South African Institute of Tax Professionals

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The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
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BY EMAIL: policycomments@sars.gov.za

RE: Draft Interpretation Note: Section 24I – Gains or Losses on Foreign Exchange Transactions

We write to comment on the draft interpretation note which provides guidance on the interpretation and application of section 24I of the Income Tax Act ("the Act").

A. Background

Section 24I governs the income tax treatment of foreign exchange gains and losses on exchange items. It also deals with premiums or like consideration received or paid in respect of foreign currency option contracts (FCOCs) entered into and any consideration paid in respect of any FCOC acquired by specified persons. The note deals with section 24I and other relevant provisions of the Act in detail with reference to examples. We have highlighted a few key areas and would be pleased to meet with you to discuss these and any other aspects of the note in more detail.

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B. Comments for consideration

We highlight the following comments for consideration:

1. Cross currency swaps

The note does not deal with cross currency swaps (or cross currency interest rate swaps). It is therefore not apparent what SARS' views on the appropriate tax treatment of cross currency swaps are. For example, whether these instruments fall within section 24I (based on their characteristics that are similar to a forward exchange contract in relation to the foreign exchange component) and section 24K (based on their characteristics that are similar to an interest rate agreement in relation to the interest component). Alternatively, whether a cross currency swap falls outside of both these provisions. A discussion on this topic might fit into paragraph 4.5.3. (a) which deals with the definition of a forward exchange contract.

This matter also has relevance to the discussion in paragraph 4.7.1. of the note, that deals with the deferral of gains and losses in certain circumstances. If the cross currency swap is viewed as a foreign exchange contract, then section 24I(7) may result in alignment of the timing of the tax treatment of the foreign exchange losses/gains on the cross currency swap and the hedged debt. If the cross currency swap is not viewed as a foreign exchange contract, the timing of the tax events on the two instruments will not be aligned and the tax implications are unlikely to reflect the economically hedged position of the taxpayer.

We appreciate that these kinds of derivatives could be designed in different ways and that their nature and treatment is complex. We would be pleased to meet with SARS to discuss them and their tax treatment in detail.

2. Section 24I(7) – exchange differences that arise before an asset is brought into use: pool of funding

Section 24I(7) effectively defers the recognition of the exchange differences until the underlying asset being funded is brought into use. More guidance is required on the application of section 24I(7) where a taxpayer uses a pool of funding to finance its business. Taxpayers often have a credit facility with no direct link of the funding to a specific asset, including assets not yet in use. For example, a revolving bank credit facility can be used for ongoing operational expenditure, including salaries and wages, as well as to acquire assets. The business can draw down on the facility up to the upper credit limit but is not obliged at any time to utilise the full facility. (This is the inverse scenario of the one discussed in paragraph 4.7.2. of the note where it is clear that the funding was raised for certain specific purposes.) In particular, the guidance should address whether section 24I(7) only applies to a situation where a specific debt will explicitly fund the acquisition of an asset or whether one should also consider pooled funding when applying section 24I(7). From a practical perspective, it would be extremely difficult and arbitrary to try to allocate a portion of pooled funds to assets not yet in use. Those assets could ultimately be funded from the pool or from another source of funds, including cash generated in the operations. It means that, looking forward, it would be almost impossible to tell how much of the current debt, if any, relates to the underlying asset not yet brought into use.

3. Reduction of debt (section 19 and paragraph 12A) – interaction with section 24I and section 25D

Paragraph 4.15 of the note confirms that the reduction amount of a foreign denominated debt must be converted to Rand at the spot rate on the date that the debt is reduced (the realisation date). It is stated that this determination should be made under section 25D as the definition of "reduction amount" does not give a different indication. Section 25D determines that the receipt/accrual must be translated to Rand at the spot rate on the date that the amount was received/accrued. This approach would also in our view be in line with section 24I(1) which defines "realised" in relation to a debt in a foreign currency to include when a debt is disposed of in any manner.

Example 60 demonstrates that, in the case of a debt reduction where a **foreign exchange loss** was realised and deducted on the debt, these losses will be recouped in terms of section 8(4)(a). On the other hand, example 38 in Interpretation Note 91 dated 21 October 2016 dealing with "Reduction of Debt" demonstrates that, in the case of a debt reduction where a **foreign exchange gain** was realised and taxed on the debt, the gains remains taxable. (It would be helpful to also include this example in the note in order to contrast it with example 60.)

The effect is that, in the case where the Rand weakened and a foreign exchange loss is realised on the debt, the debt reduction consequences (under section 19 and paragraph 12A) are applied with reference to a Rand amount (R1,200,000 in Example 60) that is greater than the Rand amount of the debt on transaction date (R1,000,000 in Example 60). The tax attributes will be reduced with reference to an amount greater than the total amount of tax attributes created on transaction date and the balance will be recouped in terms of section 8(4)(a). The net effect is likely to be that deductions/allowances would have been claimed based on R1,000,000; that R200,000 would have been deducted from income as a foreign exchange loss; that the tax attributes would have been reduced based on R1000,000; and that a recoupment would have been included of R200,000 (nil net effect).

On the other hand, in the case where the Rand strengthened and a foreign exchange gain is realised on the debt, the debt reduction consequences (under section 19 and paragraph 12A) are applied with reference to a Rand amount (R800,000 in Example 38 of IN91) that is less than the Rand amount of the debt on transaction date (R1,000,000 in Example 38 of IN91). The tax attributes will be reduced with reference to an amount less than the total amount of tax attributes created on transaction date. The foreign exchange gain realised of R200,000 stays intact. The net effect is likely to be that deductions/allowances would have been claimed based on R1,000,000; that R200,000 would have been included in income as a foreign exchange gain; and that the tax attributes would have been reduced by R800,000 (nil net effect). This approach may render the correct outcome if the funded expenditure was deductible. It is however submitted that where the debt funded the acquisition of capital assets, the outcome is not appropriate as the tax cost of the assets will be reduced by R800 000 while an exchange gain of R200 000 is included in taxable income. Based on the underlying principles of the debt reduction rules, we are of the view that the appropriate outcome should be a reduction of the tax cost of the capital asset by R1 000 000.

Although we think that the interpretation in the note (as well as in interpretation note 91) is likely to be the correct interpretation of the legislation as it stands, we question whether this is the best approach. The alternative approach would be to effectively reverse the tax treatment based on the conversion of the debt at spot at transaction date. In other words, the Rand amount of debt that was originally used to fund the assets/expenditure should be used as the basis for the debt reduction consequences. The subsequent currency gain/loss has no bearing on the cost of the assets/expenditure and should be dealt with under section 24I. Such alternative approach would effectively reduce/reverse the tax attributes on a more neutral basis, as it would have, had the debt been Rand denominated. In this regard, it should be borne in mind that the debt reduction provisions were designed primarily with Rand debt in mind.

4. Foreign exchange gains/losses on Rand denominated loans by SA parent to CFC

It often happens that a holding company would provide finance to its Controlled Foreign Companies (CFCs) by means of Rand denominated loans. On the basis that there is no economic currency exchange difference from a South African perspective as the loan remains a Rand loan in the hands of the holding company, there should not be any imputation of exchange differences arising from Rand denominated loans with a connected party. This interpretation is confirmed under point 4.11.2 on page 91 where it is concluded that:

If a CFC's exchange item is not attributable to a permanent establishment in or outside South Africa the local currency is the rand.

In effect, the local currency of the CFC is the Rand and the loan is Rand denominated so there would be no currency conversion required and hence no foreign exchange gain/loss.

An example to demonstrate this point would be appreciated.

5. Cryptocurrencies

It would be helpful if the interpretation note could provide some insight into the SARS view on cryptocurrencies and particularly whether these currencies are within the scope of section 24I or not. From an income tax perspective, we believe the main issue is whether this is "currency" within section 24I; or an asset.

We welcome the opportunity to comment on the draft interpretation note and look forward to future engagements.

Yours sincerely

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