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Pieter van der Zwan

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

Pieter van der Zwan¹

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.

Key words: Financial instruments, hedged relationship, IFRS-based taxation

¹ Associate Professor, North-West University (South Africa). pieter.vanderzwan@nwu.ac.za

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 exposures of the authorised person. The scope of section 24JB was further narrowed by amendments at the end of 2016 to exclude companies whose principal trading activities constitute a treasury operation.

A hedging relationship involves two elements, namely an underlying transaction or exposure to a risk and an instrument used to hedge some or all of the risks arising from the exposure. Where a hedge has been entered into to cover an exposure to a risk arising from the hedged transaction, the entity should no longer be economically exposed to the effects of the particular risk to the extent that the hedge is successful (Correia et al., 2003; PWC, 2014). Any exposure to losses, but also the potential for gains, resulting from the hedged risk is neutralised.

Maroun (2015) found that the use of IFRS as a basis of taxation in terms of section 24JB may have certain problematic outcomes, with hedge accounting being one such area. As section 24JB only applies to certain financial instruments, the risk exists that the two elements of a hedging relationship do not fall within the scope of this provision. It is posited that section 24JB, in particular prior to its amendment in 2016, may in some instances not fully recognise the hedged relationship and result in tax consequences that do not reflect the economic transaction that has been entered into to hedge the risks.

The research question that is considered in this article is whether section 24JB, prior to the amendment in 2016,⁴ succeeded in reflecting the economic outcome of such

² Any reference to a section in this article refers to a section of the Act unless indicated otherwise.

³ The Act contains other references to IFRS as part of the criteria to determine how a transaction or event should be treated or classified from a tax perspective but not as a basis to determine the amount to be taxed.

⁴ Any reference to section 24JB in the remainder of this article refers to the provision prior to the amendment in 2016.

hedged relationships in the taxable income of authorised users to which it applies. The research reflects the findings of a conceptual analysis of the alignment between the treatment required by section 24JB and the hedge accounting principles in IFRS. The intended contribution of the research is to highlight to a broader global audience some of the specific risks that IFRS-based taxation may pose, using the application of section 24JB to hedging relationships as an illustration. In light of this objective of the research, the contribution of the research is not affected by the amendments to section 24JB that were made at the end of 2016. It is submitted that the need for these amendments confirm the validity of some of the risks of IFRS-based taxation, as identified in this research, that may be of relevance to a global audience.

The discussion in this article commences by considering profitability measures used for tax and financial reporting purposes and the possible overlap of these measures. The provisions of section 24JB in the context of hedged relationships are then considered. This is followed by a discussion of the principles of hedge accounting contained in IFRS. A conceptual analysis is performed to determine whether the use of IFRS as a basis for taxing financial instruments in accordance with section 24JB reflects the economic outcome of the hedged relationship in an entity's taxable income. The article concludes by presenting the specific risks of IFRS-based taxation, as identified from the conceptual analysis, which would be of relevance to any tax authority that considers using IFRS as a basis for taxation.

2. CONCEPTUAL ANALYSIS OF PROFITABILITY MEASURES

Section 24JB of the Act uses a profit measure determined in terms of accounting standards as a basis for taxation. This part of the article considers the objective of information prepared for financial reporting purposes and compares this to the objective of a measure of profits for purposes of taxation.

2.1 Financial reporting

Financial statements are prepared with the aim of providing information that can be used for economic decision-making by a broad range of users. These users include existing or potential investors, lenders and creditors (International Accounting Standards Board, 2015a). Traditionally, the purpose of information reported in financial statements was to provide information to business owners who were separated from those who managed and operated the business on a day-to-day basis. The information reported fulfilled a stewardship function as managers reported historic results of the businesses that they were entrusted to operate (Whittington, 2008). This purpose has evolved and a much greater focus is now placed on financial reporting that provides users with an indication of the current value of the reporting entity. This includes the use of forward-looking estimates and the measurement of balance sheet items at fair value rather than on a historical cost basis (Ball, 2006). Earnings reported in profit or loss for accounting purposes reflect not only historic and realised earnings, but also a measure of anticipated future earnings that may be relevant to stakeholders interested in valuation (Atwood et al., 2011). The balance sheet and earnings therefore reflect information that does not directly show the real net cash flows of an entity due to the fact that unrealised fair value gains or losses are also reflected. In contrast with historical cost accounting, which reported realised profits following exchange events, the use of a combination of historical cost and fair value as a reporting basis provides investors with relevant information about unrealised risk

exposures of a firm that may affect such investors in future (Nutter, 2010; Linsmeier, 2011).

2.2 Corporate tax base

Corporate tax is a direct taxation imposed on realised creations of wealth and payments (Harris, 2013). Manzon and Plesko (2001) describe the primary objective of tax law in defining taxable income or taxable profits as providing a framework to determine efficient and equitable tax liabilities in order to collect revenues to fund government expenditure. This basis for collecting taxes generally requires that income should only be taxed once such income has been severed from the capital that produced it, hence the development of the important distinction between income and capital for the purposes of determining taxable income (Holmes, 2001). If the historic or current value capital were to be taxed before realisation of the value to be derived from it, the risk exists that a taxpayer would have to dispose of some of this capital that will produce further income to be able to pay the tax. In the long run this will result in a shrinking tax base.

2.3 Differences and overlap between these profit measures

A comparison of the profitability measures for financial reporting and as a base for corporate tax highlights certain fundamental differences between the objectives of the respective profit measures. Users of financial statements may be interested in not only historical reporting but also a measure of forward-looking information which is provided by estimates and fair value accounting. Tax authorities, on the other hand, should ideally collect a share of wealth generated by taxpayers without requiring taxpayers to find cash to pay tax on gains not yet realised. Shevlin (2002) suggests that it is unlikely that a single set of rules can serve investors, lenders and other users as well as provide governments with a basis to fund social and economic objectives, while managing political interests at the same time.

Accrual or fair value based tax has been proposed by numerous authors. The main criticisms raised against a tax being imposed on accrual of value rather than on the realisation of value are based on problems arising from valuation and liquidity (Shakow, 1985). Concerns regarding liquidity to pay tax on unrealised gains in light of the need to preserve the tax base, as raised by Holmes (2001), are arguably closely related. The use of accounting profits, in particular accounting profits that include fair value measures, may therefore pose liquidity risks. In the long run this may require disposals of capital assets that may have an unrealised fair value to pay taxes. This would in turn gradually reduce the capital bases that produce income to be taxed, thereby causing a shrinking tax base. The liquidity impact of linking the tax base to an IFRS-based measure of profit was considered by the South African National Treasury when section 24JB was introduced. These concerns were mitigated by the fact that the scope of the provision is limited to instruments measured at fair value with movements in profit or loss. These instruments would generally be more liquid instruments held with a short-term or trading intention (National Treasury, 2013; Maroun, 2015). Given the short duration of the instruments, the effect of taxing unrealised gains is unlikely to be significant. In addition, specific items that could have caused liquidity problems are excluded from the scope of the provision in section 24JB (2).

Despite the differences in the objectives of the two profit measures, a degree of overlap exists between accounting profits and taxable profit. As a result, accounting profits are used as a basis for taxation in practice (Harris, 2013). However, a corporate tax base that mirrors accounting profits is an extreme that does not exist to any identifiable extent in practice. Some jurisdictions use certain elements of IFRS to determine taxable income. Harris (2013) found that the vast majority of countries recognise the relationship between accounting profits and taxable profit by requiring the use of accounting profits as a starting point for the calculation of taxable income. Shevlin (2002) suggests that this approach may reduce the ability of firms to shelter reported income from being subject to tax, as companies would generally not understate information reported in their financial statements for various reasons, including potential violation of loan covenants and negative impacts on management compensation. In South Africa, the Act prescribes a specific framework to be followed to determine taxable income. This framework is generally not linked to accounting profits. Some information contained in the financial statements, mostly historic information about transactions concluded during the period, is relevant to the tax authorities. The corporate tax return (ITR14) acknowledges this relationship between financial reporting information and taxable income as it requires profit before tax to be reconciled to taxable income (South African Revenue Service, 2016). The South African National Treasury advanced that one of the main reasons for implementing IFRS-based taxation in section 24JB was the fact that adjustments between tax and accounting profits for entities to which section 24JB apply became so divergent that it was prone to inaccuracies (National Treasury, 2013).

3. AN OVERVIEW OF SECTION 24JB AND TAX PROVISIONS RELEVANT TO HEDGED RELATIONSHIPS

3.1 Section 24JB

3.1.1 Scope of section 24JB

Section 24JB was introduced to simplify the adjustments required between accounting and taxation for large volumes of financial instruments (National Treasury, 2013). As such, it is not a provision that was intended to apply to all taxpayers. The narrow scope of the provision is reflected in its application to covered persons, a term defined in section 24JB(1). It is submitted that the persons included in this definition can be separated into two categories.

Firstly, it includes financial institutions. The definition lists the South African Reserve Bank, any bank, branch, branch of a bank or controlling company as defined in the *Banks Act 1990* (Act No 94 of 1990) (Banks Act). It also includes any company or trust forming part of a banking group as defined in the Banks Act. It does not include insurance companies or subsidiaries of insurance companies.

The second category is any authorised user as defined in section 1 of the FMA. An authorised user is defined in the FMA as a ‘person authorised by a licensed exchange to perform one or more securities services in terms of the exchange rules, and includes an external authorised user, where appropriate’. Security services include the buying or selling of securities for a person’s own account or on behalf of another person as a business, as part of a business or incidental to conducting a business, as well as the use of the trading system or infrastructure of an exchange to buy or sell listed securities.

Securities, in turn, include listed and unlisted shares, debentures, bonds, derivative instruments, notes and certain participatory interests in collective investment schemes. These authorised users are members of the JSE, as published on its website (JSE, 2017). Unlike the entities in the first category, they are not necessarily involved in the business of banking. They would rather deal with the instruments in respect of which they are authorised users in their course of their businesses. This category includes various commodity brokers and traders as members in relation to commodity derivatives. It also includes state-owned entities, such as Eskom SOC Ltd (the South African electricity utility), Telkom SOC Ltd (the South African telecommunications entity), as well as the Trans-Caledon Tunnel Authority and Transnet SOC Ltd (both involved in transport infrastructure in South Africa), that are members in relation to interest rate instruments (bonds) and certain equity derivatives.⁵ These state-owned entities are involved in significant infrastructure development (Fourie, 2001). The focus of this article, in particular the analysis in part 5, is on the application of section 24JB to authorised users, rather than banks and financial institutions.

3.1.2 *The charging provisions of section 24JB*

The charging provisions of section 24JB override the application of the normal principles that determine the timing of taxation of income or deductibility of expenditure (section 24JB(3)). Instead, section 24JB(2) determines that a covered person must include or deduct from income:

all amounts in respect of financial assets and financial liabilities of that covered person that are recognised in profit or loss in the statement of comprehensive income in respect of financial assets and financial liabilities of that covered person that are recognised at fair value in profit or loss in terms of International Accounting Standard 39 of IFRS or any other standard that replaces that standard...

This would include specific instruments and amounts that would disturb the neutrality of the corporate tax system or pose a risk to the tax base. Exclusions exist for these items. The first such exclusion is for certain listed items that are financial assets that were designated upon initial recognition in terms of International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement* of IFRS (IAS 39) (International Accounting Standards Board, 2015d) by the covered person to be accounted for at fair value through profit or loss because that financial asset is managed and its performance is evaluated on a fair value basis (section 24JB(2)(a)). The second exclusion is for any dividend or foreign dividend received in respect of an instrument measured at fair value that was recognised in profit or loss. These amounts should remain exempt as taxing dividends would disturb the exemption of dividend income at the shareholder level that is available to other taxpayers, which was not the intention with section 24JB (section 24JB(2)(b)).

Section 24JB(2) is the provision that results in amounts recognised in terms of IFRS in respect of the instruments listed in that section being used as the basis for taxing those amounts. The use of IFRS as a basis for taxation is limited to *amounts in respect of*

⁵ These entities may arguably fall outside the scope of section 24JB following the amendments in 2016. This would however depend on the purposes of their trading activities, which depend on the circumstances of each particular entity. In light of the broader objective of this article, as set out in part 1, it is beyond the scope of this article to consider the effect of the 2016 amendments on each such entity.

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 hedged by commodity forward contracts or commodity futures that fall within the scope of IAS 39 and therefore also within the scope of section 24JB. Failure to include both elements into the tax base would arguably have resulted in a timing mismatch between the gains and losses recognised in respect of an economically hedged commodity carried by the entity (de Jager et al., 2012). This would suggest that the provisions of section 24JB were intended to apply to such relationships.

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. This includes a category of financial instruments for *financial assets or financial liabilities at fair value through profit or loss*. This category of financial instruments specifically excludes instruments that form part of a hedging relationship. The wording of section 24JB(2) does not require a financial asset or financial liability to fall into this category to be within the scope of section 24JB(2). Section 24JB(2) refers to ‘amounts in respect of ... financial assets and financial liabilities of that covered person that are recognised at fair value *in* profit or loss’ (emphasis added). In the exclusions to section 24JB(2), specific reference is made in paragraph (a) to instruments designated as ‘at fair value *through* profit or loss’ (emphasis added). Given that section 24JB refers to the correct terminology in accordance with IAS 39 elsewhere in the provision, this suggests that it would be correct to conclude that the scope of section 24JB is wider than merely those amounts relating to instruments that strictly fall within the fair value *through* profit or loss category in IAS 39. Similar views on the scope of section 24JB(2) are held by Maroun (2015).

The above approach to interpreting the wording of the legislation by considering the actual wording (in this case, the word ‘in’ as opposed to ‘through’) is supported by the views expressed in *R Koster & Son (Pty) Ltd & another v CIR* 47 SATC 23, 1985 (2) SA 834 (A) that:

in construing a provision of an Act of Parliament the plain meaning of its language must be adopted unless it leads to some absurdity, inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended.

The intention of the Legislature with section 24JB in the context of a hedged relationship would therefore be important. The wording of section 24JB(2) was specifically amended from the initial Bill where section 24JB appeared for the first time. The initial version of section 24JB would have applied to financial instruments recognised *through* profit or loss. Similarly to the final version, it contained certain exclusions. The exclusions however only applied to unhedged positions (*Taxation Laws Amendment Act 2012* (Act No 22 of 2012)). At the time, the National Treasury explained this carve out from the exclusion, which effectively brought hedged positions within the scope of section 24JB, on the basis that the hedged items would also fall under the mark-to-market system. In light of this, the application of section 24JB to a hedged position would not cause any liquidity concerns that may otherwise arise from the items excluded from section 24JB (National Treasury, 2012). This explanation implies that it was intended that items that form part of a hedged relationship should fall within the IFRS-based tax treatment. The broadening of the scope of section 24JB to instruments measured at fair value in profit or loss, as opposed to strictly only those that fall into the IAS 39 category of financial instruments measured at fair value through profit or loss, supports the argument that section 24JB applies to hedged relationships where the components are measured at fair value with changes recognised *in* profit or loss, even though these items do not fall into the IAS 39 category of instruments at fair value *through* profit or loss.

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 corresponding loss or gain, as the case may be, on the hedged debt (de Koker & Williams, 2016). Furthermore, section 24I(7) determines that where a debt has been used to fund the acquisition of certain assets that have not yet been brought into use in the taxpayer's trade, the exchange differences arising on such a loan should only be taken into account by the taxpayer once the asset is brought into use. Sections 24I(7)(b) and (c) state that an exchange gain or loss on an instrument (FEC or FCOC) entered into to hedge such a loan will follow the same deferral treatment as the exchange differences on the loan.

Other than the above provisions of section 24I, which make explicit reference to a hedged relationship, the normal principles contained in the definition of gross income in section 1(1) and the deduction in section 11(a) of the Act will govern the tax treatment and timing of such implications of derivatives used for hedging purposes (Brincker, 2010). The intention and motive of the taxpayer for entering into the derivative instrument is of importance. In the case of a hedged relationship this intention will be more closely linked to the hedged transaction than to trade or speculate with the derivative instrument (Kruger, 2015).

4. AN OVERVIEW OF HEDGE ACCOUNTING PRINCIPLES

From an accounting perspective, the objective of hedge accounting is to ensure matching of the treatment of the components to the hedged relationship, being the hedged item and the hedging instrument. This primarily includes matching from a

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).

In order to qualify for hedge accounting, IAS 39 requires that certain criteria be met. These include that the hedged relationship must have been formally designated and documented at inception (IAS 39.88(a)). The hedge must be expected to be highly effective in offsetting the changes in the fair value or cash flow attributable to the hedged risk (IAS 39.88(b)). IAS 39.88(d) and (e) furthermore require that the effectiveness of the hedged relationship must be reliably measurable and that the hedge must have been determined to actually be effective throughout the periods designated. This is the so-called retrospective effectiveness test. These requirements are amended by IFRS 9 *Financial Instruments* (IFRS 9) (International Accounting Standards Board, 2015e) to more closely reflect the commercial realities of hedged relationships. As this standard only becomes effective on a compulsory basis for annual periods beginning on or after 1 January 2018 (IFRS 9.7.1.1.), the changes to hedge accounting have not been taken into account for the purposes of this research.

IAS 39 distinguishes between three types of hedged relationships. Only two are relevant for the purposes of this discussion. These are fair value and cash flow hedge relationships.

A fair value hedge is described in IAS 39.86(a) as ‘a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss’. Where such a hedged relationship exists, IAS 39.89 requires that the gain or loss from the remeasurement of the hedging instrument at fair value in the case of a derivative hedging instrument be recognised in profit or loss. In order to achieve matching and reflect the hedged relationship in the reporting entity’s profit or loss, it requires that the gain or loss on the hedged item attributable to the hedged risk (i.e. a change in fair value of the item due to identified risks) also be recognised in profit or loss. This is the case irrespective of whether such an item would otherwise have been measured on another basis in the absence of hedge accounting.

An aspect of fair value hedge accounting that is of particular relevance for this research is the inclusion of hedges of exposure arising from unrecognised firm commitments. IAS 39 defines a firm commitment as ‘a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates’. Accounting matching is achieved by recognising an asset or liability for the gain or loss made on the unrecognised firm commitment, with the corresponding entry being recorded in profit or loss (IAS 39.93). This effect in profit or loss offsets the gains or losses on the hedging instrument. When the firm commitment realises and the entity acquires an asset or assumes a liability, this asset or liability contemplated in IAS 39.93 should be set off against the initial carrying

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 other comprehensive income (hedging reserve). IAS 39.88 views a cash flow hedge as effective if the changes in the fair value of the hedging instrument offset the changes in the cash flow resulting from the hedged risk. Unless the relationship involves hedging of risks from forecast transactions, IAS 39.100 requires the amounts recognised in the hedging reserve in respect of the hedging instrument to be reclassified to profit or loss when the hedged forecast cash flow affects profit or loss. In this manner, the effects of the hedged transaction and hedging instrument are taken into account in profit or loss at the same time.

5. MISMATCHES CAUSED BY SECTION 24JB IN THE CONTEXT OF HEDGED RELATIONSHIPS

This section of the article highlights mismatches that arise when section 24JB is applied to certain types of hedged relationships by authorised users. These scenarios considered arise from practice and the tax implications thereof under section 24JB have not previously been documented in literature.

5.1 Authorised users involved in infrastructure development

South African entities involved in infrastructure development are likely to be exposed to risks arising from the arrangements entered into to fund these developments. These risks are likely to be exchange risk and interest rate risk. An interest-bearing loan from an external funder will be measured at amortised cost in terms of IAS 39. The interest on the loan will be recognised in profit or loss in accordance with the effective interest rate method, while any exchange differences arising on the instrument and the accrued interest will be accounted for in terms of IAS 21 *The Effects of Changes in Foreign Exchange Rates* (IAS 21) (International Accounting Standards Board, 2015c). This standard specifies how exchange differences should be determined and recognised in profit or loss (IAS 39.AG83). The loan, interest and related exchange differences are therefore not accounted for at fair value. If the loan is designated as a fair value hedge, one may however be able to argue that IAS 39.89(b) changes this treatment as it requires the gain or loss on the hedged item to be recognised in profit or loss.

The hedging instrument is always measured at fair value (refer to the discussion in part 4). In the case of a fair value hedge, the timing of the recognition of any gain or loss on the hedging instrument is matched with the timing of the gain or loss on the hedged item. In the case of a cash flow hedge, the recognition of the fair value movements on the hedging instrument is deferred until the hedged cash flow affects profit or loss. Under both fair value and cash flow hedge accounting, the neutral hedged position (i.e. neutral from the perspective of economic gains or loss in respect of the hedged risk) will ultimately be reflected in profit or loss.

From a tax perspective however, section 24JB will only apply to elements of the hedged relationship that are financial assets or liabilities measured at fair value and for which amounts are recognised in profit or loss. This will be the hedging instrument, which in the case of exchange and interest risk exposure is likely to include FEC, interest rate derivatives or cross currency swaps. In the case of a fair value hedge, this fair value gain or loss is taken to profit or loss immediately. In the case of a cash flow hedge, the gain or loss is initially deferred but will ultimately be recognised in profit or loss and should therefore be within the scope of section 24JB. The effect of the application of section 24JB is that the gains or losses on these instruments will be included or deducted, as the case may be, from taxable income when such gains or losses are recognised in profit or loss for accounting purposes.

As the loan, the hedged item, does not fall within the scope of section 24JB (at least in the case of cash flow hedge accounting), the provisions of section 24J, dealing with interest, and section 24I, dealing with exchange differences will be relevant. These provisions are generally aligned with the accounting treatment which will result in there being no timing mismatch. However, when the asset funded by the hedged loan is still under construction or has not yet been taken into use, section 24I(7) applies (refer to the discussion in part 3.2). The effect of this provision is that any exchange gains or losses are deferred until the asset is taken into use. As a result, the taxpayer may be in a position where the gains or losses on the hedging instruments are taken into account in taxable income when recognised in profit or loss for accounting, while some of the gains or losses attributable to the hedged risk (hedged item) are deferred on the basis of whether the asset is in use or not by a tax provision. This could result in a taxpayer being liable for tax on the gains made on a hedging instrument in times when the underlying risk on the hedged item realises, but the assets funded by the hedged item are not yet in use. This issue may to an extent be eliminated by the 2016 amendments as the entities may be authorised users primarily for treasury activity purposes.

5.2 Commodity brokers and traders who are authorised users

Commodity brokers will enter into hedged relationships in respect of commodities prior to the acquisition of the commodities and while holding the commodities with a view to selling them in the future. In South Africa the risk exposures from these transactions or events are hedged with derivative instruments listed on the JSE SAFEX (Middelberg & Buys, 2012). These derivatives are the instruments in respect of which a commodity broker will be an authorised user (refer to the discussion in part 3.1.1).

In the case of a contract with a producer to acquire the commodity in the future, the commodity broker may enter into a forward contract to sell the commodity at a determined price at a date around the delivery date. In this manner, the commodity broker ensures that it will acquire the commodity to trade in the future but is not exposed to price risk from its arrangement with the producer. The contract entered into with the producer will represent a firm commitment for the purposes of IAS 39. If the commodity broker applies hedge accounting, IAS 39 requires that the gains or losses on the derivative as well as the corresponding losses or gains in respect of the firm commitment be recognised in profit or loss. As indicated in part 4, the amounts recognised in respect of the firm commitment movements will ultimately be treated as an adjustment against the purchase price of the commodity when it is acquired. If the relationship is not accounted for using hedge accounting, IAS 39.5–39.7 may allow

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.

6. RISKS OF IFRS-BASED TAXATION AS ILLUSTRATED BY THE APPLICATION OF SECTION 24JB TO HEDGING RELATIONSHIPS OF AUTHORISED USERS

IFRS-based taxation may simplify the process of determining taxable income (National Treasury, 2013). However, certain liquidity risks arise when tax is imposed on a basis other than on a realised gain or loss basis. Some of these mismatches are evident from the analysis of the application of section 24JB to hedged relationships in part 5 above. The irony of this finding in the context of the application of section 24JB to hedged relationships is that the impact of the relationship is neutral on accounting for profit or loss but not on taxable income. It is submitted that this finding stems from the fact that in each of the instances considered in part 5 above, one element of the hedged relationship was within the scope of section 24JB (the hedging instrument), while the other (hedged item) was not. Even though Harris (2013) warns against tax provisions that fully mirror IFRS, the scenarios considered illustrate the risk of partially applying certain provisions of IFRS as a basis for taxation. If all the IFRS provisions relevant to a transaction are not included in the tax base, a mixed tax base could apply to a single transaction. This has the potential to cause mismatches such as the ones illustrated in part 5. It is submitted that both the approaches of a tax base that fully mirrors IFRS or a partial or adapted IFRS basis may be problematic. This casts doubt about the appropriateness of IFRS as a basis for taxation.

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 IFRS-based taxation is applied, this should be limited to narrow and well-defined transactions where this may be appropriate as opposed to overall classes of persons and instruments.

In the context of commodity brokers and SAFEX derivatives, the provisions of section 24JB are not necessarily the only cause of the mismatch. As these derivatives (hedging instruments) are marked-to-market and settled on a regular basis, some arguments may exist that these mismatches could have existed previously as well. As such, the use of IFRS, which takes the hedged relationship that the derivative forms part of into account, should be welcomed by the affected taxpayers as a positive development. In light of this it is submitted that the use of IFRS as a basis for taxation will not necessarily be inappropriate, especially in cases where the accounting treatment reflects the economic substance of a transaction. Similarly to the conclusion in relation to infrastructure developing entities, the recommendation in this regard is however that it may be more appropriate to follow IFRS principles for specific well-defined transactions where it may be appropriate, in this instance, hedged relationships entered into by commodity brokers. The views expressed in the context of infrastructure developing entities are also relevant in this context of commodity brokers, as the wide inclusion of instruments based on the nature of the person as an authorised person may include certain trading instruments not used for hedging that the commodity broker may have into the fair value tax net while the person is not an authorised user in respect of all of these instruments.

Where a transaction exists for which IFRS may be an appropriate basis for taxation, it is imperative that *all* the relevant IFRS provisions be used as a basis for taxation to avoid mismatches. It is submitted that section 24JB lacks in this regard as it does not recognise hedging concepts used for accounting purposes, for example, firm commitments. Similarly, it does not apply to inventory remeasured under hedge accounting or hedged items affected by cash flow hedge accounting. As a related point it is submitted that linking tax law to another framework would require the Legislature to be, and constantly remain, up-to-date with any changes to how IFRS may have an impact in any manner on the tax base. The imminent transition to IFRS 9, which contains its own hedging rules, is a good example of this. Maroun (2015) similarly identified the risk that tax law linked to IFRS may no longer be fully within the control of the Legislature, even though this concern would partially be addressed by carve outs in the tax legislation where the accounting treatment may pose a

particular tax risk. However, such carve outs run the risk of causing mismatches. It is submitted that if the use of IFRS as a basis for taxation ends up requiring various complex carve outs, tax law drafted to have a similar outcome to IFRS would be a more feasible alternative.

As a last observation from the analysis in part 3.1.3, it is submitted that when linking one framework (in the case of section 24JB in determining taxable income) to another (elements of IFRS-based profit or loss), the use of accurate terminology is of utmost importance. If the phrase ‘amounts in respect of ... financial assets and financial liabilities of that covered person that are recognised at fair value *in profit or loss*’ (emphasis added) in section 24JB is interpreted as referring to the IAS 39 category of *financial assets or financial liabilities at fair value through profit or loss*, this has a significant effect as this IAS 39 category of financial instruments excludes derivative instruments that form part of a hedged relationship. Uncertainty of this nature does not contribute to the objective of simplification of the taxable income calculation.

7. CONCLUSION AND RECOMMENDATIONS

This article considered whether section 24JB of the Act succeeds in reflecting the economic outcome of such hedging relationships in the taxable income of authorised users who are required to apply this provision. The research however aimed to achieve a broader objective by illustrating some of the risks of IFRS-based taxation from the analysis of section 24JB.

In relation to the detailed provisions of section 24JB, part 5 of this article contains a number of technical concerns that should be considered by the Legislature to ensure that this section has no unintended consequences when it is applied to hedged relationships of authorised users. Some of these concerns may have been addressed by the 2016 amendments to section 24JB. The analysis of the provision prior to its amendment is however useful as it illustrates the risks that IFRS-based taxation may have.

Part 6 of the article provides a broader perspective on risks posed by IFRS-based taxation. It is suggested that IFRS-based taxation may be appropriate in certain instances. The application of this basis of taxation should preferably be limited to specifically identified and narrowly-defined types of transactions rather than broad categories of instruments or persons. The inherent risks of the tax base being linked to an external framework and the interpretation issues that may arise from terminology not being absolutely consistent between the two frameworks should be closely considered if an IFRS-based approach to taxation is followed.

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