THE TAX TREATMENT OF RECEIPTS AND ACCRUALS ARISING FROM EQUITY OPTION CONTRACTS

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ABSTRACT

In this thesis the tax treatment of equity option contracts is examined. The writer gives an overview of the derivatives market in general and discusses the nature and effect of equity options in detail. Limited amendments have been made to the South African Income Tax Act No 58 of 1962 ('the Act') since the emergence of derivative instruments and at present only three types of derivative instruments are recognised: forward exchange and option contracts relating to forward exchange, interest rate swaps based on notional capital amounts and option contracts. Other than section 24I of the Act which deems all receipts and accruals from foreign exchange contracts to be income, the other sections dealing with derivatives do not concern themselves with capital or revenue classification. Accordingly, the classification of receipts and accruals arising from an equity option transaction is generally governed by the ordinary principles of South African tax law with the added problem of there being limited South African case law applying these general principles to such transactions.

The research undertaken in this thesis results in the establishment of a framework designed to determine the classification as revenue or capital the receipts and accruals arising from equity option contracts. Speculating, trading and investing in equity options is examined with regard to the general principles of South African tax and available case law. Hedging transactions are analysed with specific reference to their exact nature as well as general tax principles and available case law. The analogy of Krugerrands is used to draw parallels with the tax treatment of receipts and accruals arising from equity options used for hedging purposes. Once the theoretical framework has been established for revenue or capital classification, the actual tax treatment of both revenue and capital receipts is examined with reference to the Act and issues such as the gross income definition, the general deduction formula, trading stock and timing provisions are analysed and applied to receipts and accruals arising from equity option transactions. The thesis concludes with a summary of the findings and recommendations are made based on the research conducted.

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CHAPTER 1: INTRODUCTION

1.1 A brief introduction to the derivative market

A financial derivative is a financial instrument whose value depends on the value of another financial instrument or asset (Kolb: 1997). There are four basic types of financial derivatives, namely forwards, futures, swaps and options. A forward contract is a contract negotiated in the present that gives the contract holder both the right and the full legal obligation to conduct a transaction at a specific future time involving a specific quantity and type of asset at a predetermined price (Kolb: 1997). A futures contract is a forward contract that has been highly standardised and closely specified. As with a forward contract, a futures contract entails the exchange of some asset at a future date for cash, with the payment of the asset to occur at the future delivery date (Kolb: 1997). The purchaser of a futures contract is to receive delivery of the asset and pay for it, while the seller of the contract promises to deliver the asset and receive payment. Unlike forward contracts, futures contracts are traded on an established exchange and as such are formally regulated. A swap is an agreement between two or more parties to exchange sets of cash flows over a period into the future (Kolb: 1997). The cash flows that the parties to the contract receive are generally tied to debt instruments or the value of foreign currencies. An option contract gives its owner the right, but not the legal obligation, to conduct a transaction involving an underlying asset at a predetermined price (Kolb: 1997).

Financial derivatives add many important features to the financial market:

- Market completeness: A complete market is one in which all identifiable trading and investing strategies can be implemented by utilising the available instruments in the market. This is a desirable characteristic of a financial market because it helps market participants to maximise their welfare by enabling them to fulfill all of their trading and investing requirements. Financial derivatives provide a mechanism with which market participants can employ a wide variety of trading and investing strategies which are not possible to replicate utilising traditional financial instruments such as equities and bonds. Derivative instruments therefore play an important part in contributing to the completeness of the market.

- Speculation: The derivatives market allows traders to take a wide range of trading positions which further add to the completeness of the market.
- Risk management: Financial derivatives provide a tool for market participants to manage their risk by allowing them to protect their position in the markets by entering into hedging transactions (that is, a transaction which aims to protect the value of a particular asset or group of assets from negative market movements).
- The concept of arbitrage: An arbitrage opportunity is the chance to make a risk-free profit with no actual investment of capital (Kolb: 1997). With arbitrage trading, two identical assets are identified with different prices, allowing traders to profit from such pricing mismatch. An example of an arbitrage trading opportunity is when a company's share is traded on more than one exchange and in different countries. Due to exchange rate differences there are often pricing mismatches which can be taken advantage of. Derivative instruments make it easier to exploit arbitrage opportunities due to their liquidity and low trading cost.
- Trading efficiency: Traders may find trading financial derivatives more attractive than trading the underlying asset due to the fact that the derivative market is often more liquid and cost effective than the market in which the underlying asset is traded.

The growth of the markets in which derivative instruments are traded has been significant. The last few decades has seen the emergence of derivative instruments to trade such fundamental products as agricultural, commodities, energy, precious metals, currencies, equities and debt instruments. In South Africa, the development of exchange traded derivative instruments started in the late 1980's when Rand Merchant Bank Limited ('RMB') commenced the trading of five futures contracts on various equity indices and government bonds in September 1987. RMB acted as the sole exchange, market maker and clearing house. In September 1988, twenty one South African banks and financial institutions established the South African Futures Exchange ('Safex') and the Safex Clearing Company. Based on statistics provided by Safex on 4 December 2003, it is evident that by August 1990 the approximate monthly volume traded through Safex was sixty thousand derivative contracts and by June 1992 monthly volume exceeded one hundred thousand contracts. In January 1993 monthly volume exceeded two hundred thousand contracts and for the first time in December 1993 monthly volume exceeded one million contracts. For the twelve month period ending 4 December 2003, derivative contracts traded through Safex equated to approximately seventeen and a half million with a trade value of four hundred and twelve billion Rand. It is therefore clear that the growth in the use of financial derivatives in South Africa has been substantial and the use of derivatives has become a fundamental part of the South African financial market.

1.2 An overview of equity options

1.2.1 Introduction

An equity option contract is a type of option contract which gives its owner the right, but not the legal obligation, to conduct a transaction involving an underlying share, basket of shares, equity index or equity indices (in this thesis the term 'share' must be read to include a basket of shares, an equity index and a basket of indices) at or before a predetermined future date (the exercise or strike date) and at a predetermined price (the exercise or strike price) (Kolb: 1997).

Equity options can be classified as either put options (the right to sell a share) or call options (the right to buy a share). For every owner of an equity option there must be a seller. The seller of an equity option is called an option writer or issuer. Equity options may either be cash settled or physically settled. A physically settled option entails a sale or purchase of the underlying share on which the option is written, whilst a cash settled option entails a cash payment to the holder on the exercise date of an amount equal to the market price of the share on which the option is written, less the exercise price. The period which an equity option contract has to run until the exercise or strike date is referred to as the 'term to strike'. 'American' equity options may be exercised at any time up until the exercise date whilst 'European' equity options may be exercised only on the predetermined exercise date. The consideration an equity option writer receives for issuing an equity option is termed the option premium.

An equity option contract has some important characteristics:

- It conveys upon the holder a right and not an obligation. Since the option can be abandoned without further penalty, the maximum loss the buyer faces is the cost of the option premium;
- By contrast, if the buyer chooses to exercise the right to buy or sell the underlying share, the writer or issuer has an obligation to deliver or take delivery of the underlying share.

Equity options can be structured with a strike price which is either 'in the money', 'at the money' or 'out the money'. With regard to a call option, an 'in the money' option has a strike price which is less than the current share price to which the option is referenced, an 'at the money' option has a strike price equal to the current share price and an 'out the money' option has a strike price greater than the current share price. With regard to put options the aforementioned would be the opposite. In return for writing an 'in the money' equity option the option writer would demand a higher premium whilst a smaller premium would be charged for an 'out the money' put option. This is due to the fact that with an 'at the money' option the writer has a higher probability of having to perform in terms of the contract.

Equity options are mainly utilised for speculative, investment and hedging purposes. The main participants in the equity options market are pension funds, asset managers and retail investors. Pension funds and asset managers would typically enter into tailor-made option contracts structured by a financial institution based on their unique requirements ('over the counter options'). In order to enter into a tailor-made over the counter option, the minimum deal size would be approximately ten million Rand. The retail investor is primarily involved in exchange traded options which are traded on Safex or on the JSE Securities Exchange ('JSE') in the form of the warrants market. The warrants market is the most accessible market for the retail investor due to the low minimum trade size (the approximate minimum trade size is one thousand Rand) and competitive cost structure. In essence, a warrant is exactly the same as an equity option and in this thesis the terms 'warrant' and 'equity option' are used interchangeably. In his book, 'The Investors Guide to Warrants', Andrew McHattie states the following regarding equity warrants as trading instruments (1992: 4):

> If shares are the normal vehicle for stock market investment, then warrants are the 'sports' model for the adventurous. They can certainly move rapidly enough. Warrants are a wonderful bull market instrument and they can inject excitement into a pursuit which is too often as prim as it is profitable. Some of the more colourful market characters who have learnt about the market in depth and examined the finer points of warrant trading cannot understand why people want to buy shares at all when they can have warrants. Why settle for a thirty percent gain when your profit might be one hundred percent? The premier attraction of warrants has always been their ability to produce huge profits from small market movements, yet few investors appreciate the wide range of applications for which warrants are suitable. Used as a hedging instrument, warrants can actually reduce risk, or they can be used in conjunction with capital shares to offer enormous capital exposure from a small stake.

As alluded to by McHattie, equity options are not only excellent trading instruments but can be utilised as effective hedging tools as well as for investment purposes.

1.2.2 Speculating or trading with equity options

The simplest strategy for a person who is optimistic, or 'bullish', about the prospects for a particular company's share, or the equity market in general, would be to either purchase call options or sell put options. Alternatively, a negative or 'bearish' view would entail a strategy of either purchasing put options or selling call options. The practical example below illustrates this principle.

Assume a speculator believes that share A, currently trading at R 90 per share, will perform well over the next seven months. In order to profit from this view the speculator could do one of the following:

- purchase call options on share A; or
- write put options on share A.

In terms of the first transaction, share A 'at the money' call options with a strike price of R 90 and a term to strike of seven months could be purchased for a premium of, say, R 0.30 per option. For every twenty five options held the speculator will be given the right to purchase one share A on expiry of the equity option in seven months at a price of R 90 per share. The number of option contracts required in order to take up one share is termed the 'cover ratio' and as such the aforementioned call option has a cover ratio of 25:1. Assume the speculator purchases 100,000 options for a cost of R 30,000 and on the strike date share A is trading at R 100 per share, the return would be calculated as follows (assuming a cash settlement):

Cost of options (100,000 x R 0.30)	(R 30,000)
Cash settlement $\frac{100{,}000}{25}$ x (R 100 – R 90))	R 40,000
Simple return over seven months	33%
Effective annual return	50%

The above example illustrates how effective equity options can be when used as trading instruments. For an initial capital outlay of R 30,000 the speculator has replicated a R 360,000 position in the underlying asset, share A. This feature inherent in equity options is termed 'effective gearing' and the higher the gearing factor the more sensitive the return will be relative to the actual performance of the underlying share. Although the effective gearing makes substantial returns possible with a relatively small investment of capital, the maximum potential loss is limited to the premium paid.

Alternatively, the speculator could issue 100,000, seven month 'at the money' put options (that is, put options with a strike price of R 90 per share) on share A at a premium of R 0.30 per option and a cover ratio of 20:1. In terms of the put options issued, the speculator would have the legal obligation to purchase 5,000 company A shares should the price of share A be less than R 90 per share on the exercise date. On the expiry date there could be three possible outcomes:

(i) The price of share A remains static at R 90. The options will be allowed to expire, being worthless, and the speculator will realise R 30,000 in premium income; or

(ii) The price of share A rises, to say R 100 per share, as expected, and the put options expire out the money. Once again the speculator will realise R 30,000 in premium income; or

(iii) The price of share A falls, to say R 80 per share, and the options are exercised against the speculator. Assuming the speculator immediately sells the shares he has purchased in terms of the put options at the market price, the speculator's return will be as follows:

Premium received (100,000 x R 0.30)	R 30,000
Cost of shares ($\frac{100{,}000}{20}$ x R 90)	(R 450,000)
Proceeds from sale of shares ($\frac{100{,}000}{20}$ x R 80)	R 400,000
Net loss	(R 20,000)

The above is clearly a riskier strategy than purchasing share A call options as in the first example. Although the maximum potential return is far greater than simply purchasing call options on share A (in theory the potential return the writer of the option can earn is infinite as there is no initial negative cash flow involved upfront), unlike the call option strategy where the maximum potential loss is limited to R 30,000 the potential loss by writing put options on share A is R 420,000 (R 450,000 – R 30,000).

Speculators could use the same techniques for taking advantage of an anticipated fall in the price of a share. Instead of either purchasing call options or selling put options, the speculator would purchase put options or write call options. However, unlike the case of a written put option where the potential loss can be substantial but nonetheless limited, a written call option has unlimited loss potential as theoretically the price of a share is uncapped. In practice, speculators when suffering heavy losses which are no longer sustainable will cancel their position by taking an equal and opposite position in the market. Furthermore, option writers will almost always ensure that their financial exposure is suitably hedged.

1.2.3 Utilising equity options for investment purposes

The same techniques as employed by a speculator could be employed by an investor who wished to dispose of a share held on capital account (that is, as an investment) or wished to purchase a share to be held on capital account. If an investor needed to secure a future selling price for a share held on capital account, a physically settled put option could be purchased. As the strike price would be known at the outset of the transaction, the investor would have certainty in terms of the selling price on the exercise date. For an investor who wished to secure the purchase of a share at some time in the future a physically settled call option could be used in order to set the purchase price. Where a share has very low liquidity, equity options can be effectively employed to secure the sale or purchase of such a share.

1.2.4 Hedging with equity options

Especially in market conditions where volatilities are high, equity options are widely utilised for hedging purposes. The goal of a hedge transaction is to create a position that once added to an investor's or speculator's portfolio will offset the price risk of another fundamental asset holding (Reilly, Brown: 2003). Through hedging, market participants can choose to shift their risk to market speculators.

Assume an investor holds share B which is trading at a price of R 18 per share. Due to anticipated weakness in the share price, 'at the money' put options could be purchased with a strike price equal to the current share price of R 18 per share. This would ensure that should the share price come under pressure, share B could be sold for at least its current market price on the exercise date.

1.2.5 Size of the equity option market and potential growth

As already highlighted, the South African derivative market has grown substantially over the last twenty years. Although the derivative market has become very sophisticated, the equity option contract is still one of the most widely utilised derivative instruments. Based on statistics supplied by Safex as at 4 December 2003, it can be seen that the publicly traded equity options market based on the six months trading period ending on 4 December 2003 had an approximate average daily turnover value of four and a half million Rand.

Based on an analysis of one of the country's largest stockbroker's client accounts over a three year period ending September 2003, it was evident that the use of options for trading and portfolio management purposes had increased by approximately twenty two percent per annum. It is submitted that across the industry a similar increase would be evident. It is further anticipated that this positive trend in the use of equity option contracts is likely to continue. In the opinion of the writer, a major catalyst for future growth in the equity options market is the enactment of the Collective Investment Schemes Control Act (No 45 of 2002). Prior to the enactment of such Act, the Unit Trust industry was prohibited from utilising derivative instruments in unit trust portfolios. Since the inception of the Act in 2002, unit trust funds may now hold up to five percent of their net assets in derivative instruments. According to information supplied by the Association of Unit Trusts, as at 30 September 2003 the market value of unit trusts classified as 'South African general equity funds' was forty eight billion Rand. As such, the potential surge in equity option activity as a result in the aforementioned change in legislation is self evident.

1.3 An introduction to South African income tax

In South Africa, income tax is levied in terms of the Income Tax Act No 58 of 1962 (as amended) ('the Act'), which provides for the levying of four different types of tax. These taxes are:

- Normal tax (the taxation of capital gains is incorporated into normal tax);
- Donations tax;
- Secondary tax on companies; and
- Withholding tax on royalties.

With regard to this thesis, and by way of background, it is only necessary to discuss income and capital gains tax.

Normal tax is a levy imposed on all persons who have taxable income and is charged annually by applying predetermined rates which vary depending on the legal nature of the person involved. Generally speaking, in the case of companies (including close corporations) the rate of normal tax is thirty percent, for trusts the rate is forty percent and for natural persons the rate of tax varies between eighteen and forty percent depending on the quantum of the person's taxable income. In terms of the tax rates applicable to the 2004 tax year, a natural person who has taxable income of up to seventy thousand Rand pays tax at a rate of eighteen percent. Taxable income in excess of seventy thousand Rand is taxed at a gradually increasing rate until taxable income of two hundred and fifty five thousand Rand is reached, whereafter tax is levied at a rate of forty percent. For natural persons the actual amount of tax payable is reduced by five thousand four hundred Rand with additional tax relief of three thousand one hundred Rand available to natural persons over the age of sixty five.

As from 1 October 2001 a tax known as 'Capital Gains Tax' ('CGT') was introduced into the Act. In terms of the tax, a portion of the gains made by a person on the disposal of capital assets on or after 1 October 2001 are included in taxable income and subject to normal tax. The amount of the gain included depends on the legal nature of the person. For natural persons, twenty five percent of the gain is included whilst in the case of a company (including a close corporation) or a trust, fifty percent is included. The effective rate of CGT is therefore a maximum of ten percent for a natural person, fifteen percent for a company or close corporation, and twenty percent for a trust. It is therefore clear that taxable capital gains give rise to tax at a lower effective rate than the tax on income. The correct classification of a receipt or accrual as either a revenue receipt (subject to income tax) or a capital receipt (subject to CGT) is therefore of critical importance.

The determination of taxable income follows a sequence as prescribed in the Act which can be summarised as follows:

Gross Income (section 1 of the Act)		XXX
Less:	Exempt Income (section 10 of the Act)	(XXX)
Income		XXX
Less:	Deductions (sections 11 to 19 and 23, mainly)	(XXX)
Add:	Taxable Capital Gains (section 26A)	XXX
Taxable Income		XXX

'Taxable Income' is therefore the amount on which normal tax at the applicable rate is calculated. The terms 'Gross Income', 'Income' and 'Taxable Income' are all defined in the Act.

'Gross income' is defined in section 1 of the Act as follows:

> 'gross income', in relation to any year or period of assessment, means -
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) ...
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature ...

The Act does not define receipts and accruals of a capital nature and it has been left to the Courts to establish tests which assist in classifying amounts as either capital or revenue. It can be noted at this stage that those taxpayers who are in the business of writing equity option contracts in order to earn premium income, or those taxpayers holding equity options on revenue account (that is, speculators and traders) would need to include all receipts and accruals with regard to such equity options as gross income for income tax purposes. This is because such taxpayers are not transacting with equity options on capital account and as such all receipts and accruals would fall within the definition of 'gross income'. Taxpayers holding equity options on capital account (that is, investors) would fall within the CGT regime. Whilst the aforementioned appears straightforward, the actual classification of a receipt or accrual from an equity option contract as capital or revenue is often extremely difficult and the major thrust of this thesis is the construction of a theoretical framework which can be utilised to assist in such classification.

'Income' is defined in section 1 of the Act as:

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

'Taxable income' is defined in section 1 of the Act as follows:

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

Whether or not a transaction gives rise to an amount of a revenue nature or of a capital nature has tax consequences that are material in assessing the overall return on a transaction involving a financial derivative due to the fact that CGT is levied at a rate lower than income tax. In the past the provisions of the Act have dealt with the taxation of receipts and accruals arising from actual assets and not with derivatives which derive their value from an underlying asset or group of assets. Limited amendments have been made to the Act since the emergence of derivative instruments in financial markets and at present the Act recognises only three types of financial arrangements that can be classified as derivative transactions: forward exchange and option contracts relating to foreign exchange (section 24I of the Act), interest rate swaps based on notional capital amounts (section 24K of the Act) and option contracts (section 24L of the Act). However, other than section 24I which deems all receipts and accruals from foreign exchange contracts to be income, the aforementioned sections do not concern themselves with capital or revenue determination and deal merely with the timing of recognition of a receipt or accrual for income tax purposes. Accordingly, the taxation of gains and losses arising from derivative transactions is generally governed by the ordinary principles of South African tax law with the added problem of there being limited South African case law applying these general principles to such transactions. As a result there is a fair amount of uncertainty with regard to how a South African Court would treat such transactions.

Based on the above, it is therefore critical that issuers of derivative instruments, financial advisers, asset managers and other users become aware of the tax implications arising from the use of derivatives. No investment or trading decision utilising derivatives can be made without fully taking into account the tax implications. Unfortunately for the participants in the derivative market, the taxation aspects are complicated and there is no real specific legislation dealing with all the relevant issues. The general principles of South African tax law therefore have to be utilised together with the available relevant case law which is minimal.

1.4 Research problem and objective of the research

The research problem to be addressed in this thesis is the equitable tax treatment of equity option contracts. In this regard, the main objective of the research is to assess whether existing tax legislation together with current case law is sufficient to formulate a comprehensive framework for the taxation of receipts and accruals arising from equity option transactions. There are various aspects regarding equity option transactions which need clarification, in particular with regard to hedging transactions. Where it is concluded that legislation and existing case law is insufficient, a theoretical framework is recommended which aims to provide an effective tool with which to assess the correct tax treatment of any receipt or accrual related to any equity option transaction.

1.5 Research methodology and scope

The research undertaken is of a qualitative nature, comprising a critical analysis and interpretation of the relevant provisions of the Act, associated case law and the writings of experts in the field of taxation and finance.

The theoretical framework for the study is formulated in tax legislation and interpretations by the judiciary, in the form of tests to be applied to the transactions concerned. To the extent that the theoretical framework is inadequate or inappropriate, or the judicial tests contradictory, the research proposes a theoretical decision-making model.

The scope of this research is confined to equity option contracts only. The research is also limited to the tax implications of entering into an equity option contract as it applies to South African resident taxpayers. The major thrust of the research will be aimed at the issue of the capital or revenue classification of receipts and accruals arising from equity options as this is the most complicated tax issue. Once a framework has been established for such classification, the remaining tax issues are fairly straight-forward. As such, the key to fully comprehending the exact tax implications of entering into an equity option contract lies in the formulation of the aforementioned framework. The actual tax treatment of revenue and capital receipts and accruals arising from an equity option transaction (once the complicated issue of classification has been resolved) is examined within the ambit of the income tax and capital gains tax regime respectively. In this regard, there are certain interesting aspects, in particular in respect of equity options held as trading stock. It must once again be stressed, that the real challenge of the research, and therefore its main emphasis, is the issue of revenue or capital classification of receipts and accruals arising from equity options.

1.6 Brief overview of the research

In Chapter 2, the classification of receipts and accruals arising from trading, speculating and investing in equity options is dealt with. The general principles of South African tax law are examined and together with available case law applied to equity option transactions in order to construct a framework for the correct classification of receipts and accruals arising from equity option transactions.

Chapter 3 analyses equity option transactions entered into for hedging purposes. General principles of tax law are discussed as well as available case law. The exact nature of hedging transactions is examined with reference to international precedent and generally accepted South African accounting practice. By way of analogy, the tax treatment of receipts and accruals arising from Krugerrands is discussed and parallels are drawn with equity option transactions entered into for hedging purposes.

Chapter 4 outlines the actual tax treatment of revenue receipts arising from equity option contracts as prescribed by the Act. The general deduction formula is discussed and applied as well as the provisions relating to trading stock. The timing of receipts and accruals for income tax purposes is also highlighted.

Chapter 5 examines the actual tax treatment of capital receipts and accruals resulting from equity option transactions with reference to the provisions of the Act dealing with CGT.

Chapter 6 concludes the thesis and summarises the research. Recommendations based on the research undertaken are also made and opportunities for further research highlighted.

CHAPTER 2: CAPITAL OR REVENUE DETERMINATION OF RECEIPTS OR ACCRUALS ARISING FROM EQUITY OPTION TRANSACTIONS, OTHER THAN HEDGING TRANSACTIONS

2.1 General South African tax principles

2.1.1 Introduction

There are two parties to any equity option contract, namely the option writer or issuer and the option holder. From the option holder's perspective there are three potential receipts or accruals which could arise: receipts or accruals from the disposal of the option itself, receipts or accruals when the option is exercised (for cash settled options) and receipts and accruals from the disposal of the underlying share (for physically settled options). From the option writer's perspective the only relevant receipt or accrual is the option premium. The option premium is the amount received to compensate the writer for the potential loss as a result of issuing the option contract and is determined with reference to the perceived risk of a particular transaction.

In terms of the Act, revenue receipts and accruals are subject to income tax whilst capital receipts are subject to CGT. As the rate of CGT is generally lower than income tax, it is imperative from a taxpayer's perspective that the correct classification of a receipt or accrual is established. The classification of a receipt or accrual as capital or revenue will therefore have a major influence on the return arising from an equity option transaction on an after-tax basis. As stated in the introduction, the limited provisions in the Act dealing with derivatives do not assist with capital or revenue classification with regard to equity options, and as such one has to rely on general South African tax principles and available case law. Over the years the Courts have laid down various tests to be applied in deciding whether a receipt or accrual is of a capital or revenue nature.

Of these tests one has emerged as the dominant test, namely 'intention'.

2.1.2 Intention

Intention was referred to in the case of *CIR v Stott* AD 252, 3 SATC 253 where the Court was called upon to decide whether the sale of certain land in Natal gave rise to a receipt of a capital or revenue nature. The taxpayer was an architect and land surveyor who over a period of approximately twenty years had made numerous investments in land. In 1920 he purchased 54 acres of coastal land with the main intention of building a house on the land to serve as a residence. After building the house the taxpayer subdivided the land, retained the portion with the house on, and sold the balance off over the next few years in individual lots. In 1921 he bought a small farm which was subject to a long lease and after a breach by the lessee he cancelled the lease and re-let the farm subject to his right to subdivide the land and sell it in lots which he subsequently did at a profit. The Commissioner included both the proceeds from the sale of the seaside property, as well as the farm, as gross income when assessing the taxpayer on the grounds that they were of a revenue nature. The Special Court backed the view of the Commissioner and held that by dividing the land into lots and selling them at a profit the taxpayer had changed his original intention from one of investment to one of a scheme of profit making. On appeal, the Natal Provincial Division reversed the decision of the Special Court, holding that the proceeds were accruals of a capital nature. In coming to its decision the Court ruled that both the seaside land and the farm land were bought as ordinary investments of surplus funds and that there was no evidence to show that the taxpayer had changed his intention.

In his judgment Wessels JA said (at 261) the following about the importance of the intention of a taxpayer when examining the issue of capital or revenue determination:

> It is unnecessary to go so far as to say that the intention with which an article or land is bought is conclusive as to whether the proceeds derived from a sale are taxable or not. It is sufficient to say that the intention is an important factor and unless some other factor intervenes to show that when the article was sold it was

> sold in pursuance of a scheme of profit making, it is conclusive in determining whether it is capital or gross income.

In *SIR v Trust Bank of Africa Ltd*, 1975 (2) SA 652 (A), 37 SATC 87, the taxpayer was a commercial bank which did some sharedealing ancillary to its banking business. In 1965 the executive committee of the bank decided to acquire a substantial shareholding in an investment fund for the main purpose of obtaining additional banking business on the back of the investment. Based on considerable pressure by the management of the fund the bank was persuaded to sell its shareholding to two other banks who were also members of the fund and a substantial profit was realised. The Secretary sought to tax the profit and the taxpayer appealed on the basis that the shares were acquired with the main purpose of obtaining additional banking business and not for resale at a profit and as such the amount was capital in nature. The Special Court ruled in favour of the taxpayer and on appeal by the Secretary the case went to the Appellate Division which also ruled in favour of the taxpayer on the basis that the shares were acquired for the purpose of extending the bank's income producing operations rather than for resale at a profit. With regard to the importance of the intention of the taxpayer the following was stated by Botha JA (at 102):

> ... upon whether the purchase, holding and sale of these shares were steps in a scheme of profit-making, that is, to make a profit by the resale of the shares at an enhanced price; or whether the sale constituted the realisation of a capital asset acquired and held for purposes other than such a profit making scheme, this is fundamentally a question of intention, *viz* the intention of the appellant in regard to this particular transaction and, more especially, its intention at the time when the shares were acquired.

The rule as it applies is firstly that the intention of the taxpayer at the date of acquisition must be established and secondly that it is then possible to have a change of intention in the intervening period prior to the sale of the asset. Broadly speaking, the intention which a taxpayer may have at the time of acquisition may be one of the following:

Investment: to acquire and hold the asset as an income producing asset (that is, as a generator of a flow of future income). An asset which is acquired with this intention is a capital asset and in the absence of a change of intention the sale of such an asset will give rise to a receipt or accrual of a capital nature.

Speculation or trading: for the purpose of making a gain by selling the asset in a scheme of profit making. In other words the intention is not to use the asset as an income producing asset but rather to realise the profit inherent in the asset. The asset is therefore acquired as trading stock with the intention of resale at a profit. The sale of such an asset will give rise to a receipt or accrual of a revenue nature.

It may also be the case that a taxpayer acquires an asset with a mixed intention, that is, partly for investment purposes and partly for speculative purposes. The principle established in *CIR v* Levy, 1952 SA 413, 18 SATC 127 with regard to the issue of a mixed intention is that the dominant intention of the taxpayer in acquiring the asset in question must be ascertained in order to determine whether the asset was acquired on capital or revenue account. It was stated in the case of *African Life Investment Corporation Ltd v SIR*, 1969 SA 259, 31 SATC 163 that whether or not an intention is dominant in the sense that another co-existing intention may be effected at a profit without attracting liability for income tax is a matter of degree depending on the circumstances of the case.

2.1.3 Conclusion

Based on general South African tax principles as set out above, it is clear that all receipts and accruals as a result of any speculating or trading in equity options would constitute revenue. In this regard, and in the opinion of the writer, it is submitted that the following would be good objective indicators that should be examined in order to establish whether a taxpayer is in fact speculating or trading:

- repetition, regularity and frequency of trades and an intention to engage in trades routinely and systematically;
- turnover or volume of trades;
- evidence of a discernible system of trading (employing particular or sophisticated buying and selling strategies, preparation of contingency plans and preparation of budgets and targets);
- the engagement of an adviser with professional management skills;
- significant market research; and/or
- prior involvement in the industry or a related business occupation.

2.2 Isolated transactions

Although repetition, regularity and frequency would be one of the good indicators as to a trading or speculative intention, once off transactions in equity options, not in the ordinary course of a taxpayer's business, can also be classified as revenue. In *ITC 382* (1937) 9 SATC 439, the President of the Court had the following to say about the taxability of isolated transactions (at 440):

> So far as the question of isolated transactions is concerned, this has been settled by numerous decisions in the Supreme Court and in this Court and that if a profit

arises out of trading it is taxable notwithstanding the fact that the transaction is an isolated one.

As such, a once off transaction in equity options will be treated no differently.

In *ITC 43* (1925) 2 SATC 115, the taxpayer carried on business as a country storekeeper and as part of such business it was customary to enter into transactions in grain and other produce. The taxpayer entered into what was effectively a cash settled futures contract for the supply of grain at a fixed price in the future. Due to a sudden rise in grain prices the counterparty to the futures contract was faced with a loss on the contract and paid a certain sum of money as consideration for the cancellation of the contract. The Commissioner assessed such amounts as taxable income and the taxpayer appealed on the basis that the transactions were gambles in futures only and as such were speculative transactions of an isolated nature. The Court held that the transactions, though differing in character from those ordinarily undertaken by the taxpayer, were within the scope of his business and required the experience acquired in the conduct of that business, and that consequently the profit derived from the contract was income liable to taxation. It is submitted that although the decision of the Court was correct in the sense that a taxpayer cannot rely on the isolated nature of a transaction to avoid liability for income tax, the fact that the transaction was speculative in nature (by the admission of the taxpayer) was all the Court required to come to the decision.

In *ITC 118* 4 SATC 71, the taxpayer was employed in an attorney's office during the platinum boom. During such time he came across information that norite, a formation in which platinum had been found to exist, was present in Rustenburg. At that time no discoveries of platinum had yet been made in that area. The taxpayer, acting on the information, raised the necessary capital and acquired options over land in the area. Shortly after the options had been acquired by him he sold them for a profit which was included by the Commissioner as taxable income in the taxpayer's return of income. The taxpayer objected and then appealed on the basis that the profit in question was of a capital nature. The Court ruled against the taxpayer and held that the options had been acquired for the purpose of disposing of them at a profit in a scheme of profit making. One of the arguments put forward by the taxpayer was the fact that the transaction was isolated and as such it should not be classified as revenue. The Court held that the isolated nature of the purchase and sale of the options was irrelevant. The President of the Court said the following in this regard (at 270):

> If a man engaged in a single transaction with the express purpose of profit-making he was carrying on a transaction in the nature of a business. 'Business' might be defined as anything which occupied the time and attention of a man for profit.

2.3 Nature of the equity option and sale of the underlying share

It has also been held that where an option is acquired with the intention of making a profit from the sale of the underlying asset that both the option and the underlying asset will be treated as being held on revenue account. In *ITC 640* 15 SATC 229, the taxpayer purchased an option on a property with a sale price of £ 20,000 for £ 250. Prior to the expiry of the option the taxpayer sold such option to a third party for a sum of £ 5,000, which amount the Commissioner assessed as income. The taxpayer objected to such assessment on the grounds that the transaction was not in the ordinary course of his business and as such was of a capital nature. The taxpayer, although he had previously been engaged in the business of a speculative builder, during the year of assessment in question was engaged in farming, having retired from the business of a builder. The Court dismissed the appeal on the basis that the taxpayer had not discharged the onus resting upon him of showing that the probabilities were more in favour of his having entered into the transaction for the purposes of making a property investment as opposed to acquiring a property for trading purposes. As such, the Court held that the proceeds of the option were of a revenue nature.

In the Zimbabwean case *SAM v COT* (2) SA 75 (ZR) 42 SATC 1, it was suggested that if an option was obtained for the purpose of acquiring a capital asset, a decision to exercise the option and sell the underlying asset instead of allowing the option to lapse would render the proceeds taxable as the decision to acquire and sell the asset constituted a change in intention. In terms of the facts of the case, the taxpayer company obtained an option to purchase two mining claims for £ 140,000. In terms of the option the company was entitled to erect plant and machinery for the purpose of prospecting and removing samples of minerals and of generally investigating the potential of the claims, but was not entitled to derive profit from such operations during the existence of the option. Initially the option was for a period of one year, but was later extended. During the subsistence of the initial option agreement the taxpayer conducted tests to determine the economic value of the claims as well as the value of other adjoining claims which it had pegged and spent about £ 100,000 in surveying, sinking shafts and erecting headgear. Upon running into financial difficulties, the taxpayer agreed to sell claims held to a new company in which the taxpayer had a fifty percent equity stake. A condition of the sale was that the taxpayer had to exercise its option so that the company formed could purchase all the claims. The taxpayer made a profit of £ 160,407 on the sale of the claims received by virtue of the exercising of the option. The Commissioner assessed this amount as taxable income, and the taxpayer appealed on the ground that the option was purchased with the intention of acquiring the claims which were to be held on capital account. The Court ruled against the taxpayer and the judge expressed the view that where an option is exercised for the admitted purpose of selling the subject matter thereof, then the assets have been acquired for purpose of resale and a liability for tax arises irrespective of the original purpose in acquiring the option. In delivering judgment Goldin J said the following (at 6):

> If, instead of taking up an option to acquire a capital asset an option is exercised for the purpose of selling the subject matter thereof, then it can be said that there has been a change of intention. In other words, the original intention for obtaining the option was incapable of fulfillment, and the choice before the option holder

> can be, as in this case, either to let the options lapse or to take them up for the purpose of selling the assets acquired. In my view, in such a situation, irrespective of the fact that the option was acquired for the purpose of obtaining a capital asset, when that ceases to be possible and the option is exercised in order to sell the property thus acquired, the option is then exercised and the property is then acquired as a scheme of profit making.

However, in *ITC 1427* 50 SATC 25 the decision in *SAM v COT* was found to be wanting. In this case the taxpayer was a farmer who had rented a farm for a period of five years and at the same time was granted an option to acquire the farm and its equipment or alternatively the shares of the company owning the farm together with the shareholders' claims against the company and the farm equipment. During the second year of the lease the farmer exercised the option to buy the farm on the back of an unsolicited offer substantially higher than the option price. His stated reason for exercising the option and selling the farm was that in his opinion the sale price was greatly in excess of the market value of the farm and as such he could not refuse the offer. At the buyer's request the shares in the company were taken up by the farmer and subsequently sold. The Commissioner assessed the sale proceeds as taxable income in the farmer's hands. On appeal, the Court held that the proceeds from the sale were on capital account due to the fact that when the taxpayer acquired the option his intention was to acquire and hold a capital asset and that such an intention remained unaltered. The Court also held that there was no evidence of a profit making scheme on the farmer's part in selling the farm.

2.4 Time of ascertainment of intention

Matla Coal Ltd v CIR 1987 (1) SA 108 (A), 48 SATC 223 reinforces the ruling in *ITC 1427* and is further authority for the fact that the correct time for the ascertainment of an option holder's original intention is the time when the option was acquired and not when the option is exercised. In this case the taxpayer had entered into an agreement to dispose of certain mining rights and received a substantial consideration for the purchase of those rights. The taxpayer, after the end of the year of assessment under review, entered into a novation of the original agreement, as a result of which what had been a payment for the disposal of the rights became a payment of the consideration due under a restraint agreement. The Court held that this payment had to be characterised for tax purposes either at the time of payment or, at the latest, at the end of the year of assessment. It held that the payment had been for the purchase of the mining rights and that they had been acquired and held as income producing capital assets. Corbett JA said the following (at 223):

> ... in determining the intention with which the coal rights were acquired by Matla, regard must be had, to the time when the prospecting contracts, containing the options were first entered into.

Thus, a taxpayer who acquires an option with the intention of securing an income producing asset and later exercises the option at a time when there is a profit to be made, can resist a Revenue attack on the basis that the time for ascertaining intention is the time when the option was initially acquired, not at the later date of exercising the option when he was reasonably certain that disposal would give rise to an attractive commercial profit. The aforementioned principle was also confirmed in *ITC 1208* 36 SATC 80.

2.5 The tax consequences of speculating, trading or investing with equity options

Based on the above it is therefore submitted that from the equity option holder's perspective, providing the original intention (and that there is no subsequent change in intention) of entering into a call option is to acquire the underlying share which is to be held as an investment, that is, on capital account, then any receipts or accruals from the option itself or from the disposal of the underlying share would be on capital account. Applying the same reasoning, the proceeds from any put option purchased for the purposes of securing a future selling price for the sale of a share held on capital account, as well as any proceeds from the option itself, would be of a capital nature. However, any receipts or accruals derived from the sale of equity options held as trading stock would be treated as revenue. Similarly, any receipts or accruals derived from the sale of equity options held with the intention of acquiring a share to be held as trading stock or for speculative purposes would constitute revenue. If such options were physically exercised the sale of the underlying share would also be on revenue account.

As highlighted in the introduction, the vast majority of retail investors utilise the warrants market when wishing to gain exposure to equity options. This is the case due to the small minimum capital outlay required to effect trades and the low cost structure. As stated above, in order for such taxpayers to hold their warrants on capital account they must have purchased the warrants in order to secure the purchase or sale of a share which in the case of a call warrant is to be held on capital account and with regard to a put warrant is currently held on capital account. It is submitted that this is not the case with the vast majority of participants in the warrant market. Warrants are marketed by the primary issuers (large financial institutions such as Deutsche Bank, JP Morgan, UBS Warburg, Investec Bank, Standard Bank and FirstRand) as effective trading instruments due to the inherent gearing and limited potential loss. Based on an examination by the writer in September 2003 of one of South Africa's largest stockbroker's account holders who regularly purchased warrants, the following was found:

- approximately eighty three percent of account holders examined sold their warrants prior to maturity;
- of the warrants held until maturity ninety six percent were cash settled (that is, the underlying share was not acquired);
- with regard to call warrants, those accounts which had direct equity investments and/or cash on the account as well as call warrants, the ratio of capital required to take up the underlying shares in terms of the warrant holding to direct equity and cash on the account was approximately 5:1; and

- with regard to put warrants, for those accounts which had direct equity investments and/or cash on the account as well as put warrants, there was approximately a seventy five percent occurrence of there being none of the underlying shares held. Furthermore, a number of the put warrants examined did not allow for physical settlement.

The above was based on the analysis of one hundred random accounts containing warrant positions and the account history was examined from the period 1 January 2001 to 31 July 2003.

The above seems to indicate that the vast majority of taxpayers utilising warrants are doing so for speculative or trading purposes and without the intention to purchase or sell the underlying share on the exercising of the warrant. If challenged by Revenue, and based on the results of the examination as set out above, it is submitted that Revenue would not find it difficult to prove that any receipts or accruals were of a revenue nature. It is further submitted that the potentially perilous tax position facing many warrant holders is due to a lack of understanding as to how the instruments function within the context of the income tax regime. This is furthermore aggravated by the majority of financial institutions marketing such warrants not including any information regarding the tax implications of holding warrants in their marketing material.

As alluded to above, the overwhelming majority of option writers or issuers are South Africa's largest financial institutions. It is clear that any option premiums received by such institutions would constitute revenue received in a scheme or business of profit making. However, it would appear that if an investor holding a share on capital account wrote a put option on such share then any premium received would also be on capital account. Authority for this is to be found in *ITC 321* 8 SATC 236 in which the taxpayer, a farm owner, entered into a contract with a third party in terms of which she granted the right to prospect for minerals and an option to purchase the mineral rights themselves. In consideration for the granting of such rights the taxpayer received certain sums of money which the Commissioner assessed as taxable income. The taxpayer appealed against the assessment and the Court accepted that the farms were held by the taxpayer as a capital asset on the basis that the farms were acquired a number of years previously by virtue of marriage and the taxpayer had never intended to make a profit on them other than by farming. In delivering judgment, the President of the Court said the following (at 243):

> In the present case, as far as the appellant is concerned, there never was any acquisition or any intention to make profit, and there is no question even of resale. The farms were acquired by virtue of marriage a quarter of a century before the prospecting and option contract was entered into, and without any view to turning them to account except as ordinary farms. The money for the rights granted was an accretion to capital, in that the farms were thought to be gold-bearing, or at least to warrant expenditure in determining whether they were gold-bearing, in which case the value of the property itself would be enhanced enormously. In another sense, the moneys obtained under the prospecting and option contract were a purely fortuitous acquisition, for we are told (and it is well known) that just at this time there was great prospecting activity in this district. In either event, the payment of the moneys under the contract was of a capital nature.

In *ITC 962* 24 SATC 651 the facts were that the appellant's wife, who was married to him in community of property, entered into a contract whereby an option was granted to a third party to purchase from her certain farms at a set price subject to the condition that the option should continue for a period of ten years with a sum of £ 4,000 being paid annually. The Court accepted the principle that any receipt or accrual by virtue of an option granted to purchase a capital asset would also be of a capital nature. The same principle was applied in *SIR v Struben Minerals (Pty) Ltd* (1966) 26 SATC 248 where the taxpayer company had entered into a contract with a mining and prospecting company in terms of which the latter was given the right for a five year period to prospect and search for minerals on a certain farm and at any time during that period to purchase all the rights to the minerals. The Court held that the proceeds received related to a sale of a capital asset and as such were also capital in nature.

Conversely, in *ITC 721* 17 SATC 485 the appellant company was the owner of certain immovable properties from which it derived income by way of rent. In consideration for the grant of an option to hire for an agreed rental one of the appellant company's properties if and when the tenant then in occupation of the property should vacate it, the appellant company received during the year of assessment under review an amount of £ 200. It was held that that the amount received from the option holder, having resulted from the productive use of the capital invested in the property concerned by the company in order to earn profits, and the sum having been acquired by the company in the way of its business, was an amount properly classified as income and not capital.

2.6 Conclusion

Based on the analysis thus far, it is submitted that when equity options are examined with regard to general South African tax principles and available case law, and insofar as an investment, speculative or trading intention is established, the following summary sets out the applicable tax treatment of such equity option contracts:

Option Holders

- where equity option contracts are held as trading stock, or for speculative purposes, with the intention of deriving a profit from their resale, then any receipts or accruals from the disposal of such options would constitute income;
- where a taxpayer holds call options for the purpose of acquiring a share to be held as trading stock or for speculative purposes, then any receipts or accruals from the disposal of such options as well as the underlying share would constitute income;

- where a taxpayer holds call options for the purpose of acquiring a share to be held as a capital asset, then any receipts or accruals from the disposal of such options as well as the underlying share would constitute capital;
- where a taxpayer holds put options for the purpose of disposing a share held as trading stock or for speculative purposes, then any receipts or accruals from the disposal of such options as well as the underlying share would constitute income; and
- where a taxpayer holds put options for the purpose of disposing a share which is held on capital account, then any receipts or accruals from the disposal of such options as well as the underlying share would constitute capital.

Option writers

- option premiums received by taxpayers who are in the business of writing options or who utilise options for trading or speculative purposes would be classified as income by virtue of the fact that they are clearly involved in a scheme of profit making;
- option premiums received with respect to put options issued by a taxpayer with regard to the sale of a share held on capital account would constitute capital; and
- option premiums received with respect to put options issued by a taxpayer with regard to the sale of a share held as trading stock would constitute income.

CHAPTER 3: HEDGING TRANSACTIONS

3.1 Introduction

It would appear from the discussion in chapter two, that general tax principles and relevant available case law are adequate enough when examining the tax treatment of equity options acquired for trading, speculative or investment purposes. A difficulty arises, however, when looking at the tax treatment of equity options utilised for hedging purposes. With current volatility in global and local equity markets a growing number of investors are turning to put options to hedge themselves against negative price movements in the equity market. An understanding of the tax treatment of such transactions is therefore essential. The complexities of the tax issues regarding hedging are mainly confined to cash settled put options as it has been shown that should a taxpayer on the exercising of a put option dispose of the underlying share (that is, physically settle the option) then the nature of the proceeds so received would be dependant on whether the share was held on capital or revenue account. In this regard the tax issue is no different to the disposal of any share and the abundance of case law in this regard together with the general principles of South African tax law provide established guidelines.

A cash settled put option entails the taxpayer electing to continue holding the underlying share over which the option is written and instead to receive settlement in cash. For example, assuming an investor holds share C, currently trading at say R 1 per share, and wishes to protect himself against any negative price movement. In order to do so, 'at the money' put options are purchased with a strike price of R 1 and an exercise date in one year. Assuming on the exercise date share C is trading at R 0.90 the option would clearly be 'in the money'. The option holder would have two choices, he could either sell the underlying share C for R 1 per share or he could elect to receive a cash amount equal to R 0.10 per share C. Should the taxpayer physically settle the option then the nature of the proceeds will be dependant on whether share C was held on capital or revenue account. What would be the correct tax treatment of the R 0.10 per share received, however, should the taxpayer elect for cash settlement and as such not dispose of share C? As stated earlier, it is interesting to note that certain put options traded in the warrants market do not allow physical settlement.

3.2 General principles

As a general principle, it has been suggested that hedging transactions, other than forward exchange contracts and foreign currency options which are dealt with in section 24I of the Act, should be treated along the lines of insurance contracts (Hutton: 1998, Byala: 1995). When the South African courts are confronted with the capital or revenue nature of an amount received or accrued in terms of an insurance policy the critical issue is whether such payment fills a hole in the taxpayer's profits or in the income producing structure. If the amount fills a hole in the profits the payment will generally be regarded as income and similarly if it fills a hole in the capital structure it would be capital in nature. This test was formulated in the English case of *Burmah Steamship Co Ltd v IRC*, 1931 SC, 16 TC 76.

In *ITC 594* 14 SATC 249, the taxpayer was an engineering company which carried on an engineering business and during the year of assessment, as a result of a fire, recovered an amount from an insurance company in respect of loss of profits in terms of a policy which covered the annual net profits received by the company. The Commissioner assessed the payment as revenue and raised income tax on the amount. On appeal by the taxpayer, the Court held that due to the fact that the payment was a substitute for the company's profits that such payment was correctly assessed as income. In delivering the judgment the President of the Court said the following (at 250):

> 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 been for the intervention of the

> occurrence insured against, then the amount so received in substitution is coloured by, so to speak, or assumes the character of the accrual for which it is substituted. Thus, where trading stocks covered by insurance are lost, the amount received under the insurance policy is to be identified in character of that of the trading stocks insured and lost. Such stocks being floating and not fixed capital, the insurance monies received in respect of their loss is not to be regarded as an accrual of a capital nature.

It was similarly held in *ITC 597* 14 SATC 264 that the proceeds from an insurance policy to replace trading stock which had been lost whilst in transit constituted a revenue receipt in the hands of the taxpayer. In passing his judgment the President of the Court stated the following (at 266):

> Both therefore under our law and under the English law and the Canadian law it seems clearly established that where the taxpayer recovers a sum of money under an insurance for loss of profits, the sum so recovered is an accrual or receipt of income, and is not excluded there from as being an accrual of a capital nature.

Conversely, in *ITC 942* 24 SATC 446, the appellant company took out an insurance policy on the lives of its directors which was payable to the company on the event of the death of the first dying of the directors. The stated purpose of the appellant company in taking out the policy was to provide a fund solely for the purpose of paying out the loan account of the deceased director. The Commissioner included the payment in terms of the policy in the taxable income of the appellant company. The taxpayer lodged an objection on the basis that the payment represented a capital accrual as the death of a director was never envisaged to cause the company to suffer loss nor make a profit therefrom and as such the proceeds from the policy were never intended to compensate the company for lost profit. In delivering judgment in favour of the appellant, Kuper J said the following (at 445):

> But in the instant case the policy was not taken out to maintain its profits for it would suffer no loss on the death of a director but to preserve the income-making machine, for if on the death of a director a large sum was standing to his credit on a loan account any attempt to compel payment of such a sum might lead to the liquidation of the company. This was the eventuality the directors wished to guard against.

As mentioned, it has been suggested that any receipts or accruals arising from derivative transactions utilised for equity hedging purposes should be treated along the same lines. Following this reasoning therefore, any equity option hedging strategy utilised to protect the value of an underlying share which represents a capital asset should also be on capital account whilst the hedging of a share held as trading stock would however give rise to a revenue receipt. Support of this supposition within the context of forward contracts on foreign currency can be found in *ITC 1498*, 53 SATC 26. In this case, the appellant company carried on the business of proprietor, printer, publisher and distributor of newspapers and miscellaneous periodicals. In order to fund the purchase of a new printing press, the company obtained a US Dollar loan from its bank. In order to hedge its Rand liability arising in terms of the loan, the company entered into a series of forward exchange contracts based on the Rand/USD exchange rate. The effect of the transaction was to neutralise the impact of currency movement on the US Dollar denominated loan. During the period of the loan the Rand depreciated against the US Dollar resulting in an increased Rand cost in terms of the outstanding loan amount. However such losses were offset (that is, hedged) by gains made in terms of the forward exchange contracts. Whilst the losses were allowed as deductions in terms of what was then section 24B(1) of the Act, the Commissioner sought to tax the gains made in terms of the forward contracts as income. The appellant company admitted that due to exchange rate fluctuations there may well be a profit made on the forward exchange contracts but it stated that it was not its purpose and at all times it acted on the advice of its bankers. The company therefore contended that the gains made were fortuitous. Ruling in favour of the taxpayer, Jennet J said the following (at 265):

> It can be accepted that in acquiring the press the appellant acquired a capital asset ... and the loan or money spent in acquiring the printing press must also be capital expenditure ... We are not dealing with a taxpayer trafficking in exchange and there is no reason why the foreign exchange contracts which relate to the repayment of the loan for the purpose of acquiring the printing press should not assume the character of their originating cause, namely the capital expenditure ... This conclusion is dependent on the intention of the appellant with regard to the foreign exchange contracts ... We are satisfied in the present cases that the gains by the appellant on the forward exchange contracts entered into by it, are gains of a capital nature.

Further support to the above decision is to be found in the unreported case of *Caxton Limited* (8386) heard in the Transvaal Income Tax Special Court in August 1988 in which the Court ruled that a loss with regard to forward exchange contracts utilised to hedge the foreign currency purchase price of a printing press were losses of a capital nature. Like in *ITC 1498* this was based on the fact that the press was deemed to be held on capital account. Conversely, in *ITC 340* 8 SATC 362, the taxpayer carried on a business of trading certain imported goods from London for which he paid in sterling. Due to currency fluctuations, he entered into a forward exchange contract with his bank in order to hedge his exposure. He treated any 'profit' arising from such forward contracts as capital and during the year of assessment in question this amount was substantial. The Secretary for Inland Revenue assessed these profits as taxable income and the taxpayer appealed on the basis that he contended that he was not speculating in foreign currency. The Court accepted the taxpayer's contention but ruled that the profits from the forward contracts were revenue in nature as they formed an integral part of the taxpayer's business and were utilised to hedge the revenue cost of the taxpayer's trading stock. It should be noted that all the abovementioned cases were dealt with prior to the introduction of section 24I of the Act.

3.3 Other considerations

It is very tempting, based on the above, to immediately draw the conclusion that cash settled put options when utilised for hedging purposes should be treated on the same basis as payments in terms of contracts of insurance. In other words, where an equity option is acquired to hedge a share held on capital account then any accrual or receipt derived from the option would be on capital account and where trading stock is hedged then any receipt or accrual would be revenue in nature. It is submitted that this would be an oversimplification of the situation as it pertains to options and the hedging of equity investments in general. With the tax treatment of receipts or accruals in terms of insurance contracts there is inevitably a direct offset of the insurance proceeds with a corresponding actual loss with regard to the insured asset. Cash settled put options do not entail the sale of the underlying share and as such can it be said that a taxpayer has suffered an actual economic loss as opposed to a notional loss when the underlying share has not been sold?

In the case of insurance the test to determine whether the payment is revenue or capital is to determine whether such payment fills a hole in the capital structure or the profits of a taxpayer. Assume that share D, held on capital account, is hedged by the purchasing of a one year 'at the money' put option. On the strike date share D has dropped twenty percent in value and the put option is exercised and cash settled. The taxpayer would have realised a profit of twenty percent but could it be said that the taxpayer has experienced an offsetting loss of twenty percent when share D has not been sold? Will the twenty percent cash profit have filled a hole in the taxpayer's capital or income producing structure? It is submitted that until such time as a share is actually sold, the taxpayer would not have suffered an actual economic loss but rather a notional loss would have been incurred. The South African taxing acts 'are not concerned with notional income or expenditure' (*Meyerowitz*, 2003: 11.41), and as such notional profits or losses as a result of an equity option transaction have no tax implications.

It may be argued that even where equity hedging is utilised and a profit has been derived from such hedging, that such profit indeed fills a hole in the capital structure of the taxpayer regardless of the fact that the underlying share has not been sold. This would be based on the premise that the share would have dropped in value and therefore its income producing capacity would have been compromised. It is submitted, however, that the fall in value of a share does not necessarily entail a corresponding decrease of income in the form of dividends. Annexure A represents the actual dividend distributions during the three year period ending 4 January 2003 together with the absolute price movement of the All Share 40 Index which is a broad market benchmark for the JSE and consists of the top forty blue chip shares weighted in terms of market capitalisation. From the graph it can be ascertained that the performance of the index (on an annual compounded basis) has been a positive 5.97 percent per annum over the period whilst actual dividend distributions have increased by 14.73 percent per annum. The actual dividend distribution is not to be confused with the dividend yield which is a factor of the actual dividend relative to the share price. As share prices drop, and assuming a constant dividend distribution, the dividend yield will increase. Annexure B looks at the same situation for the two year period ending 4 January 2004 and it can be ascertained from the graph that while the index has depreciated in value on an annual compounded basis by -5.13 percent per annum, actual dividend distributions have increased by 4.88 percent per annum. Over the year period ending 4 January 2004 as demonstrated in Annexure C, actual dividends distributed have decreased by -4.2 percent whilst the value of the index has increased by 8.13 percent. On calculating the correlation between the decrease or increase in dividends and the decrease or increase in value of share prices as represented by the All Share 40 Index, and bearing in mind that a perfect positive correlation is represented by a value of 1 and a perfect negative correlation by a value of -1, the following is evident; over three years the correlation is 0.15, over two years is equal to -0.32 and the correlation over one year is -0.21. There is therefore no mathematically significant correlation between the increase or decrease in the value of share prices and the increase or decrease in actual dividends distributed over the periods reviewed, and in fact over the one and two year period, negative correlations were observed.

Based on the above, it is therefore clear that the fluctuation in share prices does not necessarily imply a direct correlation with actual dividend income generated. This would especially apply to a bear market situation where general market sentiment rather than company specific factors can affect a share price negatively. In fact, it is submitted that during bear markets where share prices are under severe pressure, many companies actually increase their dividend payments in order to attract investors who are wary of adverse market conditions and rely on high dividend yields as a cushion against negative price movements. It would be fair to say, however, that where a company's share price is severely affected by company specific factors (such as severe losses, fraud, bad management etc.), this would impact on its ability to generate increasing dividends and in such a case the drop in value of the share would entail a diminution of income producing capability. Regardless of the aforementioned, as a general statement it does not always follow that lower share prices or values imply lower dividends and in fact, as shown, there can actually be a negative correlation between the two. Therefore, it is submitted that although the analysis of cash settled put options utilised for hedging with reference to the treatment of insurance payments is useful, it is by no means conclusive.

3.4 The analogy of Krugerrands

A very useful and interesting analysis is to look at the treatment of the proceeds from a sale of Krugerrands. Like option contracts, when dealing with Krugerrands one is not dealing with an asset which has an income producing capacity. However, like option contracts, Krugerrands are often bought as a hedge (against inflation and political and economic uncertainty). The first reported case regarding Krugerrands was *ITC 1355* 44 SATC 132 in which the taxpayer had acquired Krugerrands due to his mistrust of paper currency and due to the perceived advantage of holding gold in times of distress. Due to family requirements the taxpayer was compelled to sell a portion of the coins held. The Court held that he had acquired the Krugerrands as an investment of a capital nature and had not changed his intention. In *ITC 1379* 45 SATC 236, the taxpayer acquired coins to protect himself against political uncertainty. He was of the belief that Krugerrands were ideal for this purpose as gold was traditionally a good store of wealth and they were easily transportable. He purchased the coins over a long period and sold his entire holding in a single day after reading newspaper reports stating that the price of gold was too high. The Court accepted the taxpayer's contention that he purchased the coins as a capital asset. The same conclusion was reached in *CIR v Nel* 59 SATC 349, where the taxpayer had purchased Krugerrands with the intention to hold them as a hedge against inflation. After a period of eleven years, during which time the coins had appreciated significantly in value, the taxpayer sold the coins in order to raise funds for a motor vehicle which he urgently needed to purchase for his wife. The Court held that the coins were held on capital account and as such the profit on the sale was not subject to income tax.

In *ITC 1543* 54 SATC 446, the taxpayer was an investment holding company whose assets were mainly listed shares, Krugerrands and certain loans. The shares of the taxpayer were held by a trust, the beneficiaries of which were the children of A, the founder of the taxpayer. The majority of the Krugerrands (approximately two hundred) were bought between 1975 and 1977 and a few in 1978. During 1987 and 1988 about one hundred of the coins were sold and the Commissioner assessed such sale proceeds as income. The taxpayer appealed on the basis that the reason for acquiring the Krugerrands was in order to hedge itself against inflation. At the time the coins were bought the taxpayer needed no income from the capital invested in the coins. It was stated that the sale of the coins in the 1987 tax year was to obtain money to re-roof the house in which A lived. The coins sold in the 1988 tax year were sold because they were not yielding income and as the gold price was coming down, it was decided to put money into shares where there was income. The Court allowed the appeal on the basis that the taxpayer had acquired the coins as a capital asset and that there was no change of intention at the time of sale.

In all the above cases where the Court ruled in favour of the taxpayer, the Courts examined the taxpayers *ipse dixit* and applied the general established principles when testing such *ipse dixit*, in particular the intention with which the coins were acquired and the reasons for the sale. In *ITC 1543* Fagan J said the following (at 449):

> There is no reason, in principle, why the disposal of Krugerrands should not be subjected to the same tests applying to other assets in their classification as being either of an income or of a capital nature.

By contrast, in *ITC 1525* (1991) 54 SATC 209 the Court ruled that the disposal of Krugerrands by the taxpayer constituted revenue. In the case, the taxpayer had invested his surplus funds in Krugerrands on the advice of his accountant and the coins represented his savings. After not being able to obtain traditional finance in order to inject working capital into his business, the taxpayer sold his coins in order to provide funding. In delivering judgment, Howie J said the following (at 203):

> We have to bear in mind that what he accumulated in this regard and what he realised in 1986 for purposes of working capital, were not paintings or jewelry or carpets or vehicles or shares, all of which have either an income producing capacity or ... an economic utility. Obviously a coin does not produce an income while you hold it and, unless worked, for example, into jewelry, it does not have an economic utility other than, of course, the utility that it can simply be sold when cash is needed.

The Court came to the conclusion that due to the fact that the taxpayer utilised Krugerrands as a savings mechanism, he must have envisaged making a profit.

In *ITC 1526* 54 SATC 216, the taxpayer was an investment company which after receiving a large amount of cash had acquired its entire Krugerrand holding in one transaction. Its stated intention for acquiring the coins was as a storage of wealth for its controller's children and to provide a hedge against inflation. When the taxpayer needed to fund new ventures, reduce debt and purchase property the Krugerrands were sold in order to provide funding. The taxpayer's contention that the coins were acquired with a degree of permanency was refuted and the Court ruled that the dominant intention of the taxpayer was linked to the inherent capacity of Krugerrands to increase in value and to take advantage of such increase.

Therefore in both *ITC 1525* and *ITC 1526*, the taxpayers could not discharge their onus of convincing the Court that the coins were acquired with a capital intention and not for the purpose of resale at a profit. What is furthermore clear is that where the taxpayers have managed to convince the Court that their main or dominant intention of acquiring Krugerrands was in order to hedge against inflation or economic or political uncertainty that the proceeds of any sales were accepted as being on capital account.

3.5 Hedging transactions and shares

Like cash settled put options, Krugerrands utilised for hedging against inflation would by their nature be akin to a hedge against notional losses. In the case of an inflation hedge, the intention is to hedge against a nominal drop in value of an asset, or assets, caused by an increase in inflation. With regard to Krugerrands, and especially before the 1980's, as the price of gold was highly correlated to the inflation rate, the holding of Krugerrands was regarded as an effective inflation hedge. With regard to equities, what exactly would constitute a hedging transaction? The South African courts have never had to deal with this situation as it applies to the hedging of an equity portfolio and unfortunately the South African Revenue authorities have not issued guidelines in this regard. In Australia and the United Kingdom, the respective Revenue authorities have issued guidelines with regard to the tax treatment of derivatives utilised in hedging transactions. In Australia, the tax authorities in 'Tax Ruling IT 2228 – The Taxation of Futures', state the following regarding hedging:

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

What is important about the above is that in Australia a requirement for a transaction being classified as a hedging transaction would be the subsequent sale of the goods being hedged. With regard to hedging equities this would entail an actual sale of the underlying share. The outcome of the transaction is therefore a decisive factor in classifying a transaction as a hedging transaction. However, it must be borne in mind that it appears as if the ruling was issued with mainly the treatment of commodity futures in mind. What is furthermore important, however, is that in terms of the Australian treatment of futures and options, the fact that a transaction is not classified as a hedging transaction in terms of IT 2228, does not necessarily mean that any receipts or accruals from such transactions will be of a revenue nature. This is due to the fact that in terms of Australian legislation a speculative transaction may well escape income tax if the taxpayer was not deemed to be carrying on a trade (this is not the case in South Africa where, as already highlighted, once off isolated transactions may well give rise to receipts or accruals of an income nature).

In the United Kingdom in terms of Statement of Practice SP 3/02 - 'Tax Treatment of Transactions in Financial Futures and Options', it is stated that in order to be classified as a hedging transaction there must be 'the intention to eliminate or reduce risk' and as such 'the financial futures or options transaction must be economically appropriate to the elimination or reduction of risk.' In terms of SP 3/02, in determining whether a transaction is 'economically appropriate' the transaction must be one which, by virtue of the relationship between fluctuations in its price and any fluctuations in the value of the underlying asset or liability may reasonably be expected to be appropriate to be used to eliminate or reduce risk. Unlike the Australian tax treatment of hedging, in the United Kingdom a derivatives transaction could still fall within the ambit of a hedging transaction even if the underlying asset was not subsequently sold on the termination of the hedging position.

As stated above, in South Africa the tax authorities have not issued any guidelines regarding equity derivatives in general and there are therefore no guidelines in terms of what would constitute an equity hedging transaction. What is of use to note is the definition of a hedging transaction for accounting purposes as set out by the South African Institute of Chartered Accountants in the Statement of Generally Accepted Accounting Practice AC 133:

> .143 Under this statement, a hedging relationship qualifies for special hedge accounting if, and only if, all of the following conditions are met:
>
> a) At the inception of the hedge there is formal documentation of the hedging relationship and the enterprise's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the enterprise will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or the hedged transaction's cash flows that is attributable to the hedged risk.
> b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the

originally documented risk management strategy for that particular hedging relationship.

c) For cash flow hedges, a forecasted transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect reported net profit or loss.

d) The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item and the fair value of the hedging instrument can be reliably measured.

The statement says the following about the assessment of hedge effectiveness.

> .147 A hedge is normally regarded as highly effective if, at inception and throughout the life of the hedge, the enterprise can expect changes in the fair value or cash flows of the hedged item to be almost fully offset by the changes in the fair value or cash flows of the hedging instrument, and actual results are within a range of 80% to 125%. For example, if the loss on the hedging instrument is 120 and the gain on the cash instrument is 100, offset can be measured by 120/100, which is 120 per cent, or by 100/120, which is 83%. The enterprise will conclude that the hedge is highly effective.

3.6 Hedging and the taxpayer's intention

It is submitted therefore that with regard to cash settled put options, the critical issue is whether the option was in fact entered into for hedging purposes. The issue of onus, as prescribed in section 82 of the Act, is of critical importance and as can be seen clearly from the cases dealing with Krugerrands where the taxpayers were able to convince the Court of a hedging intention the relevant proceeds were classified as capital. In discharging the onus of proving that the intention with which a particular put option was acquired was for hedging purposes, the Courts would not regard the taxpayer's *ipse dixit* as decisive (as in *ITC 1185*, 35 SATC 122) but would examine all relative facts and circumstances. With regard to cash settled put options, it is submitted that the following would be important factors the Court would consider:

- *Correlation between the put option and the underlying share being hedged:* It is submitted that the Courts would utilise, but not wholly rely on, the guidelines as set out in AC 133 to determine whether in fact an effective hedge existed. This would be the case especially if the taxpayer was a company and as such bound by the disclosure requirements of AC 133. The critical issue for any taxpayer would be whether the value of the put option was sufficiently negatively correlated with the value of the share being hedged. In this regard should a taxpayer wish to hedge an exposure to a particular share, it would be easier for a taxpayer to contend a hedging transaction if the option was on the share itself and not the index or sector in which the share was traded. Another important factor would be the issue of value. If an investor wished to hedge an equity position in the amount of say one million Rand and purchased put options with a notional value of two million Rand then the taxpayer would have difficulty in arguing a hedging intention. It is furthermore submitted that should a taxpayer own a share in one entity, and undertake a hedge in another entity, that although inversely correlated, the transaction would not strictly constitute a hedging transaction.

- *Reinvestment of cash settlement:* It is submitted that where a taxpayer reinvests the cash settlement in the underlying share that the Court would look favourably on this as it would represent a bolstering of the capital or income producing structure of the taxpayer (that is, the underlying share) should the drop in value also have resulted in a reduction in the share's ability to pay dividends. A 'roll over' of the hedge would also be viewed in a favourable light.

- *Frequency:* A taxpayer who undertakes transactions in cash settled put options on a systematic and regular basis may well be deemed to be involved in a scheme of profit making with the proceeds being classified as revenue.

3.7 Conclusion

Taking the above objective factors into account, should the Courts accept the taxpayer's stated intention that a cash settled put option was purchased for hedging purposes and are satisfied that an effective hedge was in existence then it is submitted that the nature of the proceeds would be dependant on the nature of the underlying share. Where a share held on capital account was being hedged then the cash settlement would be capital, whereas the cash settlement would be revenue if a share held for trading or speculative purposes was being hedged. It must be borne in mind that with a true hedging intention, although the taxpayer may very well contemplate a profit from the option itself, the hedge would be equally effective should the option position realise a loss due to the negative correlation with the value of the share being hedged. In this regard, contemplation must not be confused with intention in the sense that profit contemplated and in fact realised is in a sense fortuitous and not sought or worked for (see *CIR v Pick 'n Pay Employees Share Purchase Trust*, 1992 (4) SA 39 (A), 54 SATC 271), and as such, contemplation does not taint the capital nature of a receipt or accrual.

In the absence of either a hedging intention or an intention to acquire or sell the underlying share could it ever be said that an option contract in itself could be held on capital account as an investment? In the past it may well have been contended that investors with a relatively small amount of capital would only be able to reduce their company specific risk by investing in options which due to the small amount of upfront capital required would enable such an investor to gain exposure to a spread of shares. However, with the sophistication inherent in today's equity markets, it is possible to gain broad equity market exposure with a minimal amount of capital due to the introduction of index tracking listed securities which are easily traded on the JSE (such as the Satrix 40, FINI 15 and INDI 25). Furthermore, unlike a Krugerrand which can be held by a taxpayer 'for keeps', an equity option has a determinable settlement date. It is therefore submitted that an equity option in its own right could never be held as a capital asset in the absence of a hedging intention or an intention to acquire or sell the underlying share. Without the aforementioned intention it follows that the only benefit attributable to the holding of an equity option would be the ability to generate a profit from its sale or settlement on the exercise date and as such the option would always be held on revenue account.

The research thus far has established a framework to assist in the classification as either revenue or capital any receipt or accrual arising from an equity option transaction. The actual tax treatment of revenue and capital receipts arising from equity option transactions is dealt with in Chapter 4 and 5.

CHAPTER 4: THE TAX TREATMENT OF REVENUE RECEIPTS AND ACCRUALS ARISING FROM EQUITY OPTION CONTRACTS

4.1 Introduction

Receipts and accruals (that is amounts received in cash or in kind and amounts to which a person has an unconditional right) are included in taxable income and subject to normal tax if they comply with the provisions of the definition of 'gross income' as contained in section 1 of the Act. From an income tax perspective, expenditure and losses incurred in generating gross income is allowed as a deduction when calculating a taxpayer's ultimate liability for tax. The determination of such deductible amount is governed by the general deduction formula which consists of both section 11(a) of the Act and section 23(g) of the Act.

4.2 The general deduction formula

4.2.1 Section wording

The preamble to section 11 which is of vital importance and section 11(a) reads as follows:

> 11. For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived - ...
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

Section 23(g) of the Act states the following:

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

4.2.2 The trade requirement

It is clear from the preamble to section 11 of the Act that in order for a taxpayer to deduct an amount in terms of the general deduction formula, such taxpayer must be carrying on a 'trade'. The term 'trade' is defined in section 1 as follows:

> 'trade' includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent ... or any design ... or any trade mark ... or any copyright ... or any other property which is of a similar nature.

It is clear from the definition that the term 'trade' covers a wide spectrum of activities but there are certain activities, such as passive investing, which fall outside this definition. As such, financial institutions in the business of issuing equity options in return for premium income and those taxpayers who hold equity options as trading stock (that is, on revenue account) would be carrying on a trade as contemplated in the definition. Although any receipts and accruals earned by a taxpayer in a once off, or isolated, speculative transaction would be classified as gross income, it is worthwhile contemplating whether such a once off transaction could be classified as a 'trade' for the purposes of the definition. The definition of 'trade' includes a 'venture'. In *ITC 368* (1936) 9 SATC 211 the word 'venture' was held to refer to a transaction in which something is risked with the object of making a profit, in other words a financial or commercial speculation.

As such, it would appear that a once off speculative transaction would fall within the definition of trade.

4.2.3 Not of a capital nature

In terms of section 11(a) only expenditure which is not of a capital nature will be allowed as a deduction for income tax purposes. There is no definition of the expression 'of a capital nature' contained in the Act and as such one has to analyse available common law in order to obtain guidance. In this regard, the primary test applied by the South African Courts when deciding on whether expenditure or a loss is of a capital or revenue nature is to ask whether such expenditure or loss should be properly regarded as part of the cost of performing the taxpayer's income generating operations (revenue expenditure) or whether it is more properly regarded as part of the cost of acquiring, enhancing or adding to the taxpayers income earning structure (capital expenditure). In *New State Areas Ltd v CIR* 1946 AD 610 (at 620), Watermeyer CJ stated the following regarding the aforementioned test:

> The problem which arises when deductions are claimed is therefore usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery ...
>
> The conclusion to be drawn from all the cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is the important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure, even it is paid in annual installments; if on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-

> producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure even if it is paid in a lump sum.

Similarly, in *George Forest Timber Co Ltd,* 1924 AD 516, Innes CJ formulated the test as follows:

> Now, money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield a future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit and money spent in working it. The one is capital expenditure, the other is not. The reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profits.

In applying this test to ascertain the capital or revenue nature of expenditure or losses incurred by a taxpayer in respect of an equity option transaction, the Court would have regard to the purpose for which the expenditure in question was incurred which will ultimately depend on the taxpayer's purpose of entering into the transaction in question. Utilising the established framework it is possible to ascertain whether such purpose was a revenue or capital purpose. Once such classification has taken place, any expenditure or losses incurred with regard to an equity option contract held on revenue account will automatically be classified as revenue expenditure and *prima facie* qualify as a deduction in terms of section 11(a). As such, an in-depth analysis of the capital or revenue nature of expenditure is not necessary as it is the taxpayer's purpose of entering into the equity option contract which is of critical importance when classifying expenditure as revenue or capital, and such purpose can be ascertained utilising the comprehensive framework established in this thesis.

4.3 Section 24L – timing of recognition of income and expenditure

Section 24L was introduced into the Act in 1999 and specifically deals with the timing of the recognition of option premiums. The wording of the section in full is attached to this thesis as Annexure D.

An 'option contract' for the purposes of section 24L excludes a foreign currency option contract as defined in section 24I of the Act but otherwise includes any contract to buy or sell a certain quantity of tangible or intangible things before or on a future date at a prearranged price, or to pay or deliver money before or on a future date, depending on whether the prearranged value or price of an asset, index, currency, rate of interest or any other factor is higher or lower before or on that future date, than a prearranged value or price. An equity option contract would therefore clearly fall within the ambit of an 'option contract' as envisaged by section 24L.

Any premium or other consideration paid in terms of or on acquisition of an equity option is therefore deemed to have been expended or incurred on a day-to-day basis over the term of the contract, except where there is an early exercise, termination or disposal. In that event, the as yet unincurred portion of the option premium will be brought to account on the date of exercise, termination or disposal. Conversely, the recipient of the option premium brings the amount concerned to account on the same basis. Where the option premium includes an amount which represents the intrinsic value of an equity option (that is, the difference between the market value of the underlying share on the day the equity option is acquired and the 'strike price' which is to be paid by the option holder for the acquisition or disposal of the share on the exercise of the option) that intrinsic value is deemed to be incurred on the date of the exercise, termination or disposal of the option contract.

Section 24L does not deem the amount accrued (or incurred) to be either 'gross income' or deductible expenditure, as the case may be, so it is necessary in the first instance to determine whether the option concerned is a revenue item in the hands of the purchaser, seller or issuer. However, it is expressly stated that the section does not apply where an option contract is held or acquired as trading stock. The impact of this exclusion would seem to be that the section effectively applies only to issuers or writers of options, since acquirers or holders of options who do not hold such options as trading stock would logically hold the options for capital purposes. This would render the timing of accrual or incurral irrelevant for income tax purposes, as the income or the expenditure related to these options would not be included in gross income or deducted from income tax.

4.4 Equity options held as trading stock

4.4.1 Introduction

The term 'trading stock' is widely defined in section 1 of the Act to include:

> Anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, sale or exchange by him or on his behalf, or the proceeds from the disposal of which forms part or will form part of his gross income, or any other consumable stores and spare parts but does not include a foreign currency option contract and a forward exchange contract as defined in section 24I.

4.4.2 The workings of section 22

In terms of section 22 of the Act, taxpayers who hold assets as trading stock must include the value of trading stock held and not disposed of at the beginning of a tax year (that is, opening stock) and at the end of that year (that is, closing stock) when determining taxable income. In other words, the value of the taxpayer's opening stock and closing stock are compared and the excess of the closing stock value over the opening stock value or the opening stock value over the closing stock value is included in or deducted from the taxpayer's taxable income, as the case may be.

In terms of section 22(2) of the Act, the amount which must be taken into account in respect of the value of opening stock which formed part of the taxpayer's closing stock in the preceding year of assessment is the amount which was taken into account in determining the taxpayer's taxable income for that year, and in the case of opening stock which did not form part of the taxpayer's closing stock at the end of the previous year, the cost price of such trading stock to the taxpayer. In terms of section 22(1)(a) of the Act, the amount which must be taken into account in respect of the value of closing stock, other than closing stock consisting of any instrument as contemplated in section 24J(9), is the cost price of such trading stock to the taxpayer,

> less such amount as the Commissioner may think is just and reasonable as representing the amount by which the value of such trading stock, not being shares held by any company in any other company, has been diminished by reason of damage, deterioration, change in fashion, decrease in market value or for any other reason satisfactory to the Commissioner.

It can be seen from the above, that the value of closing stock can never be brought into account at a higher value than its cost price even if the market value is higher. This ensures that taxpayers are not taxed on any unrealised profits. The write down of closing stock (other than to the extent that closing stock consists of shares held by a company) will enable the taxpayer to claim a deduction to the extent that the value of closing stock at year-end is lower than its cost price.

The word 'share' is not defined in the Act and therefore it must bear its ordinary meaning applying the rules of statutory interpretation. As such, it is clear that that the word 'share' would not include an equity option even though such an option is to purchase or sell an underlying share. The effect of section 22(1)(a) is therefore to allow any person holding equity options, including a corporate entity, a deduction in respect of unrealised losses on options held by it as trading stock at year-end where the market value of such options has fallen below their opening stock value (which is either their original cost to the taxpayer or their original cost less any decrease in market value as at the end of the previous year). As this loss has not been actually incurred by the taxpayer, it would not be an allowable deduction in terms of section 11(a) of the Act, however the workings of section 22 allow the taxpayer a deduction for the amount which the value of the option at year-end is less than its original cost or opening stock value.

As previously stated, there is no provision in section 22 requiring any increase in the market value of an equity option held as trading stock at year-end to the extent that such market value is in excess of the original cost to be taken into account. Such equity option would be valued at its original cost and the unrealised appreciation in its market value would not be recognised for income tax purposes. The application of section 22 to equity options held as trading stock therefore allows the taxpayer the advantage of deferring any unrealised profits and deducting any unrealised losses on such options for income tax purposes.

4.4.3 Valuation of equity options held as trading stock at year-end

In terms of section 82 of the Act, the taxpayer bears the onus of establishing any diminution in the market value of an option to the Commissioner's satisfaction. Where the option is traded on a recognised exchange (for instance Safex or the warrant market) or where a sufficiently active market for the equity option exists, this diminution should be calculated with reference to the publicly quoted market value of the option in question at year-end. By contrast, the market value of equity options not publicly quoted (for instance tailor made options issued by a financial institution) will have to be established in accordance with one of the more commonly used option valuation models, such as the Black and Scholes model, the Binomial model or the Cox Ross model, or alternatively in terms of any generally accepted accounting practice approved by the Commissioner. In light of the finding of the Court in *ITC 1489* 53 SATC 99 that the Act by implication requires the taxpayer to disclose the basis on which trading stock has been written down, the taxpayer's return should clearly indicate the model used for the valuation (Byala: 1994)

4.5 Conclusion

Utilising the prescribed framework as set out in this thesis, where it is determined that a taxpayer has entered into an equity option transaction on revenue account, all receipts and accruals from such an equity option contract would constitute 'gross income' as defined in the Act and taxable as such. Any expenditure or losses incurred attendant on an equity option contract acquired or held on revenue account would be revenue expenditure and would qualify for a deduction in terms of section 11(a) of the Act. The taxpayer's ultimate liability for income tax would therefore be the amount of the receipt or accrual less such deductible expenditure or losses as determined in terms of section 11(a) of the Act. Taxpayers who hold equity options as trading stock will further be subject to the provisions of section 22 of the Act which in certain circumstances will allow an income tax deduction to the extent that equity options held as trading stock at year-end have diminished in value relative to the cost price of the equity options (or its opening stock value).

CHAPTER 5: THE TAXATION OF CAPITAL RECEIPTS AND ACCRUALS ARISING FROM EQUITY OPTION CONTRACTS

5.1 Introduction

Capital Gains Tax ('CGT') was introduced in South Africa on 1 October 2001 and is dealt with in the Eighth Schedule of the Act. There is no definition in the legislation of what constitutes a capital gain. Instead, in terms of paragraph 35(3)(a) of the Eighth Schedule, the proceeds of any transaction which must be brought into account for normal income tax purposes, are excluded from the calculation of a capital gain. Therefore, in determining whether the disposal of a particular asset is subject to CGT, it is first necessary to decide on the basic principles of taxation whether the disposal is on revenue or capital account. This determination can be made utilising the framework as formulated in this thesis.

Broadly speaking, a capital gain is calculated by determining to what extent the proceeds of the disposal of a capital asset exceed the 'base cost' of such asset. The 'base cost' of an asset is in essence the cost of its acquisition and any improvements thereto and is dealt with in paragraph 20(1) of the Eighth Schedule. Once a capital gain has been computed, in terms of section 26A of the Act, a portion of that gain (dependant on the legal *persona* of the taxpayer concerned) is included in the taxable income of the taxpayer for the year of assessment in which the gain is realised. Accordingly, a capital gain which is brought to account is actually subject to income tax and the colloquial term 'capital gains tax' is therefore something of a misnomer.

5.2 Disposal of equity options held on capital account

5.2.1 Disposal of equity options other than by way of exercise

In terms of paragraph 20(1)(a) of the Eighth Schedule, the base cost of an asset held on capital account is the actual expenditure incurred in respect of the cost of acquisition or creation of the asset. As such, in calculating a capital gain by virtue of the disposal of an equity option held on capital account, its actual cost will be taken into account and to the extent that the proceeds so received from the disposal of the equity option exceed the base cost the taxpayer will have a CGT liability.

With regard to the term 'disposal', paragraph 11(1) of the Eighth Schedule states the following:

> 11(1) ... a disposal is any act, forbearance or operation of law which results in the creation, variation or transfer or extinction of an asset, and includes -
>
> (a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;
>
> (b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset; ...

It is clear from the above that a 'disposal' for CGT purposes would not only apply to the sale of an equity option prior to the expiry date of such option, but would also include the actual expiry of the option on the expiry date. When an option expires there will be no proceeds and a capital loss will arise. Paragraph 18 of the Eighth Schedule deals with a situation where a person who is entitled to exercise an option to acquire an asset to be held on capital account or to dispose of an asset held on capital account allows the option to expire or disposes of it in any manner other than by exercising it. As a general rule, any capital loss as a result of the non-exercising of an option must be disregarded for CGT purposes. However, this general rule is subject to paragraph

18(2) of the Eighth Schedule which renders the general rule contained in paragraph 18(1) not applicable to any option to acquire or dispose of:

- a coin made mainly from gold or platinum;
- immovable property, except property to be acquired as a primary residence;
- a financial instrument; or
- a right or interest in any of the above.

'Financial instrument' is defined as follows in section 1 of the Act as follows;

> 'financial instrument' includes -
>
> (a) a loan, advance, debt, stock, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;
>
> (b) any repurchase or resale agreement, forward purchase arrangement, forward sale arrangement, futures contract, option contract or swap contract;
>
> (c) any other contractual right or obligation which derives its value from the value of a debt security, equity, commodity, rate index or a specified index;
>
> (d) any interest-bearing arrangement; and
>
> (e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset ...

It is therefore clear from the definition that a share would fall squarely into the definition of 'financial instrument' and as such the loss limitation rules of paragraph 18 of the Eighth Schedule would not apply to equity options. As such, where the disposal of an equity option contract (other than by way of exercise) gives rise to a capital loss, such capital loss will be allowed as a deduction to be offset against additional capital gains a taxpayer may have.

5.2.2 Disposal of equity options by way of exercise

In terms of paragraph 58 of the Eighth Schedule of the Act, a taxpayer must disregard a capital gain or loss determined with regard to the exercising of an option which results in the taxpayer either taking delivery of or disposing of the underlying asset. With regard to the acquisition of a share by way of an equity option, once exercised and the underlying share acquired, the option will effectively terminate and a capital loss will arise. This capital loss must be disregarded for CGT purposes in terms of paragraph 58 of the Eighth Schedule. It is difficult to imagine a situation where the exercise of an equity option will ever give rise to a capital gain in its own right as the benefit which arises upon the exercising of an equity option to acquire the underlying share can only be the favourable price of the share so acquired. This notwithstanding, any capital gain or loss as a result of the exercise of an equity option must be disregarded for CGT purposes.

Although it may seem from the above that the cost of acquiring an equity option with the intention of acquiring or disposing a share to be held or held on capital account is ignored for CGT purposes, there are provisions in the Eighth Schedule which deal with this issue. In terms of paragraph 20(1)(f) of the Eighth Schedule, if a share is acquired or disposed of by the exercise of an option then the actual cost of the option is added to the base cost of the share itself.

5.3 Time of disposal

In terms of paragraph 13(1)(a)(vi) of the Eighth Schedule when an option is granted, renewed, or extended the time of disposal will be the date on which the option is granted, renewed, or extended. When an option is exercised, the time of disposal is the date on which it is exercised.

5.4 Conclusion

All capital receipts and accruals with respect to equity options will fall into the CGT regime as set out in the Eighth Schedule of the Act which prescribes well defined rules for their treatment. A disposal of an equity option other than by way of exercise will attract CGT to the extent that the proceeds from such disposal exceed its base cost, whilst any losses will be allowed to be offset against any other capital gains the taxpayer may have. When equity options are exercised and the underlying share acquired or disposed of, the exercise is not treated as a CGT event. The cost of the option is instead added on to the base cost of the share involved.

CHAPTER 6: RESEARCH CONCLUSION AND RECOMMENDATIONS

6.1 Introduction

Financial transactions are changing rapidly and are becoming increasingly sophisticated and complex. Furthermore, as global financial markets become more integrated, many of the financial instruments developed elsewhere in the world are within a very short period of time entering into the South African market. The increase in the complexity and use of derivative instruments has not been accompanied by amendments to tax legislation. In the past, although the South African Revenue Service has appointed a number of internal committees which have looked at this area of taxation, the legislation resulting from these efforts has not been encompassing and a number of important issues have not been addressed (Hutton: 1999). As a result, the general principles of South African tax and available common law have to be relied upon.

6.2 Summary of chapters and findings

6.2.1 Chapter 1: Introduction

Derivative instruments have enjoyed tremendous growth in use over the last couple of decades, both internationally and in South Africa. One of the most widely used derivative instruments is the equity option contract which gives the holder the right, but not the obligation, to acquire or sell an underlying share from or to the issuer of the option at a predetermined price and at or before a predetermined date in the future. Equity options can be effectively used for speculating, trading, investment and hedging purposes.

In South Africa, income tax is levied on receipts and accruals of a revenue nature, while receipts and accruals of a capital nature fall into the CGT regime. As CGT is levied at a lower effective rate than income tax it is essential that the correct classification takes place. The Act does not define receipts and accruals of a capital nature and it has been left to the Courts to establish tests which assist in classifying amounts as either capital or revenue. The lack of specific legislation regarding derivatives in general and specifically equity options often make the aforementioned classification problematic.

The main thrust of this thesis has been the development of a theoretical framework for the correct classification of receipts and accruals arising from an equity option contract as either capital or revenue. Equity option transactions entered into for trading, speculative, investment and hedging purposes have been examined. Subsequent to the framework for the correct classification being outlined, the actual tax treatment of both revenue and capital receipts has been analysed within the ambit of the South African income tax and CGT regime respectively.

6.2.2 Chapter 2: Capital or revenue determination of receipts or accruals arising from equity option transactions, other than hedging transactions

In South Africa, the issuers of equity options are the large financial institutions. Such institutions which are clearly in the business of writing equity option contracts in order to earn premium income, would include such premium income as 'gross income' for income tax purposes. This is because such taxpayers are not transacting with equity options on capital account and as such all receipts and accruals would fall within the definition of 'gross income' as defined in section 1 of the Act. Option premiums, however, received by a taxpayer who issues an option in order to secure the sale of a share which is held as an investment on capital account will be capital in nature. The issue surrounding the tax treatment of equity options acquired or held by taxpayers is more problematic.

As a result of a general lack of specific legislation aimed at financial derivatives and in particular equity options, the general principles of South African tax law as well as available case law have to be utilised in order to ascertain the revenue or capital nature of a receipt or accrual arising from an equity option. The Courts have laid down various tests over the years to determine whether a receipt or accrual is of a revenue or capital nature. Of these tests one has emerged as the dominant one, namely 'intention'. In terms of this test the first step is to establish the intention of the taxpayer at the time of acquiring an asset and then secondly to determine whether there has been a change of intention during the period up until the date the asset is disposed of. The intention of the taxpayer may either be one of investment or speculation. It is also possible to have a dual intention, in which case one must determine the primary or main intention. Assets held for investment purposes are held on capital account (subject to CGT) whilst assets held with a speculative or trading intention are held on revenue account (subject to income tax).

Good objective factors to examine in order to establish whether equity options are held on revenue account would include the following:

- repetition and regularity of trades on a routine and systematic basis;
- high turnover or volume of trading activity;
- the use of a identifiable trading system;
- the use of a professional adviser with established management skills;
- in-depth market research; and/or
- prior involvement in the industry.

It is important to note that although repetition and frequency are important indicators of a speculative or trading intention (that is, the holding of equity options on revenue account), an isolated equity option transaction could also be classified as revenue.

In the case law discussed, it was ascertained that where an equity option was acquired with the intention of making a profit from the sale of the underlying share, then both the equity option and the share itself are held on revenue account. The opposite would be true of an option acquired in order to secure the purchase or sale of a share to be held or held for investment purposes (that is, both the option and the share would be of a capital nature). Equity options may in their own right be held for trading purposes, (that is, without the intention of ever acquiring or selling the underlying share) in which case they are held on revenue account.

The correct time for ascertaining a taxpayer's intention with regard to the acquisition of an equity option is the time the option was acquired and not when exercised. Initial case law seemed to indicate that on exercising an option in order to sell the underlying share, the taxpayer was automatically deemed to have a speculative intention and as such the proceeds would always be on revenue account and subject to income tax (*SAM v COT* (2) SA 75 (ZR) 42 SATC). Later cases, however, went against the aforementioned principle (*ITC 1427* 50 SATC, *Matla Coal v CIR* 1987 (1) SA 108 (A), 48 SATC 223) and are authority for the view that the correct time for the ascertainment of an equity option holder's original intention is the time the contract was entered into and not the time when exercised. As such, an investor who acquires an equity option in order to purchase a share to be held on capital account and later exercises the option and sells the underlying share when there is profit to be made, will be able to argue that his intention when entering into the option contract should be determined at the time of acquisition of the option and not when the option was exercised and the share sold.

6.2.3 Chapter 3: Hedging transactions

One of the major uses of an equity option is for hedging purposes, that is, as an instrument with which to minimise financial risk. As far as taxation is concerned, a problematic area with regard to the aforementioned arises with cash settled put options where on maturity the holder does not elect to sell the underlying share being hedged but rather receives a cash payment. Cash settled put options are problematic in that as shown, where a taxpayer on exercising an equity option disposes of the underlying share, the nature of the proceeds would be dependant on whether such share was held on revenue or capital account. Using the abundance of case law in this regard, together with the general principles of South African tax law, it is possible to ascertain whether the share in question was held on revenue or capital account. With a cash settled put option, however, the taxpayer continues to hold the share and instead opts to receive a cash settlement which is designed to provide compensation for the diminution in value of the underlying share during the period the equity option was held.

It has been suggested by tax commentators that the issue of equity options utilised for hedging purposes should be examined along the lines applicable to insurance contracts (Hutton: 1998, Byala: 1995). The general principle of insurance payouts, as set out in the English case of *Burmah Steamship Co Ltd v IRC*, 1931 SC, 16 TC 76, is to establish whether a payment in terms of an insurance contract fills a hole in the taxpayer's income producing structure (in which case it is capital) or in the actual profits of the taxpayer (in which case it is revenue). Applying this reasoning to cash settled put options used for hedging purposes, in instances where the share being hedged is held on capital account the cash settlement would also be on capital account, whereas the hedging of a share held on revenue account would also constitute revenue. Although useful, one should not rely solely on the aforementioned principle.

Unlike insurance contracts where payments are made to compensate taxpayers for actual losses, when a put option is cash settled the underlying share being hedged or 'insured' is not disposed of. Until a share is actually disposed of it cannot be said that a taxpayer has suffered any economic loss and at best a notional loss would have been incurred. Furthermore, the diminution in the value of a share is not perfectly correlated to the share's ability to generate income in the form of dividends and as such it does not hold true that the drop in the price of a share necessarily leads to a decrease in dividend income. As such, a drop in the price of a share may not result in a corresponding drop in its ability to generate dividend income and therefore the basis on which the general principle governing insurance payments is founded may not be applicable. In other words, a cash payment received by a taxpayer from a cash settled put option may not necessarily compensate such taxpayer for a 'hole' in his income producing asset as a drop in the price of a share may not in the first instance create such a 'hole'. In support of the aforementioned, an analysis of the South African equity market over a one, two and three year period was undertaken and it was shown that there was a far from perfect correlation between the fluctuation in share prices and actual dividends paid.

It is useful to examine the tax treatment of Krugerrands when dealing with the issue of equity options as utilised for hedging purposes. Krugerrands were a popular asset class bought for the purposes of hedging against the effects of inflation as well as political and economic uncertainty. Krugerrands were able to provide the aforementioned hedging qualities due to the fact that their value was linked to the gold price which had a positive correlation to the movement in the rate of inflation. As the gold price was furthermore seen as a safe haven in times of distress, the value of Krugerrands also increased in times of political and economic uncertainty. What is clear from all the reported cases regarding the revenue or capital nature of Krugerrands is that in instances where taxpayers were able to convince the Courts that their intention was hedging, then the Court held that the Krugerrands were held as capital assets and as such not subject to income tax. Hedging against the effects of inflation is akin to hedging with cash settled put options in that in both cases there is no actual sale of the asset being hedged. It is submitted that in instances where equity options are being used to hedge a share held on capital account then any cash settlement would also be of a capital nature, whilst cash settlements received from the exercise of an equity option to hedge a share held on revenue account would be of a revenue nature. It is therefore of critical importance to determine, with regard to equity options, what exactly would constitute a hedging transaction.

The South African Courts have never had to address the issue of hedging transactions with regard to equities and the South African revenue authorities have not issued any guidelines in this regard. In Australia, in terms of 'Tax Ruling IT 228 – The Taxation of Futures', one of the requirements of a hedging transaction is that the underlying asset being hedged must be sold. As such, a cash settled put option would not be treated as a hedge transaction in the Australian context. In the United Kingdom this is not the case and in terms of Statement of Practice SP 3/02 it is stated that in order for a transaction to be classified as a hedging transaction there must be 'the intention to eliminate or reduce risk' and the transaction entered into must be 'economically appropriate'. The statement states that in order to be 'economically appropriate' there must be a close negative correlation between the value of the hedging instrument and the asset being hedged. From a South African perspective when assessing what constitutes a hedging transaction, it is of use to examine the definition of a hedging transaction as set out by the South African Institute of Chartered Accountants in the Statement of Generally Accepted Accounting Practice AC 133. In terms of this statement, the essential elements of a hedge transaction are as follows:

- the hedge must be highly effective, that is, there must be a strong negative correlation between the value of the underlying asset being hedged and the hedging instrument; and
- hedge effectiveness should be capable of being reliably measured and a correlation of at least eighty percent is required in order for the hedge to be classified as 'effective'.

In the absence of guidelines from the South African Revenue Authorities, and especially where the taxpayer is a company subject to the provisions of AC 133, it is submitted that the guidelines as set out in the statement should be followed. It is further submitted that other than a close negative correlation between the value of the hedging instrument and the asset being hedged, a Court would look to the following additional important factors when assessing a potential hedging transaction involving the use of cash settled put options:

- Reinvestment of cash settlement: It would be easier for a taxpayer to argue a hedging intention when the cash settlement is reinvested in the underlying share;
- Frequency: A taxpayer who frequently undertakes transactions in cash settled put options on a systematic and regular basis may well be deemed to be carrying on a

scheme of profit making with the result that the cash settlement would be subjected to income tax;

- Closeness of the link between the hedged item and the hedging instrument: It would be easier for a taxpayer to demonstrate a hedging intention when the put option used as the hedging instrument had as the underlying share the exact share being hedged. In other words, in order to hedge Share A, the taxpayer should purchase Share A put options as opposed to purchasing put options on the market as a whole. The issue of value is also important. If a one million Rand position in Share A was being hedged, the notional value of the shares underlying the Share A put options should also be in the region of one million Rand.

Taking the above factors into account, should the Courts accept the taxpayer's stated intention that a cash settled put option was purchased for hedging purposes and were satisfied that an effective hedge was in existence, then it is submitted that the nature of the proceeds would be dependant on the nature of the underlying share. Where a share held on capital account was being hedged then the cash settlement would be capital, whereas the cash settlement would be revenue if a share held for trading or speculative purposes was being hedged.

6.2.4 Chapter 4: The tax treatment of revenue receipts and accruals arising from equity option contracts

Utilising the established theoretical framework, where it is resolved that a receipt or accrual arising from an equity option transaction is of a revenue nature, then the amount would be classified as 'gross income' and subject to income tax as prescribed by the Act.

Expenditure and losses incurred in generating taxable income are allowed as deductions in terms of the general deduction formula which is contained in section 11(a) and section 23(g) of the Act. In order to qualify as a deduction, the expenditure in question must not be of a capital nature and must have been incurred as part of the taxpayer's trade and in the production of income. 'Trade' is a broadly defined term and would include not only the activities of the financial institutions involved in the business of issuing equity options in order to earn premium income, but would also include any speculative or trading activity.

The capital or revenue nature of expenditure is not dealt with in the Act and case law in this regard has to be examined. The primary test applied by the Courts is to ask whether the expenditure in question is part of the cost of performing the taxpayer's income generating operations (revenue expenditure) or whether it is more properly regarded as part of the cost of acquiring, enhancing or adding to the taxpayer's income earning structure (capital expenditure). In applying the test with regard to expenditure or losses incurred in an equity option transaction, the Court would have regard to the purpose for which the expenditure or losses were incurred and this in turn would be dependant on the purpose with which the taxpayer entered into the transaction. Utilising the framework established in this thesis, it is possible to establish whether such purpose was a revenue or capital purpose. Once a revenue purpose has been established the expenditure or loss in question would *prima facie* qualify for a deduction in terms of section 11(a) of the Act.

Section 24L of the Act sets down rules dealing with the timing for income tax purposes of revenue receipts and accruals with regard to all option contracts. As the section does not deal with options held as trading stock, its application is limited to the writers or issuers of equity options and the premium income earned. The section prescribes that any premium income earned in terms of an option contract is deemed to have accrued on a day-to-day basis over the life of the contract. Should an equity option be exercised early then the unaccrued portion of the option premium is brought into account on the actual exercise date.

Section 22 of the Act deals with trading stock. With regard to equity options, the effect of section 22 is to oblige taxpayers who hold equity options as trading stock to bring into account the value of such options at the tax year-end as closing stock when determining taxable income. The value of such closing stock is limited to the original cost but may be written down to the extent that there has been a diminution in value. Section 22 therefore ensures that unrealised profits on equity options held as trading stock are not taxed, whilst taxpayers are permitted to write down closing stock and claim a deduction equal to the reduction in value. Equity options traded on an exchange must be valued with reference to their quoted price, whilst untraded options should be valued using an acceptable mathematical model. Section 22 specifically prohibits the write down at year end of closing stock of a company to the extent that such closing stock consists of shares. An equity option however would not fall into the definition of a 'share' and as such the limitation would not apply to equity options held by a company.

Once a receipt or accrual is determined to be of a revenue nature, a taxpayer's ultimate liability for tax with regard to such a receipt or accrual earned on revenue account would be determined by applying the gross income provisions of the Act together with the general deduction formula, the timing provisions of section 24L of the Act and the trading stock provisions of section 22.

6.2.5 Chapter 5: The tax treatment of capital receipts and accruals arising from equity option contracts

Receipts and accruals of a capital nature would potentially fall into the CGT regime as set out in the Eighth Schedule of the Act.

The basic principles of CGT entail the inclusion of a certain percentage of a capital gain in a taxpayer's taxable income. Due to the fact that the total capital gain is not included in taxable income (the maximum inclusion rate is applicable to trusts and equates to twenty percent) the effective rate of CGT is lower than the effective rate applicable to income. In general terms, a capital gain is calculated by subtracting from the proceeds derived from the disposal of an asset, its cost price.

The Eighth Schedule of the Act has some specific provisions dealing with options. In terms of the definition of 'disposal' for CGT purposes as set out in paragraph 11(1) of the Eighth Schedule, the exercising of an option would fall within the definition. A 'disposal' for CGT purposes would therefore not only include the sale of an option but also the exercise thereof. In terms of paragraph 18 of the Eighth Schedule, any capital loss arising from the disposal of an option, other than by way of exercise, must be disregarded for CGT purposes. However, excluded from this loss limitation provision are equity options, and therefore any loss derived by a taxpayer from a equity option contract may be offset against any other capital gains the taxpayer may have when calculating the overall CGT liability. The aforementioned is however subject to the provisions of paragraph 58 of the Eighth Schedule in terms of which a taxpayer must disregard a capital gain or loss from the exercising of an option which results in the taxpayer either taking delivery of, or disposing of, the underlying asset. Although this may seem to render an inequitable tax effect, the cost of any option utilised to dispose of or acquire such asset may be added onto the cost of the asset when determining the capital gain or loss with regard to the asset itself. The cost of the option is therefore indirectly taken into account for CGT purposes. Paragraph 13(1)(a)(vi) of the Eighth Schedule prescribes that when an option is granted, renewed or extended the time of disposal will be the date on which the option is granted, renewed or extended, whilst the time of disposal of an option which is exercised is the date on which such option is exercised.

The Eighth Schedule of the Act sets out well defined rules for the treatment of equity options held on capital account. Once the difficult issue of revenue or capital classification has therefore taken place, the tax treatment of capital receipts and accruals arising from equity option contracts is fairly straightforward.

6.3 Conclusion and recommendations

Although problematic at times, this thesis has shown that with regard to equity options, the general principles of South African tax law together with applicable case law is sufficient when examining the tax treatment of these transactions, and in the opinion of the writer does provide an equitable framework with which to analyse equity option transactions. As such, it is submitted that specific legislation in this regard is not required. This is based on the opinion that great importance should be placed on the economic substance of a financial arrangement and specific legislation may not be able to provide the flexibility to deal with the many forms of derivative instruments. Any legislation which adopted a 'product approach', that is, the drafting of legislation for each specific type of instrument, would not keep up with the rapid pace at which new instruments are being introduced into the market.

Clarification from the Revenue authorities with regard to what exactly constitutes a hedging transaction is urgently needed. Unlike various overseas countries such as Australia and the United Kingdom, the South African Revenue authorities have not issued any guidelines as to what they consider constitutes an equity hedging transaction. A financial market thrives on efficiency and when an important issue such as the taxation implications of a particular transaction is not certain this causes market imperfections. It is strongly recommended that the Revenue authorities bring out a Practice Note addressing their approach to equity hedging transactions. In particular the Note should highlight exactly what in the view of Revenue would constitute a hedge transaction. It is submitted that a good basis to adopt with regard to the exact nature of a hedge transaction would be the provisions of AC 133 of Generally Accepted South African Accounting Practice as it relates to the definition of an 'effective hedge'. Once clarity is achieved as to what exactly constitutes a 'hedging transaction', then, as stated above, general tax principles and case law provide a sufficient framework for determining the correct tax treatment.

The derivatives market is developing at a rapid pace and although still effective and widely employed, equity options are fairly simplistic in terms of the financial technology which is currently utilised. It is submitted that with regard to the more exotic equity instruments the general principles may not be sufficient as they were developed long prior to the innovation of these instruments and are not equipped to deal with many of the complexities that arise in taxing them.

Based on the aforementioned, there are numerous further research opportunities in assessing the tax implications of such exotic instruments and the development of a framework for their equitable tax treatment. This thesis has shown, however, that by utilising existing case law and the general principles of South African tax law, a comprehensive and equitable framework can be developed and effectively utilised for the classification of all receipts and accruals arising from equity option contracts.

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ITC 1208 36 SATC 80

ITC 321 8 SATC 236

ITC 962 24 SATC 651

ITC 721 17 SATC 485

ITC 594 14 SATC 249

ITC 597 14 SATC 264

ITC 942 24 SATC 446

ITC 1498 53 SATC 26

ITC 340 8 SATC 362

ITC 1355 44 SATC 132

ITC 1379 45 SATC 236

ITC 1543 54 SATC 446

ITC 1525 54 SATC 209

ITC 1526 54 SATC 216

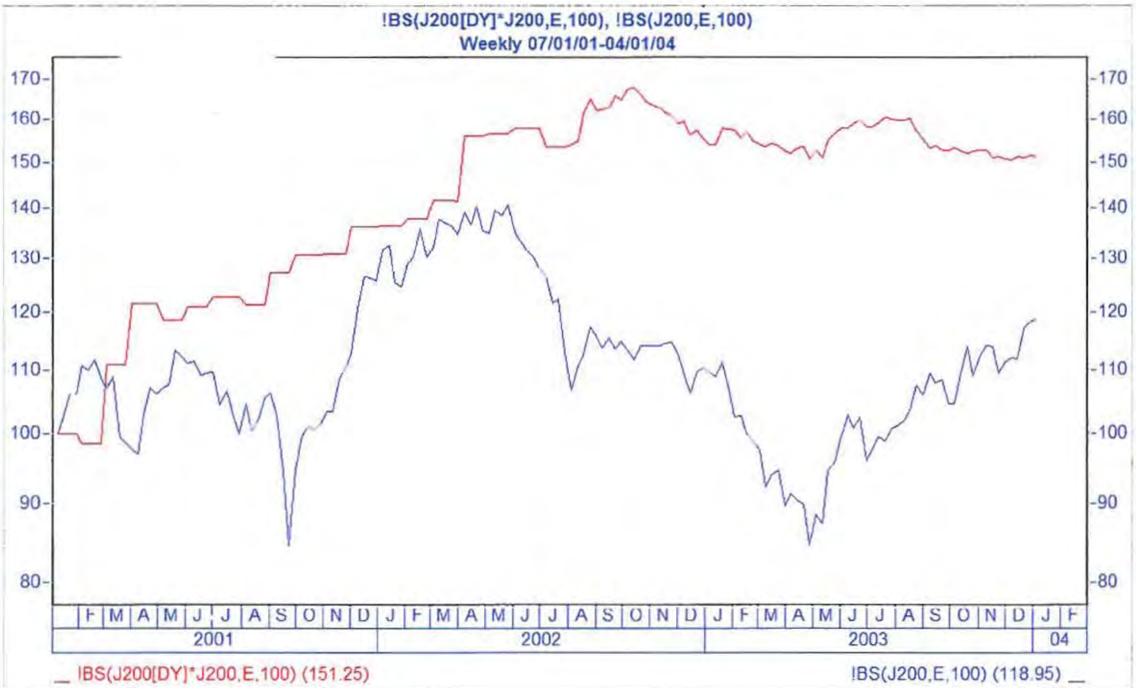
ITC 368 9 SATC 211

ITC 1489 53 SATC 99

ITC 1427 50 SATC 25

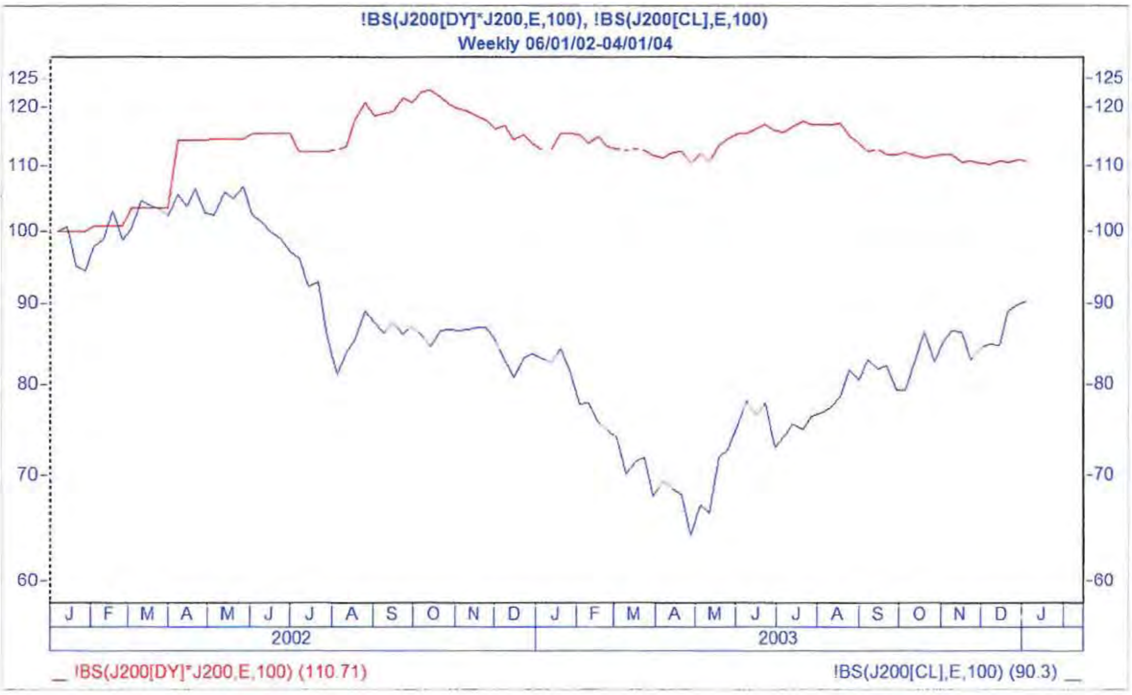
ANNEXURE A: GRAPHICAL REPRESENTATION OF THE VALUE OF THE JSE ALSI 40 INDEX RELATIVE TO ACTUAL DIVIDEND DISTRIBUTIONS OVER A THREE YEAR PERIOD

Index:	JSE ALSI 40
Period:	07/01/2001 – 04/01/2004 (last three years)
Red Line:	Growth in dividend income
Blue Line:	Growth in price



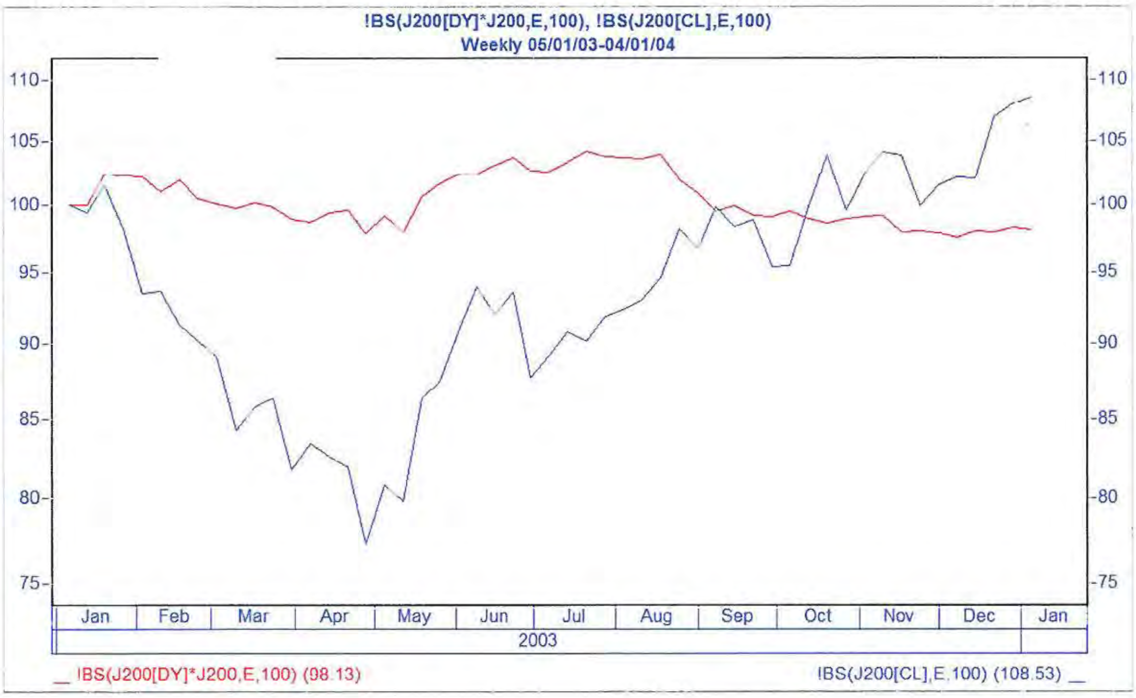
ANNEXURE B: GRAPHICAL REPRESENTATION OF THE VALUE OF THE JSE ALSI 40 INDEX RELATIVE TO ACTUAL DIVIDEND DISTRIBUTIONS OVER A TWO YEAR PERIOD

Index:	JSE ALSI 40
Period:	06/01/2002 – 04/01/2004 (last two years)
Red Line:	Growth in dividend income
Blue Line:	Growth in price



ANNEXURE C: GRAPHICAL REPRESENTATION OF THE VALUE OF THE JSE ALSI 40 INDEX RELATIVE TO ACTUAL DIVIDEND DISTRIBUTIONS OVER A ONE YEAR PERIOD

Index:	JSE ALSI 40
Period:	05/01/2003 – 04/01/2004 (last year)
Red Line:	Growth in dividend income
Blue Line:	Growth in price



ANNEXURE D: SECTION 24L OF THE ACT

24L Incurral and accrual of amounts in respect of option contracts

(1) For the purposes of this section -

'intrinsic value', in relation to an option contract, means an amount equal to the difference between the market price or value of an asset, index, currency, rate of interest or any other factor, as provided for in the option contract, on the date of acquisition of the option contract and the pre-arranged price or value provided for in the option contract; and

'option contract' means an agreement the effect of which is that any person acquires the option (excluding a foreign currency option contract as defined in section 24I(1)) -

(a) to buy from or to sell to another person a certain quantity of corporeal or incorporeal things before or on a future date at a pre-arranged price; or

(b) that an amount of money will be paid to or received from another person before or on a future date depending on whether the value or price of an asset, index, currency, rate of interest or any other factor is higher or lower before or on that future date than a pre-arranged value or price.

(2) The amount of-

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

(b) any consideration paid or payable by a person in respect of the acquisition of an option contract by such person,

shall for the purposes of this Act be deemed to have been incurred by such person on a day to day basis during the term of such option contract: Provided that-

(i) where such option contract is exercised, terminated or is disposed of, the portion of the amount attributable to the period from the date of exercise, termination or disposal until the end of the original term of the option contract shall be deemed to have been incurred by such person on the date of exercise, termination or disposal of the option contract;

(ii) the provisions of this section shall not be applied to an option contract held by a person as trading stock;

(iii) where such amount includes an amount representing the intrinsic value in relation to the option contract, so much of such amount so representing the intrinsic value shall for the purposes of this Act be deemed to have been incurred by such person on the date of exercise, termination or disposal of the option contract.

(3) The amount of any premium or like consideration received or receivable by a person in terms of an option contract shall for the purposes of this Act be deemed to have accrued to such person on a day to day basis during the term of such option contract: Provided that where such option contract is exercised, terminated or disposed of, the portion of the amount attributable to the period from the date of exercise, termination or disposal of such option contract until the end of the original term of the option contract shall be deemed to have accrued to such person on the date of exercise, termination or disposal of the option contract.

[S 24L inserted by s 28(1) of Act 53 of 1999.]