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A critical analysis of section 241 of the Income Tax Act

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THE SCHOOL OF ACCOUNTANCY



UNIVERSITY OF THE WITWATERSRAND, JOHANNESBURG

A research report submitted to the Faculty of Commerce, Law and Management in fulfilment of the requirements for the degree of Master of Commerce

A critical analysis of Section 24I of The Income Tax Act

ABSTRACT

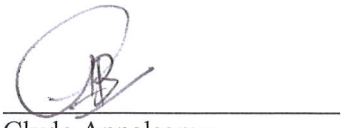
The impact of foreign exchange gains and losses affects multinational corporations globally. This paper critically evaluates current South African tax legislation on the treatment of such foreign exchange gains and losses, specifically in relation to foreign exchange contracts. The research highlights the statutory requirement to utilise a 'market-related forward rate' when calculating foreign exchange gains and losses on foreign exchange contracts, and examines the complexities and elements of subjectivity involved in determining this rate. The research then performs an analysis of the requirements to utilise an 'alternate rate', with the analysis highlighting the limited guidance provided by the South African Revenue Service and the need for further guidance. A comparison is done between the South African tax legislation on the treatment of foreign exchange gains and losses on foreign exchange contracts, and that of the United States of America and the United Kingdom, which suggests that current South African tax legislation is outdated, requiring revision to align it with current global treatment. The research highlights areas of taxation that appear to be obsolete and, as such, concludes by providing recommendations for modernisation.

Key words:

Market-related forward rate, foreign exchange gains and losses, foreign exchange contracts, alternative rate, time value of money

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted for any other degree or examination at any other institution or at any other time.



Clyde Appalsamy
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Chapter 1: Introduction

1.1 Context of the study

Multinational corporations buy and sell products and services that are priced at functional currencies prevailing in the countries in which these transactions originate (Wolf, 2014 (p.1)). Where a multinational corporation in South Africa imports goods from Germany, the German exporter will expect settlement in euros. There then arises the problem of how to control and manage the foreign currency exchange risk from the changing values of the euro compared to the South African rand.

There are three general foreign exchange risks that arise from translation, transaction, and economic exposures. Translation risk comes from transactions in foreign countries that have already been entered into (Koening, 2014 (p.2)). For example, a South African multinational corporation has subsidiaries and assets in countries around the world. These subsidiaries and assets are expressed in a foreign currency. In preparing the South African multinational's annual financial statements, the foreign subsidiaries and foreign assets will need to be translated into the South African rand in order to be consolidated into the local results of the multinational. Transaction risk comes from having to conduct commercial transactions in foreign currencies (Koening, 2014 (p.2)). A company is required to convert the foreign currencies into the local currency for the purposes of reporting and consolidation. This conversion may result in gains being made if the local currency becomes stronger or losses suffered if the local currency becomes weaker. Economic risk, also known as operating risk, is associated with the revenue, demand and costs for a company's products in a country when exchange rates fluctuate (Koening, 2014 (p.2)). For example, if the euro drops in value, a South African company's product in Germany will become more expensive and less attractive to the German customers. This could result in lower sales for the South African company and, ultimately in reduced profits.

The increased volatility of exchange rate fluctuations in the recent past has led to the creation of increased foreign exchange risk for multinationals. The need to manage this risk has resulted in multinationals conducting various hedging operations through regulated financial institutions in an attempt to minimise the financial risk of loss caused by movements in foreign currency rates. One typical type of hedge is known as a foreign exchange contract. This is a contract entered into between the exporter and the bank that allows the exporter to sell a fixed amount of foreign exchange to the bank at a predetermined future date and a predetermined foreign exchange rate (Wolf, 2014 (p.2)).

International Financial Reporting Standards (IFRS) outlines specific treatment for the recognition and subsequent treatment of these hedging instruments. The taxation treatment of these hedging instruments in a South African context, particularly that of the foreign exchange contract, differs from the IFRS treatment. This difference in treatment would in many instances create additional complexities for taxpayers who already

face the enormous challenge of attempting to manage their foreign exchange risk. This paper seeks to explore specific aspects of the tax treatment of foreign exchange gains and losses on foreign exchange contracts (FEC's) and to perform a critical analysis on section 24I.

1.2 The research problem

1.2.1 Statement of the problem

The research critically examines current tax legislation on the treatment of foreign exchange gains and losses on FEC's. An analysis is then performed into the treatment and methodologies adopted by regulated financial institutions and international accounting standards of these specific transactions. The research identifies the challenges faced when such analysis is applied to the legislation in its current state.

1.2.2 Sub-problems

The term market- related forward rate available for the remaining period of a FEC is not defined in the Income Tax Act ('the Act'). Practice Note 4 of 1999, issued by the South African Revenue Service (herein after SARS) explains this rate to be the rate at which another FEC with similar terms is offered by the authorised foreign exchange dealer used by the taxpayer on translation date. How are FEC rates determined and how does one determine what these similar terms are?

The use of an alternate rate to calculate foreign exchange gains and losses on FEC's is permitted, provided that the rate is determined and applied in terms of generally accepted accounting practice. How does generally accepted accounting practice determine an exchange rate?

How does current South African tax legislation on the treatment of gains and losses on FEC's compare to the legislation adopted in the United States of America and the United Kingdom and is there a need for reform?

1.3 Significance of the study

The exchange rates between various currencies of the world have for many years, increasingly, been subject to substantial fluctuations. In addition, the extent and complexity of international currency trading has also increased substantially. At present, currency markets are extremely sophisticated and are characterised by their technological advancement, their liquidity and the large variety of currency and currency instruments which are quoted and traded by way of an electronic medium. Most currency dealers manage their portfolios with the assistance of advanced computer systems which frequently revalue currency items at their latest market value during the course of a day (Practice note 4, 1999 (p.2)).

The Act, unfortunately, did not keep pace with the reality of modern currency trading. Consequently it did not reflect the economic reality of currency transactions and the accounting representation of these. In order to

address the shortcomings in the tax treatment of gains and losses on foreign exchange transactions, section 24I was introduced into the Act (Practice note 4, 1999 (p.2)).

The objectives of section 24I are described in the following manner by the 'Explanatory Memorandum on the Income Tax Bill, 1993':

'*Section 24I has the object of treating, for tax purposes, all gains made and losses incurred in respect of foreign exchange transactions in a manner which takes into account as far as possible the principles of fairness, simplicity, economic reality, current tax principles and generally accepted accounting practice.*'

In truth, though, section 24I is anything but simple and its operation is in some instances hardly fair (De Koker, 2014).

The research will provide insight into various aspects of the tax treatment of foreign exchange gains and losses on FEC's and will serve as a single reference point for taxpayers dealing with transactions of such nature. It aims at facilitating a greater degree of understanding in this area of taxation to assist with interpretation and compliance. The research will highlight areas of obsolescence and provide recommendations for reform.

1.4 Delimitations of the study

The research is restricted to a critical analysis of the treatment of foreign exchange gains and losses on FEC's and, therefore, does not cover the treatment of other financial instruments as detailed in section 24I. Whilst the research will highlight the various shortcomings of the current legislation, the research does not provide an optimal solution to the tax treatment of foreign exchange gains and losses on FEC's. The suggested recommendations will, however, contribute to reform in statutory requirements and create a greater degree of alignment to treatment in the United States and United Kindgom. Practice Note 4 covers an alternate spreading of a discount or premium in respect of an FEC, over the period of the contract in order to obtain a market-related forward rate. This research report does not address this alternative nor cover any details of such.

1.5 Research methodology

The research methodology seeks to evaluate current legislation governing the treatment of foreign exchange gains and losses on FEC's by examining the guidance issued by SARS on section 24I, in the form of Practice Note 4. An examination of the treatment of foreign exchange gains and losses on FEC's by financial institutions and IFRS will be performed. An analysis will then be performed by critically examining existing

literature to establish the rules and guidelines provided by financial institutions and IFRS on the treatment of such foreign exchange gains and losses on FEC's. A further analysis will be performed on electronic media portals dealing with tax legislation governing the treatment of foreign exchange gains and losses on FEC's in foreign jurisdictions. The differences will then be identified. The research outlined above will be used to draw conclusions on the challenges encountered when applying the aforementioned rules and guidelines provided by financial institutions and IFRS to South African legislation in its current form. Recommendations are then offered, based on the treatment by foreign jurisdictions.

1.6 Chapter outline

Chapter two will provide an overview of the treatment of foreign exchange gains and losses of FEC's in South African tax legislation found in section 24I of the Act. Section 24I(3) which states that any exchange difference in respect of an exchange item must be included in or deducted from a taxpayer's income, irrespective of whether it has been realised or not. Exchange differences whether of a capital or revenue nature must be taken into account. The chapter will demonstrate the practical application of section 24I(3) where an FEC is entered into.

In chapter three an analysis is performed into the Practice Note 4 guidance on determining a market- related forward rate utilised to calculate foreign exchange gains and losses. Focus will be given to the area where a market-related forward rate is determined by reference to a rate at which another FEC with similar terms is offered by an authorised foreign exchange dealer. The chapter will examine briefly the factors used to determine FEC rates. It will seek to highlight elements of complexity and subjectivity that are involved in attempting to determine a rate of another FEC with similar terms to be utilised to calculate the foreign exchange gain or loss.

An examination into the determination of quoted rates of FEC's is performed in chapter four. The chapter will show that variables comprising country fiscal policies and socio-economic agendas could potentially influence quoted rates on FEC's. The chapter will highlight the fact that when considering the variables used to determine FEC rates, such variables could vary significantly from one FEC to another. This precarious situation would, therefore, create complexities and elements of subjectivity in attempting to meet the requirement of Practice Note 4, which is to utilise a rate at which another FEC with similar terms offered by a financial institution to calculate foreign exchange gains and losses.

Practice Note 4 permits the use of an alternate rate to the market-related forward rate, conditional upon specific requirements being met. One such requirement is to utilise an alternate rate that must conform to generally accepted accounting practices. Chapter five performs an analysis into the requirements of generally accepted accounting practices used to regulate exchange rates of FEC's. The chapter will create an awareness of what it would entail in order to meet this specific requirement.

Chapter six will look into the requirements set out by the United States of America and the United Kingdom for the treatment of foreign exchange gains and losses on FEC's, and seek to demonstrate the contradistinction of these requirements to those of the current South African tax legislation. The simplified approach adopted by these First World jurisdictions will reveal that such jurisdictions have acknowledged the complexities involved in this area of taxation, and will highlight the ignorance on the part of the South African revenue authorities to retain obsolete legislation.

Chapter seven will conclude by summarising the existing challenges posed by complying with current tax legislation. It will further summarise recommendations that will offer a simpler approach to this complex area of taxation.

Chapter 2: The legislation explained

The treatment of FEC's in South African legislation from an income tax point of view is found in section 24I of the Act. Below are relevant definitions and paragraphs from this section.

"exchange difference" *means the foreign exchange gain or foreign exchange loss in respect of an exchange item during any year of assessment determined by multiplying such exchange item by the difference between—*

(a) the ruling exchange rate on transaction date in respect of such exchange item during that year of assessment, and—

(i) the ruling exchange rate at which such exchange item is realised during that year of assessment; or

(ii) the ruling exchange rate at which such exchange item is translated at the end of that year of assessment; or

(b) the ruling exchange rate at which such exchange item was translated at the end of the immediately preceding year of assessment or at which it would have been translated had this section been applicable at the end of that immediately preceding year of assessment, and—

(i) the ruling exchange rate at which such exchange item is realised during that year of assessment; or

(ii) the ruling exchange rate at which such exchange item is translated at the end of that year of assessment;

"exchange item" *of or in relation to a person means an amount in a foreign currency—*

(a) which constitutes any unit of currency acquired and not disposed of by

that person;

(b) owing by or to that person in respect of a debt incurred by or payable to such person;

[Para. (b) substituted by s. 53 (1) (b) of Act No. 22 of 2012.]

(c) owed by or to that person in respect of a forward exchange contract; or

(d) where that person has the right or contingent obligation to buy or sell that amount in terms of a foreign currency option contract;

"foreign currency" *in relation to any exchange item of a person, means any currency which is not local currency;*

"forward exchange contract" *means any agreement in terms of which any person agrees with another person to exchange an amount of currency for another currency at some future date at a specified exchange rate;*

"forward rate" *means the specified exchange rate as referred to in the definition of "forward exchange contract";*

"premium or discount on a forward exchange contract" *means the amount obtained by applying the difference between the forward rate in respect of a forward exchange contract and the spot rate on the date on which such forward exchange contract was entered into, to the foreign currency amount specified in such forward exchange contract;*

"realised" *means, in relation to an exchange item, where such exchange item is—*

(a) a debt in any foreign currency, when and to the extent to which payment is received or made in respect of such debt, or when and to the extent to which such debt is settled or disposed of in any other manner;

[Para. (a) substituted by s. 53 (1) (c) of Act No. 22 of 2012.]

(b) a forward exchange contract, when payment is received or made in respect of such forward exchange contract;

[Para. (b) amended by s. 27 (1) (c) of Act No. 74 of 2002 with effect from the date of promulgation of that Act, 13 December, 2002 and applicable in respect of years of assessment commencing on or after that date.]

(c) a foreign currency option contract, when payment is received or made in respect of the right in terms of such foreign currency option contract having been exercised, or when such foreign currency option contract expires without such right having been exercised, or when such foreign currency option contract is disposed of; or

(d) an amount which constitutes a unit of currency, when that amount is disposed of;

"ruling exchange rate" *means, in relation to an exchange item, where such exchange item is—*

(a) a debt in a foreign currency on—

(i) transaction date, the spot rate on such date;

[Sub-para. (i) substituted by s. 33 (1) (a) of Act No. 31 of 2005.]

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(ii) the date it is translated, the spot rate on such date; or

[Sub-para. (ii) substituted by s. 33 (1) (a) of Act No. 31 of 2005.]

(iii) the date it is realised, the spot rate on such date:

Provided that where the rate prescribed in respect of a debt in terms of this definition is the spot rate on transaction date or the spot rate on the date on which such debt is realised, and any consideration paid or incurred or received or accrued in respect of the acquisition or disposal of such debt was determined by applying a rate other than such spot rate on transaction date or date realised, such spot rate shall be deemed to be the acquisition rate or disposal rate, as the case may be;

[Para. (a) amended by s. 53 (1) (d) and (e) of Act No. 22 of 2012.]

(b) a forward exchange contract on—

(i) transaction date, the forward rate in terms of such forward exchange contract;

(ii) the date it is translated, the market-related forward rate available for the remaining period of such forward exchange contract or in respect of a forward exchange contract which is an affected contract, the forward rate in terms of such forward exchange contract;

(iii) the date it is realised, the spot rate on such date; or

(c) a foreign currency option contract on—

(i) transaction date, a nil rate;

(ii) the date it is translated—

(aa) in relation to a foreign currency option contract which is not an affected contract, the rate obtained by dividing the market value of such foreign currency option contract on that date by the foreign currency amount as specified in such foreign currency option contract; or

(bb) in relation to a foreign currency option contract which is an

affected contract, the rate obtained by dividing any amount included or deducted, as the case may be, in terms of subsection (3) (b) by the foreign currency amount, as specified in such affected contract;

(iii) the date it is realised, the rate obtained by dividing the market value of such foreign currency option contract on that date by the foreign currency amount as specified in such foreign currency option contract: Provided that where such foreign currency option contract is realised by the disposal thereof, the rate shall be obtained by dividing the amount received or accrued as a result of the disposal of such foreign currency option contract, by the foreign currency amount as specified in such foreign currency option contract;

(d) an amount which constitutes a unit of currency, on—

(i) transaction date, the spot rate on that date;

(ii) the date it is translated, the spot rate on that date; or

(iii) the date it is realised, the spot rate on that date:

Provided that the Commissioner may, having regard to the particular circumstances of the case, prescribe an alternative rate to any of the aforementioned prescribed rates to be applied by a person in such particular circumstances, if such alternative rate is used for accounting purposes in terms of generally accepted accounting practice;

***"transaction date"** means, in relation to—*

(a) . . . . . .

[Para. (a) deleted by s. 53 (1) (f) of Act No. 22 of 2012.]

(b) a debt owing by a person, the date on which such debt was actually incurred;

(c) . . . . . .

[Para. (c) deleted by s. 53 (1) (f) of Act No. 22 of 2012.]

(d) a debt owing to a person, the date on which the amount payable in respect of such debt accrued to such person or the date on which such debt was acquired by such person in any other manner;

(e) a forward exchange contract, the date on which such contract was entered into;

(f) a foreign currency option contract, the date on which such contract was entered into or acquired; and

(g) an amount which constitutes a unit of currency, the date on which that amount was acquired;

"translate" *means the restatement of an exchange item in the local currency at the end of any year of assessment, by applying the ruling exchange rate to such exchange item.*

(3) In determining the taxable income of any person contemplated in subsection (2), there shall be included in or deducted from the income, as the case may be, of that person—
(a) any exchange difference in respect of an exchange item of or in relation to that person, subject to subsections (10) and (10A); and

(6) Any inclusion in or deduction from income in terms of this section shall be in lieu of any deduction or inclusion which may otherwise be allowed or included under any other provision of this Act.

Section 24I(3) of the Act states that any exchange difference in respect of an exchange item must be included in or deducted from a taxpayer's income. The exchange difference must be included in or deducted from the taxpayer's income, irrespective of whether it has become realised or not. Both exchange differences that arise from transactions of a capital or revenue nature should be taken into account.

A look into the practical application of section 24I(3) to the scenario where an FEC is entered into is done below.

It is important to commence by looking at the definition of a foreign exchange contract. As explained in the introductory paragraph, a company enters into an FEC to hedge potential foreign currency risk as the FEC is an agreement to exchange foreign currency at a predetermined date and at a predetermined rate, eliminating exposure to exchange rate movements. The definition of an FEC in section 24I is no different from this explanation.

Section 24I(3) applies to an exchange item. Paragraph (c) of the definition of an exchange item refers to an amount of foreign currency owed by or to a person in respect of an FEC. From the definition of an FEC highlighted above, an FEC is an agreement is formed to exchange foreign currency at a future date. This would mean that for the duration of the FEC, a foreign currency amount would either be owed to or by the party who has entered into an FEC. It is therefore concluded that an FEC is an exchange item.

An FEC is realised on the date on which the payment is made or received per the agreement entered into between the parties of the agreement. If an FEC is realised during a year of assessment, the foreign exchange gain or loss calculated on the realisation date will be accounted for as a realised gain or loss.

If an FEC is unrealised at the end of a year of assessment, the foreign exchange gain or loss calculated on translation date will be unrealised.

Section 24I(3) requires taxpayers to calculate an exchange difference that will be taken into an account in their tax computation. Two types of exchange differences are highlighted in the definition of an exchange difference, firstly the difference between the ruling exchange rate on the date on which the FEC was entered into, and ruling exchange rate on the date on which the FEC is realised. Secondly, and in the instance where an FEC was not realised during the course of a year of assessment, the difference between the ruling exchange rate on the date on which the FEC was entered into and ruling exchange rate at the end of a year of assessment, referred to as the translation date.

In addition to the two types of exchange differences explained above, the definition of exchange differences also explains the situation where an FEC was translated at the end of the immediately preceding year of assessment and was either realised in the current year of assessment or unrealised at the end of the current year of assessment.

In this case the exchange difference is calculated between the ruling exchange rate that was used to translate the FEC at the end of the immediately preceding year of assessment, and the ruling exchange rate on the date on which the FEC is realised during the current year of assessment. Alternately, where the FEC remains outstanding at the end of current year of assessment, the difference between the ruling exchange rate that was used to translate the FEC at the end of the immediately preceding year of assessment and the ruling exchange rate at the end of the current year of assessment.

Chapter 3: Unpacking the market-related forward rate

In an environment where multinational corporations are constantly exposed to foreign exchange risk and enter into FEC's to mitigate against this risk, it can be assumed that one of the most common calculations that such corporations would encounter would be the calculation of their foreign exchange gains or foreign exchange losses on these FEC's.

Section 24I dictates that where an FEC is realised during a year of assessment, the foreign exchange gain or loss is calculated by multiplying the FEC by the difference between the ruling exchange rate on transaction date and the ruling exchange rate on the date that such FEC is realised. The ruling exchange rate on transaction date will be the forward rate per the FEC contract entered into. The ruling exchange rate on the realisation date will be the spot rate on the date that the FEC is realised.