

**BINDING CLASS RULING: BCR 024**

DATE: 22 December 2010

**ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)**

**SECTION : SECTION 1 DEFINITION OF “GROSS INCOME”,  
SECTION 11(a) READ WITH SECTION 23(g) AND  
SECTION 24J**

**SUBJECT : SECURITIES LENDING TRANSACTIONS – “SHORT SELLING”  
OF DEBT SECURITIES**

**1. Summary**

This ruling deals with the question as to whether the expenditure incurred to “close-out” a securities lending transaction, with debt securities as the subject-matter of the lending transaction, is deductible.

**2. Relevant tax laws**

This is a binding class ruling issued in accordance with section 76R of the Act.

In this ruling legislative references to sections are to sections of the Act applicable as at 30 September 2009 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of –

- section 1, definition of “gross income”;
- section 11(a) read with section 23(g);
- section 8(4)(a); and
- section 24J.

**3. Class**

The Class members to whom this ruling will apply will be the members as described in point 4 below.

**4. Parties to the proposed transaction**

The Applicant: A stock broking firm

The Class members: Clients of the Applicant

## 5. Description of the proposed transaction

The Applicant will facilitate the borrowing of specific debt securities on behalf of the class members. The specific detail of the proposed transaction is as follows:

- The class member (the borrower) borrows specific debt securities (the debt securities) from a lender (the lender). The borrower undertakes to return debt securities of the same kind and of the same or equivalent quantity and quality to the lender. The date on which the borrowed debt securities need to be returned (the close-out date) will be either a specified or an unspecified future date.
- The borrower further undertakes to pay to the lender compensation (manufactured interest) for the interest the lender would have received on the debt securities on the pre-determined coupon dates. The manufactured interest will be equal to the interest payable by the issuer of the debt securities plus a small margin, which represents a lending fee.
- The borrower sells the debt securities to a purchaser (the short sale) and utilises the proceeds for productive purposes.
- On the close-out date of the security lending transaction the borrower will purchase the required debt securities in the market in order to return them to the lender.

## 6. Conditions and assumptions

This ruling is made subject to the conditions and assumptions that –

- an unconditional obligation to return the debt securities to the lender must exist on the day that the security lending transaction is entered into;
- the proposed transaction is not part of an “impermissible avoidance transaction” as defined in section 80A; and
- there will be no set-off of any payments due and payable in terms of this security lending transaction between the lender and the borrower.

## 7. Ruling

The ruling made in connection with the proposed transaction is as follows:

### **Lending transactions with specified close-out dates:**

- 7.1 The proceeds of the short sale of the debt securities will result in accruals or receipts of “gross income” as defined in section 1.
- 7.2 The obligation to return the debt securities will be recognised in the year of assessment in which the securities lending transaction is

concluded and in that year of assessment the obligation gives rise to an expense as contemplated in section 11(a) read with section 23(g).

- 7.3 The amount of the expenditure referred to in 7.2 will be equal to the market value of the debt securities on the day that the securities lending transaction is entered into.
- 7.4 The borrowing of the debt securities and the obligation to return similar debt securities, coupled with the obligation to pay manufactured interest, constitutes an interest-bearing arrangement and therefore an instrument in terms of paragraph (c) of the definition of “instrument” under section 24J.
- 7.5 The borrower must calculate the accrual amount in respect of the obligation to return the debt securities and to pay manufactured interest (hereafter collectively referred to as the obligation). The accrual amount [the amount that may be deducted by the borrower for income tax purposes in respect of all accrual periods in a given year of assessment under section 24J(2)] will be the product of the yield to maturity (determined in respect of each accrual period during the year of assessment) having regard to the amount of the borrower’s obligation at that time and –
- in the first accrual period that the obligation arises, the initial amount (issue price), and
  - in subsequent accrual periods, the adjusted initial amount (the sum of the initial amount, the accrual amounts in relation to all previous accrual periods and any other payments received by the borrower in all such previous accrual periods, less any manufactured interest payments actually made to the lender plus or minus any adjustments).

For purposes of calculating the yield to maturity –

- the estimated future value of the debt securities at the close-out date must be used;
- the initial amount of the obligation in the current circumstance will be the issue price which will be the market value of the debt securities at the time that they are borrowed;
- paragraph (d)(ii) of the definition of “yield to maturity” in section 24J provides for the yield to maturity to be re-determined where, amongst others, there is a variation or alteration in the obligations of the borrower in relation to an instrument. The yield to maturity relating to the obligation would thus have to be periodically re-determined based on changes in the market value of the debt securities to be returned to the lender. The re-determined yield to maturity would be applied to the initial amount or adjusted initial amount of the relevant

accrual period to which the re-determined yield to maturity relates; and.

- where the calculated rate of compound interest per accrual period results in a negative rate of interest, the rate of compound interest per accrual period must be treated to be zero.

7.6 On the close-out date of the securities lending transaction, the borrower will have to calculate whether an adjusted gain or loss has been made on transfer or redemption of the debt securities. The adjusted gain will be included in the borrower's income under section 24J(4A)(b). To the extent that an adjusted loss has been realised, this loss will be deductible from the income of the borrower under section 11(a) read with section 23(g), provided all of the requirements are met.

**Lending transactions without specified close-out dates:**

- 7.7 The proceeds of the short sale of the debt securities will result in accruals or receipts of "gross income" as defined in section 1.
- 7.8 The obligation to return the debt securities will be recognised in the year of assessment in which the security lending transaction is concluded as giving rise to an expense as contemplated in section 11(a) read with section 23(g).
- 7.9 The amount of the deduction referred to in 7.8 will be equal to the estimated market value of the debt securities on the close-out date of the security lending transaction.
- 7.10 The amount of any manufactured interest payable by the borrower to the lender of the debt securities will be deductible in terms of section 11(a) when the issuer of the debt securities pays a coupon in respect of those debt securities, as it is at that time that the borrower incurs expenditure as contemplated in section 11(a).
- 7.11 In the year of assessment when the borrower acquires the debt securities to return them to the lender, the borrower will be entitled to a deduction under section 11(a) of an amount equal to the excess cost of the debt securities over the initial deduction or, in the event that the cost of the debt securities is less than the initial deduction, the borrower must recoup the amount of the difference under section 8(4)(a).

**8. Period for which this ruling is valid**

This binding class ruling is valid for a period of five (5) years as from 9 December 2009.

Issued by:

**Legal and Policy Division: Advance Tax Rulings  
SOUTH AFRICAN REVENUE SERVICE**