, 3 January 2019. Bank Z ensures that it holds the required ABC shares to protect itself from unforeseen market movements. Bank Z assigns the relevant voting rights on the shares to the buyer. The payoff to the three taxpayers at maturity will be the market price of ABC shares as at 29 March, less the current market price. This might be negative or positive.

An equity call option: an option is purchased allowing a purchase of the shares at a fixed price at a future date. The seller, Bank Z, will make physical delivery of 100 ABC shares

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[33] Longmore LJ *Lomas* (n 21) n 566.
[34] Templeman LJ in *Citibank Investments Ltd v Griffin* (2000) STC (SCD) 92. The High Court of Appeal affirmed this approach, stating that designing the investment for a capital rather than income profit was 'a choice which faces any investor'. See D Southern 'The taxation of derivatives' (1998) 4 *British Tax Review* 348–63 at 369, compared to the view of SARS in its *Tax Guide for Share Owners* Issue 3 at para 3.4.6.

on 29 March 2019 in terms of the agreement entered into on the trade date, 3 January 2019, if each of the three clients above exercises their option to buy. The transaction price or *strike price* for ABC is set in the contract. For the sake of this example, the price is R25. A price above R25 would imply that the taxpayer will exercise the option. The taxpayer will receive ABC shares valued at R25 + 'x'. If the price is below R25, the taxpayers will not exercise the option as there is no incentive to pay more than the current market price for ABC. A premium of 'y' is paid by the three taxpayers to secure the right to exercise the option. If the option turns out to be favourable for the buyers, this advantage would have been secured by the earlier payment of the 'y' premium. If the market moves negatively and the options are not exercised, the premium is effectively lost to the buyers. Bank Z therefore ensures that it holds the required ABC shares to protect itself from unforeseen market movements. Bank Z assigns the relevant voting rights on the shares to the buyers.[35]

In both cases, the price of the instrument is usually determined by a pricing model used by the bank which would include consideration for the current price of the shares, a view on the future value of the share based on research and market data, the supply and demand in the market for the share currently, availability or liquidity, general market conditions and volatility, as well as the cost to the bank for carrying the transaction through to maturity.

If these two transactions were imposed on the facts in *Pick 'n Pay*,[36] it is quite probable that a court would want to know why any forward view and contract related to the price of the share or its delivery was necessary. The employee share trust existed to place Pick 'n Pay shares 'in the hands of eligible employees'.[37] The price over time was a function of the company's

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[35] 'The term 'equity share' is defined in s 1(1) [of the Eighth Schedule] and means 'any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.' See SARS *Comprehensive Guide to Capital Gains Tax* Issue 7 (2018) 26.
[36] *CIR v Pick 'n Pay* (n 6).
[37] Ibid.

performance and general market conditions. The trustees did not have a mandate to optimise the purchase price of shares. Profits might now well be considered 'designedly worked for' and not 'fortuitous'.[38]

Secondly, if these two transactions were imposed on *Nussbaum*,[39] it is likely that their inclusion in the taxpayer's share portfolio would still point to receipts of a revenue nature, given the overall context of the taxpayer's management of the portfolio.[40] Not only were shares 'farmed' assiduously, but in addition thereto, the taxpayer was using derivatives to take a forward view on where that price was headed and purchasing additional economic exposure to ABC Ltd in anticipation of further gains.[41]

The purchase of an equity option could therefore be considered characteristic of an activity associated with a share dealer[42] – if the price target is achieved, the option is exercised. If not, the option is not exercised and the premium 'y' is forfeited. The court *a quo* mentioned that the respondent had not once mentioned a falling market. All the sales were in a rising market and they were extensive.[43] There was therefore no risk management motive at work to protect the portfolio from losses. The equity option will in all likelihood therefore be viewed as part of the broader context of trying to capture further capital gains subject to the dictates of the market and, given the finding of the court *a quo*, determined to be of a revenue nature. The onus would be on the taxpayer to show that, at the time of purchasing the option,[44] there was a

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[38] Ibid.
[39] *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283.
[40] Which Howie JA described in *Nussbaum* ibid (at 1162) as of such an extent that one is 'struck forcibly by the scale and frequency of respondent's share transactions. Those considerations are, of course, not conclusive but they are of major importance.'
[41] Howie JA noted that the sales were 'almost without exception profitable': *Nussbaum* (n 39) 1164–1165.
[42] For further attributes associated with traders see *CIR v Stott* 1928 AD 252 and *Berea West Estates (Pty) Ltd v SIR* 1976 (2) SA 614 (A) 635, as referred by Corbett JA in *Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (A), 39 SATC 163 at 126.
[43] See Howie JA in *Nussbaum* 1165 and 1166: 'He farmed his portfolio assiduously. The number, frequency and profitability of sales, especially of short-term shares, bears clear enough testimony to that.'
[44] *ITC 1427* 50 SATC 25.

capital motive more aligned with the primary motive of investment, rather than the secondary motive of dealing for profit.

Assume now that Nussbaum purchases the equity future in view of the fact that the physical shares are tightly held and that the taxpayer's stockbroker advises that ABC Ltd has recently secured licensing rights that will significantly improve its dividend yield. The taxpayer in this instance purchases the future in anticipation of being able to secure the physical shares when available for purchase in the market. The intention behind this transaction is perfectly rational and normal when managing capital assets in a portfolio. Had the physical shares been available, they would have been purchased, rather than the future. It could therefore be reasonably argued that the transaction fell within the primary intention of the respondent as an investor and that there was nothing to indicate that this transaction fell outside the 82 per cent of the share portfolio that was managed as an investment.[45] The character of the derivative should therefore be determined with reference to the time when it was first acquired.[46] If, however, the physical shares (the second asset or '*res*') so acquired were sold at some point (for example, close to the exercise of the option), the argument might be made that the transaction was part of the 'farming' of the portfolio. In *'SAM' v COT*[47] it was held that it was the intention at the time of exercise that determined the tax character: 'But where the option is exercised for the admitted purpose of selling the subject-matter thereof, then the assets have been acquired for the purpose of re-sale and are therefore liable to tax.' This principle was overruled in *Matla Coal Ltd v CIR*[48] and the intention at the time of acquiring the option was treated as decisive of the character of the option, according to Corbett JA.[49] Given the frequency and extent of other transactions in the Nussbaum portfolio, the inference could be

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[45] *Nussbaum* (n 39) 1166.
[46] *ITC 1427* 50 SATC 25.
[47] *'SAM' v COT* 1980 (2) SA 75 (ZR) [32].
[48] *Matla Coal Ltd v CIR* 1987 (1) SA 108 (A).
[49] Ibid 128H–129B.

drawn that this transaction was part of his secondary profit-making purpose, as evidenced by the sale of the (second) physical asset,[50] and therefore a revenue motive at purchase could be inferred.

In a third hypothetical example, a portfolio manager managing a collective investment scheme portfolio executes the exact same transactions in an equity portfolio called 'Best Equity Fund'. Collective investment schemes are a regulated pooling mechanism that allows the public to participate in the market by holding an undivided share or 'unit' in that portfolio of assets. Investors share in gains, losses and dividend income, proportionate to the number of units they own. The legal structure of a scheme is that of a trust, with trustees (normally a trustee service of a bank) holding the physical cash and other assets in the portfolio. This provides segregation of duty and protects investors from fraud. The scheme 'manager' (not the portfolio manager), which is a licensed financial service provider, will be responsible for operating the scheme in the best interests of investors,[51] and will attend to matters such as the appointment (or dismissal) of a portfolio manager, governance and compliance, administration of the scheme and marketing. The governing Act – the Collective Investment Schemes Control Act – and its accompanying regulations,[52] together with the standard trust deed and supplemental deeds, are used to establish individual funds within the overall scheme. The regulations specifically admit the use of derivatives in Chapter V and limit exposure of the portfolio.[53] All exposures have to be reported quarterly.[54] The funds are audited annually and the manager must submit a compliance report together with the audit report.[55] Portfolio managers also have to be licensed

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[50] See Howie JA in *Nussbaum* (n 39) at 1166: 'In my opinion respondent had a secondary, profit-making purpose.'
[51] Section 2(1) of the Collective Investment Schemes Control Act 45 of 2002 (CISCA Act) states as follows: 'A manager must administer a collective investment scheme honestly and fairly, with skill, care and diligence and in the interest of investors and the collective investment scheme industry.'
[52] Board Notice 90 of 2014.
[53] Section 15 of CISCA.
[54] Section 20 of CISCA.
[55] Section 10 of CISCA.

personally by the regulator, subject to fit and proper requirements, before they are allowed to manage money. Furthermore, there is no recorded case in our courts of such a scheme or subsidiary fund being found to be conducting a business or a scheme of profit-making in some 50 years.

For the sake of the example, Best Equity Fund executes the two transactions. The portfolio manager, having received cash from new investors purchases the future in anticipation of acquiring the physical share. The amount invested was relatively significant in relation to the overall value of the portfolio, and this would leave all investors exposed to potential underperformance against the All Share Index if ABC Ltd is not part of the portfolio composition. The equity call option is purchased because the taxpayer believes that ABC Ltd is not only a substantive weighting in the index, but also holds promise in its own right for earnings growth. A premium is therefore paid to secure the right to acquire additional exposure to ABC Ltd at the *strike price* of R25 if this view, substantiated by an analyst's research and personal judgment, proves to be correct by the end of March 2019.

Both transactions now appear to be entirely within the purview of the object and purpose of the scheme, which is a regulated investment scheme. It seems entirely unlikely that a court would consider the portfolio manager to be conducting the affairs of the portfolio in the fashion of a trader.

However, it seems equally possible that nothing prevents a manager from conducting his management of Best Equity Fund in a manner that reflects the same intent as demonstrated by *Nussbaum*,[56] contrary to the framework described above, since there are no regulations applicable to the frequency of transactions that might interfere with the prudential duties of the manager. While this is not sufficient in itself, nothing excludes the possibility of a secondary

[56] *Nussbaum* (n 39).

motive of profit-making. Let us assume further that the manager has invested funds of his own in the portfolio and that, further to this, a performance fee is charged for performance over a stated benchmark. Performance fees in turn translate into improved earnings for the portfolio management business and the manager is rewarded through a company bonus scheme for targets related to performance fee earnings. A strong personal motive may now be present if the manager believes that there is additional profit to be made by trading the portfolio, notwithstanding the higher brokerage costs and securities transfer tax that would be incurred (which are, according to industry practice, deducted from any performance calculation in the interests of the client). It is entirely possible that such a manager might through demonstrable acts consistently and extensively therefore manage Best Equity Fund in a manner commensurate with that of a share dealer. Within this context, the manager would be in breach of the CISCA framework of agreements and regulations. The two transactions executed in this context could quite easily be found by a court under general principles to produce gains or losses of a revenue nature. It would, however, be extremely difficult to impute this change of intention to the investors, given the construction of the scheme, via the fund as a taxpayer or directly in their hands. This would suggest that these circumstances relate more to the failure of the enforcement of regulation than to tax policy. The manager is clearly operating in contravention of the law and the agreement with the investors in Best Equity Fund.

Lastly, in all three cases, Bank Z has written the derivative instruments as part of its derivative dealing business in the ordinary course. All receipts, gains and losses are therefore revenue in nature in terms of section 24 JB of the ITA.

The above examples illustrate that it is entirely possible for counterparties to the same instrument to have different tax outcomes. It is also possible for buyers in these examples to have different tax outcomes or altered outcomes in exactly the same manner as for any other property. ‘Law books in the hands of a lawyer are a capital asset; in the hands of a book-seller

they are a trade asset. A farm owned by a farmer is a capital asset; in the hands of a land jobber it becomes stock-in-trade'[57] Financial derivatives are no different.

The hypothesis for this research follows the authority in *Pick 'n Pay*,[58] which is not only the leading case on income character determination, but also, it is submitted, the means by which financial derivative transactions should be adjudicated. The rights under financial derivative instruments constitute 'property' like shares and land and should be subject to the same general principles of judicial analysis.

11.3 SUGGESTED INTERPRETATIVE APPROACH IN A SOUTH AFRICAN CONTEXT

11.3.1 Introduction

As Farber stated in his analysis of the problem, referring to section 1234A (straddle rules) in the US tax code:

> Section 1234A was conceived and then modified in response to several competing and often confused lines of thinking, and that a little bit of house-keeping around various judicial doctrines might have prevented its enactment (its reasons for being) in the first place.[59]

The UK courts have also avoided analysis,[60] even when derivative-related decisions were before them. The purposive approach applied to statutory language in the USA led to a 'frolic' by the lower courts.[61] English courts, on the other hand, have begun to accept more contractual context, realising the finiteness of definition based purely on black letter words. This outcome was also characterised by a troubled journey through the courts following *Ramsay* in 1981.

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[57] Maritz J in *CIR v Visser* 1937 TPD 77, 8 SATC 271 at 276.
[58] *CIR v Pick 'n Pay* (n 6).
[59] MS Farber 'Capital ideas: The taxation of derivative gains and losses' (2010) *Tax Notes* 1495.
[60] Hudson (n 26) 343.
[61] *Arkansas Best* 485 US 212 (1988).

11.3.2 Alignment with foreign law

The sub-theme of the contingency of law has been ever-present throughout this analysis as a reminder that law does not exist on its own. It is an expression of societal values and of society's sense of justice. A body of judicial opinion relies on tradition expressed through precedent, which honours judgments through the checks and balances of referenced authority and the hierarchy of the courts. The contours of courts' *ratio decidendi* can therefore not be divorced from the effects of time and what society valued at the time.

Although the US and English courts share a largely common-law tradition, the USA has been more willing to consider economics in its interpretation (a more contextual view), while English courts have tended to follow the legal form (a literalist view).[62]

It is noteworthy that the notion that tax analysis might include disaggregation or bifurcation as an option for tax analysis as identified by Warren[63] in 2004 has been spurned on the grounds that limitations exist on the power of the courts to reconstruct transactions which are 'indissolubly linked', thereby risking converting genuine transactions into 'something quite different'.[64] Arguing on the basis of 'economic equivalence' alone cannot be used as grounds for re-characterisation.[65] The substance and the language of the agreement are both relevant to character determination.

When interpreting commercial contracts, the English courts have more recently[66] moved away from an objective literalism to one that includes context, but excludes subjective intent.

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[62] I also illustrated how *purposivism* in the interpretation of statutes was overturned in *Arkansas Best* after 25 years of development in the lower courts.
[63] See AC Warren Jr 'US income taxation of new financial products' (2004) 88 *Journal of Public Economics* 899.
[64] *Griffin (Inspector of Taxes) v Citibank Investments Ltd* (2000) STC 1010 in a second appeal brought by Revenue at [49]; Hudson (n 26) 18-61 n 123 and 18-53; *Inland Revenue Commissioners v Scottish Provident Institution* [2004] UKHL 52, [2005] STC 15 at 23.
[65] *HSBC Life (UK) Ltd v Stubbs* (2002) STC (SCD) 9.
[66] Spigelman CJ describes this as a shift from text to context. See 'From text to context: Contemporary contractual interpretation', an address to the Risky Business Conference in Sydney, 21 March 2007, published in Spigelman *Speeches of a Chief Justice 1998-2008* 239 at 240. The shift is apparent from a comparison between the first edition of Lewison *The Interpretation of Contracts* and the current fifth edition. So much has

This was affirmed in 2011 by the Supreme Court in *Rainy Sky SA v Kookmin Bank*.[67] However, within the spectrum of greater contextualism, Lord Hoffmann[68] and Lord Bingham[69] are more interested in context than objectivists like Lord Steyn:

> The aim of the inquiry is not to probe the real intentions of the parties but to ascertain the contextual meaning of the relevant contractual language. The enquiry is objective: the question is what a reasonable person, circumstanced as the actual parties were, would have understood the parties to have meant by the use of specific language. The answer to that question is to be gathered from the text under consideration and its relevant contextual scene.[70]

Hudson summarised a consensus as follows:

> Importantly, then, the parties' subjective states of mind and intentions are not the focus of the court's deliberations … it is clear that the English approach is an objective approach which begins with the wording of the contract before conducting a survey of the relevant factors which throw light on the context in which the agreement was created.[71]

This seems at odds with using the test of intention as the starting point. In the recent judgment of Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality*,[72] an important *dictum* on the subject of the proper approach to the interpretation of statute, statutory

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changed that the author, now a judge in the Court of Appeal in England, has introduced a new opening chapter summarising the background to and a summary of the modern approach to interpretation that has to a great extent been driven by Lord Hoffmann. See *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) 602H–610C n 13.

[67] *Rainy Sky SA v Kookmin Bank* (2011) 1 WLR 2900.

[68] *Investors Compensation Scheme v West Bromwich Building Society* (1998) 1 WLR 896, (1998) 1 All ER 98. See Hudson (n 26) 475 n 33.

[69] *Lord Bingham in BCCI v Ali* (2001) 1 AC 251 at 259: 'To ascertain the intention of the parties the court reads the terms of the contract as a whole, giving the words used their natural and ordinary meaning in the context of the agreement, the parties' relationship and all the relevant facts surrounding the transaction so far as known to the parties. To ascertain the parties' intentions, the court does not of course inquire into the parties' subjective states of mind but makes an objective judgment based on the materials already identified.' See Hudson (26) 476.

[70] *Sirius International Insurance Co v FAI General Insurance Ltd* (2004) 1 WLR 3251. See Hudson (n 26) 476.

[71] Hudson (n 26).

[72] *Natal Joint Municipal Pension Fund* (n 66) 602H–610C.

instruments and documents[73] is provided within the South African context. Wallis JA explains[74] the spectrum of interpretation as follows:

> At the one end, they may lead to a fragmentation of the process of interpretation by conveying that it must commence with an initial search for the 'ordinary grammatical meaning' or 'natural meaning' of the words[75] used seen in isolation, to be followed in some instances only by resort to the context. At the other, they beguile judges into seeking out intention free from the constraints of the language in question, and then imposing that intention on the language used. Both of these are contrary to the proper approach, which is from the outset to read the words used in the context of the document as a whole and in the light of all relevant circumstances.

The objective is directed at what was actually agreed between two parties:

> The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a statute or statutory enactment is to cross the divide between interpretation and legislation; in a contractual context it is to make a contract for the parties other than the one they in fact made.[76]

The approach described by Wallis JA is more inclusive of context than the English approach described by Hudson. Wallis speaks of a unitary inquiry from the outset, where the contract and the context are considered together, with neither predominating over the other.[77]

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[73] The case law is summarised in *Bastian Financial Services (Pty) Ltd v General Hendrik Schoeman Primary School* 2008 (5) SA 1 (SCA) paras 16–19. There is little or no difference between contracts, statutes and other documents, according to *KPMG Chartered Accountants (SA) v Securefin Ltd and Another* 2009 (4) SA 399 (SCA), (2009) 2 All SA 523 (SCA) para 39. See *Natal Joint Municipal Pension Fund* (n 66) 602H–610C n 14.

[74] *Natal Joint Municipal Pension Fund* (n 66) [24].

[75] 'Described by Lord Neuberger MR in *Re Sigma Finance Corp* (2008) EWCA Civ 1303 (CA) para 98 as an iterative process. The expression has been approved by Lord Mance SCJ in the appeal: *Re Sigma Finance Corp (in administrative receivership) and In Re the Insolvency Act 1986* (2009) UKSC 2, (2010) 1 All ER 571 (SC) para 12; and by Lord Clarke SCJ in *Rainy Sky SA and Others v Kookmin Bank* (2011) UKSC 50, (2012) Lloyds Rep 34 (SC) para 28. See the article by Lord Grabiner QC 'The iterative process of contractual interpretation' (2012) 128 *LQR* 41.' See *Natal Joint Municipal Pension Fund* (n 66) 602H–610C n 15.

[76] *Natal Joint Municipal Pension Fund* (n 66) [18].

[77] Ibid [19]. Three Australian judges have sought to explain the use of the expression on other grounds. Gleeson CJ in *Singh v The Commonwealth* said that 'references to intention must not divert attention from the text, for it is through the meaning of the text, understood in the light of background, purpose and object, and surrounding circumstances, that the legislature expresses its intention, and it is from the text, read in that light, that intention is inferred. The words "intention", "contemplation", "purpose" and "design" are used routinely by courts in relation to the meaning of legislation. They are orthodox and legitimate terms of legal analysis, provided their objectivity is not overlooked.' *Natal Joint Municipal Pension Fund* (n 66) [23].

This is the approach that courts in South Africa are required to follow, without the need to cite authorities from an earlier era that are not necessarily consistent and frequently reflect an approach to interpretation that is no longer appropriate. This would set the contractual terms of the derivative contract within the economic or commercial context of its application.

In conclusion, Wallis JA has indicated that this balance in approach needs to have a sensible outcome, as would be expected of reasonable people. 'An interpretation will not be given that leads to impractical, unbusinesslike or oppressive consequences or that will stultify the broader operation of the legislation or contract under consideration.'[78] The court cannot 'impose' meaning, but the obvious context to words must be adjudicated.

11.4 ADVANCING OUR TAX POLICY

11.4.1 Introduction

As mentioned above, the 1994 Tax Advisory Committee[79] document acknowledged extensive reliance on an Australian document of the same title, and sought to deal with rapidly advancing, sophisticated and complex financial instruments.[80] Possible departures from the Australian approach included applying normal tax principles, whereas the Australian Tax Authorities were in favour of all gains and losses being recognised on revenue account.[81]

> As great importance is attached to the economic substance of a financial arrangement, the approach of defining the characteristics of a financial arrangement is favoured. This method should provide the necessary flexibility to deal with new instruments as they are developed. On the other hand a products approach, which would attempt to list all the various instruments, would make it very difficult to cater for such new products as they enter the market.[82]

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[78] See *Natal Joint Municipal Pension Fund* (n 66) [26].
[79] Tax Advisory Committee *Consultative Document on the Tax Treatment of Financial Arrangements* (1994). This committee was appointed to advise the Minister of Finance on tax matters. It no longer exists. I am grateful to Dr Jan Graaff who served on the committee and who provided me with this document and related work papers.
[80] Ibid 1.
[81] Ibid 2.
[82] Ibid 3.

On the subject of hedging, the committee found the prospect of drawing up special hedging rules to be complex:

> The extent to which a transaction is hedged would also be difficult to delineate in tax law. A hedge may cover less than 100 per cent of the risk of the underlying transaction, perfect hedges being difficult to achieve in practice. However, it is inappropriate to characterize a transaction as a hedge when only a small part of the underlying is covered. Nor is it practicable to define a hedge according to the degree of risk it covers.[83]

Similar sentiments were recently expressed by the Davis Tax Committee when considering a policy response to base erosion and profit shifting:

> It is strongly recommended that South Africa moves away from anti-avoidance sections aimed at particular transactions and establish anti-avoidance principles which can be applied to a broad range of transactions without undue technicality; even if there is a risk that one or two transactions fall through the cracks, a principal approach to drafting legislation is significantly preferential to a transaction-by-a-transaction approach which we currently appear to have.[84]

This is a clear preference to avoid a US styled anti-avoidance codification – a view that this thesis supports. These pragmatic realities and the opportunity for tax avoidance, no matter how well drafted a provision might be, left the Tax Advisory Committee recommending in principle that hedges and their underlying asset or liability should be treated as a composite from an equitable tax point of view. However, the Committee avoided attempting any drafting recommendations. 'Special hedging rules … 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 to determine the extent to which practical difficulties may be overcome.'[85]

The general approach of the Committee was therefore to take economic substance into account for financial arrangements and have the taxation of those arrangements follow ordinary

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[83] Ibid 69.
[84] Davis Tax Committee *Second Interim Report on Base Erosion and Profit Shifting in South Africa* 'Summary of Report on Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements' Annexure 2 at p 4.
[85] Tax Advisory Committee (n 79) 71.

tax principles (rather than special derivative or product rules). The conclusions expressed in this thesis, after having considered the development of tax policy in the USA, the UK and Australia, expand on this reasoning and find that it can be achieved congruently with our own case law and literature, even though any form of broad correlated conclusion is troublesome.

When the US Tax Reform Act of 1986 was enacted, Congress believed that dispensing with a two-tier rate system for capital and income (such as our own) held several benefits for eliminating economic distortions:

> This will result in a tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterisation of income as ordinary or capital gain. In addition, this will eliminate any requirement that capital assets be held by the taxpayer for any extended period of time in order to obtain favourable treatment. This will result in greater willingness to invest in assets that are freely traded (e.g. stocks) and make investment decisions more neutral.[86]

As highlighted earlier, the Haig-Simons definition of income measures the increase in a taxpayer's ability to pay tax and makes no distinction between income on revenue or capital account. In a sense this treats the returns on capital and labour identically – a distinction that causes much tension in modern socio-economic discourse, but that cannot be analysed here. This is a fundamentally different departure point from that which favours capital gains for exclusion or special treatment, based on the dogma of taxing the increased value of the income producing machinery at a different rate from the proceeds of its production. If the Haig-Simons definition were to apply, this thesis would be redundant. The Haig-Simons definition would solve the problem via perfect symmetry and neutrality between these income sources. Assuming no rate differential, the following question arises: 'What are we actually discussing?' Herein lies the imperative: this analysis is ultimately not directed at the adjudication of taxation between capital and revenue, but at the correct legal analysis of the instrument. Avoidance of

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[86] Joint Committee on Taxation *Staff Paper on the Tax Reform Act of 1986*.

policy development is not an option. Donohoe, whose empirical work on this form of tax abuse stands out in the USA,[87] explains as follows:

> Financial derivatives are a leading source of corporate tax noncompliance … . Experts claim the legal patchwork of derivatives taxation encourages the development of tax planning strategies …, while the Internal Revenue Service (IRS) concedes it is 'falling farther and farther behind' financial innovation … . Although it is clear from government reports … , anecdotes …, and academic studies … that companies can avoid tax with derivatives …[88]

If the legal nature of the instrument and its appropriate interpretation is therefore not accurately understood, the many other tributaries of potential abuse persist, as illustrated through this continuum of tax planning strategies, from benign by-products of hedging to aggressive transactional design:

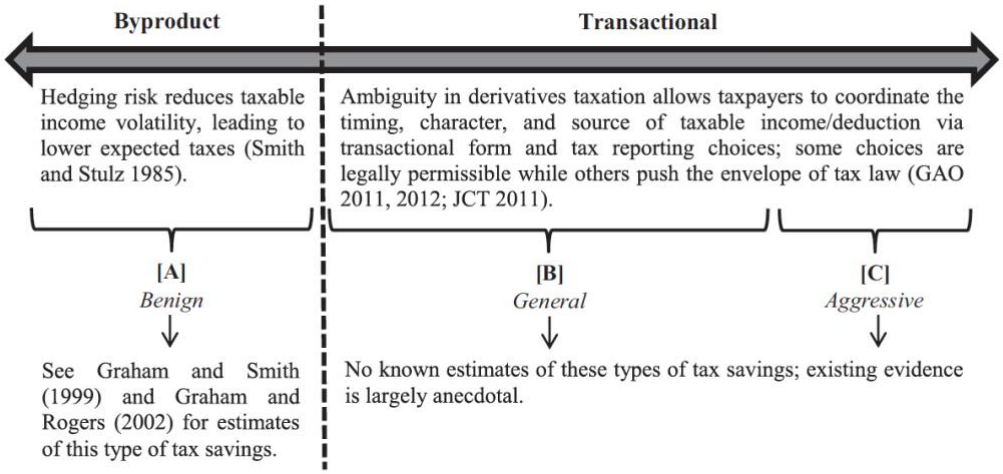

Fig. 1. Tax avoidance continuum with respect to derivatives. *Note*: This figure is adapted from Donohoe (2014a).

	Options	Forwards	Notional Principal Contracts
Timing	Deferred until sale or expiration	Deferred until settlement	Periodic and termination payments ratably; otherwise economic substance
Character	Generally capital	Same as underlying	Same as underlying for termination payments; otherwise ordinary
Source	Taxpayer country of incorporation	Taxpayer country of incorporation	Taxpayer country of incorporation

[87] MP Donohoe 'The economic effects of financial derivatives on corporate tax avoidance' (2015) 59 *Journal of Accounting and Economics* 1 at 20.
[88] Ibid 1.

Figure 11.1: A stylised (partial) illustration of the tax reporting system for financial derivatives[89]

Hudson reflected similarly on the HMRC, engaging in hand-wringing as to what to do. The current legislative approach, the Corporations Tax Act 2009, is the successor to three prior regimes, as described in chapter 7.[90] Hudson referred to a 'manufactured' code: 'My reference to "manufacturing" a code is meant to reflect HMRC's decision to create its own jargon terms for dealing with financial derivatives rather than, for example, seeking to adopt market argot or alternatively terminology used by the Financial Services Authority.'[91]

In deciding to avoid both market language and that of the regulator, the HMRC effectively became a 'taker' when taxpayers classified an instrument under accounting convention. 'Thus, HMRC was left to accept the information given to it rather than creating a strict code of prescriptive rules in legislation':[92]

> Indeed this was clear in the Finance Act 2002 and is now in the Corporation Tax Act 2009 where the modern 'narrative' form of drafting for tax statutes is used whereby a number of sections as opposed to the older, more rigid style of detailed definitions, exceptions and so forth in long, single provisions … when one thinks in the abstract of the task of taxing the derivatives markets, one cannot help those old metaphors of the difficulty of herding cats or of nailing jelly to a wall creeping unbidden into the back of one's mind.[93]

11.4.2 Options for improving certainty

Since there is no such thing as 'derivative law', the development of statutes should find a home in what Hudson calls the 'law of finance':

> [This] is how it can be established as a coherent intellectual and legal field, as opposed to being merely a descriptive account of something which is 'done' in practice. A coherent law of finance can emerge from an elision between the concepts of contract law and the rest of the general law with the contextual,

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[89] Ibid 4.
[90] Hudson (n 26) 799.
[91] Ibid 800.
[92] Ibid 801.
[93] Ibid.

> regulatory principles of financial regulation. The principles of financial regulation bind financial institutions ….[94]

The experience of the USA in particular confirms that a product-based or 'cubby-hole' anti-avoidance approach is complex and will typically lag the cut and thrust of market innovations and allow transactors to write derivative contracts to circumvent those rules. Legislating for what a capital asset is not[95] has also not been very successful. As mentioned above, the Davis Tax Committee recently cautioned against codification in the BEPS report, as did the Tax Advisory Committee in 1994. As the HMRC has done in its Business Manual, clear tax policy statements need to be made:

> Financial transactions include the acquisition, holding, dealing with, and disposal of financial assets such as shares and bonds. They also include taking synthetic positions in relation to such assets or corresponding indices, or discrete components of them. In our view, using synthetics is not itself indicative of trading. There is no conceptual difference between a 'real' and a synthetic financial transaction (for example, buying a share or entering into a derivative contract that replicates the risks and rewards of ownership). All of these approaches may form part of an investment strategy and some of them may constitute investment in themselves.[96]

This statement is congruent with the findings of this research. A comprehensive policy framework for the tax treatment of financial derivatives needs to be formulated for South Africa. Therefore a few principles for the construction of an approach for South Africa, which align with the UK approach, are proposed as follows:[97]

1. Derivatives are property in their own right and gains or losses therefrom might be capital or revenue.

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[94] Ibid 11.
[95] 'Capital assets' include all property held by a taxpayer, regardless of duration, irrespective of whether the property is used in the taxpayer's business or trade. R.C. 5751.01(F)(2)(c) stated that receipts from the assets described in IRC section 1221 or 1231 (assets used in the taxpayer's trade or business) are excluded from the definition of 'gross receipts'.
[96] Her Majesty's Revenue and Customs (HMRC) 'Business Income Manual (BIM) 56910' (undated). See https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim56910 (accessed 7 April 2015).
[97] Ibid.

2. There is no conceptual difference between taking a view on all components by buying the physical asset or entering a derivative contract that replicates ownership, or taking a view on one or a combination of the components via derivatives. Synthetics are therefore no different from physical assets and should be addressed in a fiscally neutral manner.
3. Ordinary tax principles of interpretation should be applied, with due regard to what the parties contracted within the context of their commercial agreement.
4. The nature of derivative instruments is not defined by hedging. The hedge and its underlying composite must conform to a facts and circumstances approach.
5. There is no conceptual difference between a 'long' (a 'call') or a 'short' (a 'put') position. These are simply positive or negative economic exposures to the same reference asset. Character determination is subject to ordinary tax principles for buying or selling an asset.

For a start, principles would go a long way towards improved certainty. Once the principles are agreed, a method of taxation needs to be decided beyond the perimeter of section 24JB of the ITA.

The policy choices might be summarised as follows:

1. a facts and circumstances determination as to the presence of a 'scheme of profit-making' under the common law (which is the current approach), supported by additional policy principles to improve certainty;
2. a time-based rule as applied in the USA across the tax system to distinguish between short- and long-term capital gains and losses. This implies a two-tier capital (capital gains tax (CGT)) tax rate, much like section 9C of the ITA, which would avoid the need for principles, but could create artificial lock-up effects in the economy;

3. a mark-to-market tax levied at the CGT rate where (1) above implies capital treatment. This eliminates a deferral benefit and improves cashflow to the fiscus, but creates liquidity hardships for taxpayers (favoured by recent policy thinking in the USA[98]);
4. an accounting approach, which expands on the policy applied in section 24JB of the ITA and aligns with EU fair value accounting preference.[99]

These choices all have trade-offs and need to be thoroughly considered and consulted on. Due regard also needs to be taken of the development of 'policy blocks' within the EU favouring fair value accounting, and within the USA, favouring a simple mark-to-market regime that accords with US thinking on income definition.

However, option (1) would on its own make for an immense improvement in certainty and would lead to considerable progress in South Africa.

11.5 CONCLUSION

This thesis is the culmination of an extraordinarily long journey through the literature and working in practice with these issues. Simplifying proxies were used to limit the many variables that might be encountered in policy discussions, which then result in circular debate.

Three common-law jurisdictions were reviewed in addition to our own, providing three policy approaches: (1) a common-law approach, where the facts and circumstances are assessed for evidence of a 'scheme of profit-making' as indicative of a revenue motive; (2) an accounting policy approach followed by the UK, Australia and, in part, South Africa; and (3) a highly codified system, as evidenced by US tax policy design.

The primary object of the research was not to determine the characterisation of the instruments, but to enquire where the appropriate legal analysis should rightfully begin. To this

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[98] Joint Committee on Taxation *Description of the Modernization of Derivatives Tax Act of 2017*.
[99] EU Directive 2013/34 of the European Parliament and Council regulates the taxation of financial instruments, including derivatives. Fair value accounting is the chosen basis of taxation within the EU, which includes derivatives, in terms of Articles 8, 16 and 17.

end, recent UK case law provided congruency with the *ratio* in *CIR v Pick 'n Pay Employee Share Purchase Trust*, which concluded that financial derivative instruments are capital assets in their own right. This is the essential logic that SAICA identified in its 1992 document. A comprehensive legal definition for these contracts was then posited and a approach to the interpretation of the contract by our courts was recommended, following Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality*, which strikes a balance between judicial reasoning in the US following *Arkansas Best* and the UK following *Ramsay*. This approach to interpretation adressess concerns about financial equivalence and the limits of transactional analysis that vexed earlier research. Finally, some alternatives for furthering tax policy are outlined, the foremost being the formulation of a set of principles, based both on this research and the thinking of the HMRC.

Domestic reticence towards drafting a comprehensive tax policy framework for derivatives has now provided South Africa with an advantage won from the hard experience of others. Policy progress can be achieved that keeps faith with existing jurisprudence and literature. The commercial fires that might occasionally rage have previously been resolved by our courts. The law will deal with these matters dispassionately. There is no need for a 'law of derivatives' or special conventions or contrivances:

> Law is an interpretive concept … which unites jurisprudence and adjudication. It makes the content of law depend not on special conventions or independent crusades but on more refined and concrete interpretations of the same legal practice it has begun to interpret … Law's attitude is constructive: it aims, in the interpretive spirit, to lay principle over practice to show the best route to a better future, keeping the right faith with the past.[100]

[100] R Dworkin *Law's Empire* (1986) 410–13.

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Applied	Volkswagen South Africa (Pty) Limited v Commissioner for the South African Revenue Service Judgment Date: 20/12/2017 Number of Judges : Majority 5, Minority 0 Underpinnings for the above Judgment.	At Page 721
Referred to and compared	Commissioner, South African Revenue Service v Capstone 556 (Pty) Ltd Judgment Date: 09/02/2016 Number of Judges : Majority 5, Minority 0 Underpinnings for the above Judgment.	At Page 30 31
Considered	Stellenbosch Farmer's Winery Ltd v Commissioner, South African Revenue Service; Commissioner, South African Revenue Service v Stellenbosch Farmer's Winery Ltd Judgment Date: 25/05/2011 Number of Judges : Majority 5, Minority 0 Underpinnings for the above Judgment.	At Page 369
Referred to	Commissioner, SARS v Founders Hill (Pty) Ltd Judgment Date: 10/05/2011 Number of Judges : Majority 5, Minority 0 Underpinnings for the above Judgment.	At Page 246
Referred to	WJ Fourie Beleggings BK v Commissioner, South African Revenue Services Judgment Date: 31/03/2009 Number of Judges : Majority 5, Minority 0 Underpinnings for the above Judgment.	At Page 242
Distinguished and confined to its own facts	Commissioner for the SA Revenue Service v Wyner Judgment Date: 25/11/2003	At Page 543

Number of Judges : Majority 5, Minority 0

Underpinnings for the above Judgment.

Applied	Warner Lambert SA (Pty) Limited v Commissioner, South African Revenue Service	At Page 352	

Judgment Date: 30/05/2003

Number of Judges : Majority 5, Minority 0

Underpinnings for the above Judgment.

Applied	Samril Investments (Pty) Ltd v Commissioner, South African Revenue Service	At Page 661	

Judgment Date: 25/09/2002

Number of Judges : Majority 5, Minority 0

Underpinnings for the above Judgment.

Distinguished	Commissioner For Inland Revenue v Nussbaum	At Page 1165	

Judgment Date: 29/03/1996

Number of Judges : Majority 5, Minority 0

Underpinnings for the above Judgment.

Cape of Good Hope Provincial Division

Signal Determined by: [2002] JOL 9457 (C); 64 SATC 254 (C)

Applied	Wyner v Commissioner, South African Revenue Service	At Page 748	

Judgment Date: 08/03/2002

Number of Judges : Majority 3, Minority 0

Underpinnings for the above Judgment.

Eastern Cape Division / South-Eastern Cape Local Division

Signal Determined by: [2002] JOL 9797 (E); [2002] ZAECHC 15 (E)

Discussed	Commissioner for the South African Revenue Service v Heron Heights CC	At Page 437 439	

Judgment Date: 22/05/2002

Number of Judges : Majority 3, Minority 0

Underpinnings for the above Judgment.

Applied — Commissioner, South African Revenue Service v Knuth; — At Page 1096

Commissioner, South African Revenue Service v Industrial Mouldings (Pty) Ltd

Judgment Date: 25/11/1999

Number of Judges : Majority 3, Minority 0

Underpinnings for the above Judgment.

Considered — Gore NO and Another v Master of the High Court — At Page 292

Judgment Date: 07/06/2001

Number of Judges : Majority 1, Minority 0

Underpinnings for the above Judgment.

Transvaal Provincial Division / Witwatersrand Local Division

Signal Determined by: 1999 (1) SA 264 (T); 60 SATC 141 (T)

Considered — Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd — At Page 30-31 47

Judgment Date: 05/07/1996

Number of Judges : Majority 2, Minority 1

Underpinnings for the above Judgment.

Western Cape Division, Cape Town

Signal Determined by:

Discussed — Commissioner for South African Revenue Service v Spur Group (Pty) Ltd — At Page 195

Judgment Date: 26/11/2019

Number of Judges : Majority 2, Minority 1

Underpinnings for the above Judgment.

Discussed and applied — Capstone 556 (Pty) Ltd v Commissioner, South African Revenue Service — At Page 181 182 190

Judgment Date: 26/08/2014

Number of Judges : Majority 3, Minority 0

Underpinnings for the above Judgment.

Cape

Signal Determined by:

Discussed	ITC 1715	At Page 26
	Judgment Date: 16/02/2001	
	Number of Judges : Majority 1, Minority 0	
	Underpinnings for the above Judgment.	
Applied	ITC 1717	At Page 37
	Judgment Date: 12/02/2001	
	Number of Judges : Majority 1, Minority 0	
	Underpinnings for the above Judgment.	
Referred to	ITC 1746	At Page 198
	Judgment Date: 08/12/2000	
	Number of Judges : Majority 1, Minority 0	
	Underpinnings for the above Judgment.	

Cape Income Tax Special Court

Signal Determined by: 1997 (2) JTLR 59 (C)

Referred to	ITC 1616	At Page 276 279 280
	Judgment Date: 23/01/1997	
	Number of Judges : Majority 1, Minority 0	
	Underpinnings for the above Judgment.	
Considered	ITC 1638	At Page 427 429
	Judgment Date: 23/08/1995	
	Number of Judges : Majority 1, Minority 0	
	Underpinnings for the above Judgment.	

Cape Town

Signal Determined by:

Referred to	ITC 1919	At Page 319
	Judgment Date: 05/09/2018	
	Number of Judges : Majority 1, Minority 0	

Underpinnings for the above Judgment.

Eastern Cape

Signal Determined by:

Referred to	ITC 1755		At Page 367-8
	Judgment Date: 27/05/1999		
	Number of Judges : Majority 1, Minority 0		
	Underpinnings for the above Judgment.		
Referred to	ITC 1659		At Page 242
	Judgment Date: 28/05/1998		
	Number of Judges : Majority 1, Minority 0		
	Underpinnings for the above Judgment.		

Eastern Cape Income Tax Special Court

Signal Determined by:

Considered	ITC 1680		At Page 360
	Judgment Date: 27/05/1999		
	Number of Judges : Majority 1, Minority 0		
	Underpinnings for the above Judgment.		
Referred to	ITC 1639		At Page 433
	Judgment Date: 09/05/1997		
	Number of Judges : Majority 1, Minority 0		
	Underpinnings for the above Judgment.		

Transvaal Income Tax Special Court

Signal Determined by:

Applied	ITC 1608		At Page 66 68 70
	Judgment Date: 30/05/1996		
	Number of Judges : Majority 1, Minority 0		
	Underpinnings for the above Judgment.		
Considered and discussed	ITC 1597		At Page 33

Judgment Date: 30/08/1993

Number of Judges : Majority 1, Minority 0

Underpinnings for the above Judgment.

Transvaal

Signal Determined by:

Referred to ITC 1594 At Page 267

Judgment Date: 27/09/1993

Number of Judges : Majority 1, Minority 0

Underpinnings for the above Judgment.

Referred to ITC 1581 At Page 25

Judgment Date: 23/08/1993

Number of Judges : Majority 1, Minority 0

Underpinnings for the above Judgment.

Foreign Court

Zimbabwe Income Tax Special Court

Signal Determined by:

Considered ITC 1607 At Page 342

Judgment Date: 09/05/1995

Number of Judges : Majority 1, Minority 0

Underpinnings for the above Judgment.