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Risks of IFRS-based taxation: The application of section 24JB by authorised users to hedged relationships

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Abstract
Section 24JB of the *Income Tax Act 1962* introduced IFRS-based taxation in South Africa. This research aimed to identify risks of IFRS-based taxation by performing a conceptual analysis of the application of section 24JB to hedging relationships of authorised users. The analysis identified a number of timing mismatches that arise and interpretation uncertainty when section 24JB is applied to such hedging relationships. The findings suggest that for IFRS to be an appropriate basis for taxation, its use as a tax base should be limited to specific narrowly-defined transactions as opposed to classes of instruments or persons. For such transactions, all elements of IFRS that are relevant to the transaction should be incorporated into the tax base to avoid mismatches.

1. INTRODUCTION

The South African National Treasury introduced section 24JB into the *Income Tax Act 1962* (Act No 58 of 1962) (the Act)[2] with effect from years of assessment ending on or after 1 January 2014 (*Taxation Laws Amendment Act 2013* (Act No 31 of 2013)). This provision was a first for South African tax legislation as it introduced International Financial Reporting Standards (IFRS) into the Act as a basis for determining the amount to be subject to income tax for certain financial instruments.[3] This amendment was introduced to simplify compliance by eliminating the need for complex adjustments to determine taxable income as well as enforcement by the tax authorities by requiring that certain entities determine their income for tax purposes in respect of specific financial instruments in accordance with the rules applied for financial reporting purposes (National Treasury, 2013).

The application of section 24JB is mostly limited to financial institutions, as opposed to taxpayers in general. It does however also apply to certain non-banking institutions that are authorised users as defined in section 1 of the *Financial Markets Act 2012* (Act No 19 of 2012) (FMA). These entities include commodity traders as well as entities licensed to buy or sell certain listed securities using the Johannesburg Securities Exchange (JSE) trading system. These securities may include commodity derivatives, the entities' own publicly traded debt instruments traded for market making purposes or interest rate instruments held for their own account. The derivative instruments in respect of which a person is an authorised user are often traded for the purposes of hedging certain risk expo

financial assets and financial liabilities that are *recognised in profit or loss* in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that *are recognised at fair value in profit or loss*. Instruments that are not measured at fair value are not affected by section 24JB. This would typically be loans and receivables that are carried at amortised cost (PWC, 2014). Section 24JB therefore does not apply IFRS as the overall tax base, but rather applies it selectively to certain elements, an approach also suggested by Harris (2013) in part 2.3 above.

An anti-avoidance rule exists for agreements entered into between a covered person and a person that is not a covered person with the sole or main purpose of abusing the timing differences that arise between the normal tax base for non-covered persons and the tax base applied by section 24JB (section 24JB(4)).

The remainder of section 24JB deals with transitional provisions upon the initial implementation of section 24JB and the treatment should an entity cease to fall within the scope of this provision. These provisions are beyond the scope of this article and are therefore not considered in further detail.

3.1.3 Application of section 24JB to hedged relationships

Neither section 24JB nor the explanatory memorandum that was issued when section 24JB was introduced (National Treasury, 2013) explicitly state whether the provision applies to or excludes hedging relationships. de Jager et al. (2012) identified the uncertainty in this regard as one of the criticisms against the initial draft version of the provision. Maroun (2015) found the final provisions of section 24JB to be ambiguous as far as hedge accounting is concerned.

The definition of a financial asset for the purposes of section 24JB has been drafted to specifically include 'a commodity taken into account in terms of IFRS at fair value less cost to sell in profit or loss in the statement of comprehensive income'. IAS 2 *Inventories* (IAS 2), the accounting standard that deals with inventory, generally requires inventory to be measured a cost or net realisable value, if this is lower than cost (International Accounting Standards Board, 2015b). It contains an exception for broker-traders who may measure their stock at fair value less cost to sell (International Accounting Standards Board, 2015b). A broker-trader is a person who buys commodities for others or on their own account with the purpose of selling them in the near future and generating a profit from fluctuations in price or broker-traders' margins. The definition of a financial asset in section 24JB refers to this exception in IAS 2. Section 24JB(2) requires that the income of a covered person should include or be reduced by amounts recognised in profit or loss in the statement of comprehensive income in respect of such commodities measured at fair value less cost to sell in profit or loss in terms of IFRS. No specific explanation for the inclusion of these inventory items into the scope of section 24JB was provided in the explanatory memorandum (National Treasury, 2013). It is, however, submitted that these items may often be

In addition, as further elaborated in part 4 below, hedge accounting requires measurement of the hedging instrument at fair value. Changes in this fair value are recognised in profit or loss. The timing of the recognition of these amounts in profit or loss depends on the type of hedge and when the hedged item impacts on profit or loss. IAS 39 uses very specific terminology.

A strong argument therefore exists for the view that section 24JB does in fact apply to instruments to which hedge accounting is applied. This conclusion is in line with the views of de Jager et al. (2012) who also came to the conclusion that it appears as though the intention of the Legislature was to tax all value changes from hedged items under section 24JB.

3.2 Other provisions of the Act related to hedged relationships

The Act does not contain any provision that is exclusively aimed at governing the taxation of hedged relationships. The tax implications of the hedged item or transaction and those of the hedging instrument, which is often a derivative instrument, will be determined separately in terms of the provisions generally applicable to the transaction or instrument in an unhedged position. Provisions of the Act that may be relevant to the item being hedged may include section 24J, which deals with interest, and section 24I, which deals with exchange differences, in the case of a loan. Similarly, the Act contains certain provisions applicable to derivatives irrespective of whether they form part of a hedged relationship or not, for example, section 24K and 24L that deal with interest rate agreements and options respectively (Rudnicki, 2003; Masondo, 2009).

In addition to the above, certain subsections of section 24I are aimed at instruments entered into to hedge exchange risk exposure. In the context of forward exchange contracts (FEC) and foreign currency option contracts (FCOC) section 24I contains specific timing provisions in relation to affected contracts to ensure that any exchange gain or loss in respect of a FEC or FCOC is only taken into account when determining taxable income once the debt which is hedged by such an instrument has come into existence during the year. This will to some extent ensure that the gain or loss on the hedging instrument is matched from a timing perspective with the correspondinghe .1 -.6 (i)-4.6 (t)-4

timing perspective, but also matching as far as the element of the financial statements where such gains or losses are recognised (i.e. in profit or loss or other comprehensive income) is concerned (PWC, 2014). IAS 39 prescribes rules for hedge accounting. Hedge accounting treatment overrides the ordinary treatment of the hedged instrument, and in some instances, the hedged item. The definition of a financial asset or financial liability at fair value through profit or loss excludes derivative instruments that are designated and effective hedging instruments from being classified as held for trading, and consequently from being categorised as financial instruments at fair value through profit or loss (definitions in IAS 39.9). g

amount of the asset or liability that results from the firm commitment in accordance with IAS 39.94.

Cash flow hedge accounting on the other hand does not affect the accounting treatment of the hedged item that gives rise to the cash flow to expose the reporting entity to a particular risk. IAS 39.95 requires that the portion of the gain or loss on the hedging instrument that is an effective hedge in terms of IAS 39.88 be recognised in

the agreement with the producer to be accounted for as if it was a derivative financial instrument. It is important to note that both of these scenarios are likely to reflect the neutral economically hedged position in the profit or loss of the commodity broker and entities may elect not to apply hedge accounting for this reason. However, section 24JB only applies to financial assets (which includes inventories as discussed in part 3.1.2) and financial liabilities. It does not apply to firm commitments or to items that are accounted for as if they were financial instruments. As such, the commodity broker will be required to include the gains or losses on the hedging instrument in its taxable income on the same basis as financial reporting, while the gains or losses on the hedged item will follow normal tax principles which require realisation of the transaction before its effect is taken into consideration in taxable income. This timing mismatch arises only for purposes of taxation, while accounting reflects the economically neutral position.

Once the commodity trader holds the inventory it will enter into a further derivative that offsets the movements in the value of the commodity held. This can be a SAFEX traded derivative contract (forward sales agreement) or a sales contract with a purchaser to deliver the commodity at a future date. If hedge accounting is applied to this relationship this will be a fair value hedge of the inventory on hand. As such, the changes in fair value of the commodity inventory will be recognised in profit or loss (IAS 39.89(b)) as opposed to IAS 2. The changes in the fair value of the derivative instrument will be recognised in profit or loss in terms of IAS 39.89(a). In this instance, the derivative contract will fall within the scope of section 24JB, while inventory that is not accounted for in terms of IAS 2 will be outside the scope of the provision and any gain or loss will only be reflected once the product is sold. A timing mismatch will again arise.

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Although the positions of infrastructure developing entities that are members of the JSE in respect of certain instruments and commodity brokers highlight various mismatches that can arise when using IFRS as a basis for determining taxable income, the ultimate broader finding is similar.

In the context of infrastructure developing entities that are members of the JSE in respect of certain instruments, which are likely to represent a very small part of their overall activities, the question can be posed whether all financial instruments of a certain category should be tainted and possibly be taxed in accordance with IFRS merely by reason of the fact that these entities are members of the JSE in relation to some instruments. The mismatches caused by the wide application of section 24JB to all instruments of a certain class of a covered person, irrespective of whether that is the instrument in respect of which the covered person is a member of the JSE or not, shows the risk of possibly casting the scope of a tax provision, which is motivated mainly by convenience, too wide. As such, it is submitted that the lesson to be taken from this aspect of section 24JB is that where IFRSor2 3.4 (ab 0.01s)-22the2..9 (()-2.6)-1.tr9in c

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