

## INTERPRETATION NOTE 101

DATE: 4 July 2018

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : SECTION 24I AND SECTIONS 1(1) – DEFINITION OF “TRADING STOCK”, 3(4)(b), 6quat(4), 8(4)(a), 9(2)(f), 9(4)(e), PARAGRAPH (c)(ii) AND (iii) OF THE PROVISO TO SECTION 9D(2A), 9D(6), 9D(9)(fA)(ii) AND (iii), 9D(9A)(a)(iii), 11(a), 11(i), 11(j), 19, 20(2), 22(3)(a)(i), 24J(2), (3) AND (5A) AND 25D, PARAGRAPHS 12A, 35(3)(a) AND 43 OF THE EIGHTH SCHEDULE AND PARAGRAPH 4(1) OF THE TENTH SCHEDULE**  
**SUBJECT : SECTION 24I – GAINS OR LOSSES ON FOREIGN EXCHANGE TRANSACTIONS**

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### **Preamble**

In this Note unless the context indicates otherwise –

- “**CGT**” means capital gains tax, being the portion of normal tax attributable to the inclusion in taxable income of a taxable capital gain;
- “**paragraph**” means a paragraph of the Eighth Schedule;
- “**permanent establishment**” means a permanent establishment as defined in section 1(1);<sup>1</sup>
- “**R**” means rand which is officially often referred to as ZAR;
- “**realisation date**” means the date an exchange item is realised;
- “**Schedule**” means a Schedule to the Act;
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962;

<sup>1</sup> See Annexure A.

- “**translation date**” means the last day of a year of assessment<sup>2</sup> on which an exchange item that has not yet been realised, is restated in local currency;
- “**year 1**”, “**year 2**”, “**year 3**”, “**year 4**” and “**year 5**” in any of the examples refer to calendar year 1, calendar year 2, calendar year 3, calendar year 4 and calendar year 5 respectively; and
- any other word or expression bears the meaning ascribed to it in the Act.

**Annexure B** contains an index of common terms used in this Note.

All guides and interpretation notes referred to in this Note are available on the SARS website at [www.sars.gov.za](http://www.sars.gov.za). Unless indicated otherwise, the latest issue of these documents should be consulted.

## 1. Purpose

This Note provides guidance on the interpretation and application of section 24I. Section 24I<sup>3</sup> deals with the income tax treatment of foreign exchange gains and losses on exchange items as well as premiums or like consideration received or paid in respect of FCOCs entered into and any consideration paid in respect of an FCOC acquired by certain persons.

The tax treatment of transactions denominated in a foreign currency often requires a consideration of section 24I and other provisions of the Act. This Note identifies some of the situations in which one or more of these provisions may apply. For example, if trading stock, the purchase price of which is denominated in USD, is purchased on credit from a supplier, the provisions of section 25D<sup>4</sup> and section 24I are relevant.

The income tax treatment of virtual currencies (cryptocurrencies and non-cryptocurrencies) is not considered in this Note.

This Note withdraws and replaces Practice Note 4 “Income Tax: The Treatment of Gains and Losses on Foreign Exchange Transactions in terms of Section 24I of the Income Tax Act, 1962 (the Act)”.

This Note reflects the income tax and tax administration legislation (as amended) at the time of publishing and includes the following:

- The Taxation Laws Amendment Act 17 of 2017 which was promulgated on 18 December 2017 (as per *Government Gazette* 41342).
- The Tax Administration Laws Amendment Act 13 of 2017 which was promulgated on 18 December 2017 (as per *Government Gazette* 41341).
- The Rates and Monetary Amounts and Amendment of Revenue Laws Act 14 of 2017 which was promulgated on 14 December 2017 (as per *Government Gazette* 41323).

<sup>2</sup> See 4.4.6 for the impact of the approval of different accounting periods under section 66(13A) and (13C).

<sup>3</sup> Section 24I was inserted by section 21 of the Income Tax Act 113 of 1993 and applies to years of assessment commencing on or after 1 January 1994.

<sup>4</sup> For more information on section 25D see Interpretation Note 63 “Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule”.

## 2. Background

Section 24I governs the income tax treatment of foreign exchange gains and losses on exchange items as well as premiums or like consideration received or paid in respect of FCOCs entered into and any consideration paid in respect of an FCOC acquired by specified persons.

Although the application of the section is limited to those persons listed in section 24I(2), the ambit of section 24I(2) is wide which results in the section being applicable to a large number of persons and transactions.

Under section 24I, exchange differences calculated for a year of assessment are generally included in or deducted from income whether realised or not and whether of a capital or revenue nature. The legislation was drafted in this manner in line with the view that gains and losses on foreign exchange transactions largely represent finance charges and as a result must be brought to account on a revenue basis for tax purposes at the end of a year of assessment even if not realised.

There are limited circumstances in which the inclusion of a foreign exchange gain or loss calculated in respect of an exchange item in a particular year of assessment is deferred and recognised in a later year of assessment.

## 3. The law

The relevant legislation is quoted in **Annexure A**.

## 4. Application of the law

### 4.1 Basic operation of section 24I

Section 24I(2) identifies the persons to whom section 24I applies and section 24I(3) determines which exchange differences (foreign exchange gains and losses) and premiums or like consideration on FCOCs entered into or consideration on FCOCs acquired are included in<sup>5</sup> or deducted from<sup>6</sup> income.

An exchange difference is determined on each exchange item for the year of assessment in which such exchange item arose, as well as every subsequent year of assessment until and including the year of assessment in which it is realised. To calculate an exchange difference for a specific year of assessment, a commencement date and a final date must be established in that year of assessment. The following combinations of commencement dates and final dates are possible:

- Transaction date and realisation date.
- Transaction date and translation date (last day of the year of assessment).<sup>7</sup>
- The previous translation date (last day of the previous year of assessment) and realisation date.

<sup>5</sup> Foreign exchange gains and premiums or like consideration on FCOCs are included in gross income under paragraph (n) of the definition of “gross income” in section 1(1).

<sup>6</sup> Foreign exchange losses, premiums or like consideration on FCOCs entered into and consideration on FCOCs acquired are deducted from income under section 11(x).

<sup>7</sup> See **4.4.6** for the impact of the approval of different accounting periods under section 66(13A) and (13C).

- The previous translation date (last day of the previous year of assessment) and the current translation date (last day of the current year of assessment).

The exchange difference on a particular exchange item for a specific year of assessment is determined by multiplying the foreign currency amount of the exchange item by the difference between the ruling exchange rate on the commencement date in that year of assessment and the ruling exchange rate on the final date in that year of assessment. An exchange difference calculated in this manner represents the effect of the weakening or strengthening of the relevant exchange rate over the period between the two dates and will be reflected as a foreign exchange gain or loss. This foreign exchange gain or loss is equal to the increase or decrease in the rand value of the exchange item because of movements in the relevant exchange rate. For example, when a person contemplated in section 24I(2) owes an amount in a foreign currency to another person and the rand strengthens against the foreign currency, that person will make a foreign exchange gain. Should the rand weaken against the foreign currency, the person will incur a foreign exchange loss.

The definitions which are relevant to the application of section 24I are primarily found in section 24I(1). However, some definitions are contained in section 1(1). Six key definitions in section 24I(1) are "exchange difference", "exchange item", "transaction date", "realised", "translated" and "ruling exchange rate". These definitions and various other terms are discussed later in this Note.

## **4.2 Application of section 24I to specific persons [section 24I(2)]**

Section 24I applies to the persons discussed in **4.2.1** to **4.2.6**.

Although the persons referred to in **4.2.1** to **4.2.4** could be residents or non-residents, the proviso to section 24I(2) further restricts the application of section 24I to persons falling within **4.2.1** to **4.2.4** who are residents, CFCs (controlled foreign companies) or non-residents to the extent the exchange items included in **4.2.1** to **4.2.4** are attributable to that non-resident's permanent establishment in South Africa.

Section 24I is relevant in the context of CFCs when the inclusion of a portion of a CFC's net income in a qualifying resident's income is required under section 9D(2) and the CFC's net income is calculated under section 9D(2A) (see **4.11.1**).

### **4.2.1 Any company [section 24I(2)(a)]**

Section 24I applies to any company<sup>8</sup> irrespective of whether it carries on a trade. See **4.2.7** for special rules that apply when determining exchange differences of oil and gas companies.

### **4.2.2 Any trust carrying on a trade [section 24I(2)(b)]**

Section 24I applies to any trust carrying on any trade. The section is applicable to a trust which traded throughout the year of assessment and a trust which commenced trading or ceased trading during the year of assessment.<sup>9</sup>

<sup>8</sup> See the definition of "company" in section 1(1).

<sup>9</sup> See **4.10**.

If a trust carries on a trade, section 24I applies to the trust as a whole which means it applies to all of the trust's exchange items and relevant premiums or consideration in respect of FCOCs (see 4.3) even if related to non-trade activities carried on by the trust.

The term "trade" is defined in section 1(1). In *Burgess v CIR*<sup>10</sup> the court held that it is well-established that the definition of trade should be given a wide interpretation.

The words "carrying on any trade" are not defined in the Act. Whether a person, and in this case a trust, is carrying on a trade is a question of law that must be decided on the facts of each case.<sup>11</sup>

Section 24I applies also to a trust which is not carrying on a trade in the circumstances discussed in section 24I(2)(d) (see 4.2.4).

#### **4.2.3 Any natural person holding a unit of currency or debt as trading stock [section 24I(2)(c)]**

Section 24I applies to any natural person holding a unit of foreign currency or a debt denominated in foreign currency as trading stock. If a natural person holds a single unit of foreign currency or a debt denominated in foreign currency as trading stock, section 24I(2)(c) has the effect that section 24I applies to all exchange items held by that natural person and, read with section 24I(3), means that exchange differences on all the exchange items held by that person must, as appropriate, be included in or deducted from income. For example, if a natural person holds dollars as trading stock, a dollar denominated debt as a capital asset and an FEC (forward exchange contract), section 24I will apply to the units of foreign currency, the debt denominated in foreign currency and the FEC.

Section 24I(12) deals with the deemed acquisition and deemed realisation of exchange items on hand when section 24I becomes or ceases to be applicable to, amongst others, a natural person (see 4.10).

Section 24I also applies to a natural person in the circumstances mentioned in section 24I(2)(d) (see 4.2.4).

#### **4.2.4 Any natural person or trust in relation to a forward exchange contract and a foreign currency option contract [section 24I(2)(d)]**

Section 24I applies to any natural person or trust in respect of any amount in foreign currency –

- owed by or to that person on an FEC; or
- if that person has the right or contingent obligation to buy or sell that amount under an FCOC (foreign currency option contract).

Under section 24I(2)(d), section 24I applies to FECs and FCOCs held by natural persons or trusts but does not apply to any units of foreign currency and foreign currency-denominated debt owed by or to that natural person or trust. See 4.2.2 and

<sup>10</sup> 1993 (4) SA 161 (A), 55 SATC 185 at 196.

<sup>11</sup> *CIR v Stott* 1928 AD 252, 3 SATC 253; *Platt v CIR* 1922 AD 42, 32 SATC 142 and *COT v Booyens Estates Ltd* 1918 AD 576, 32 SATC 10. See also Interpretation Note 33 "Assessed losses: Companies: The 'Trade' and 'Income from Trade' Requirements" for a discussion of the trade requirement.



**4.2.3** which deal with circumstances in which all the exchange items, including units of foreign currency and foreign currency denominated debt, held by trusts and natural persons are subject to section 24I.

#### **4.2.5 Certain non-residents having a permanent establishment in the Republic [proviso to section 24I(2)]**

The proviso to section 24I(2) provides that section 24I does not apply to an exchange item of a person listed in **4.2.1** to **4.2.4** that is not a resident (other than a CFC), unless that exchange item is attributable to a permanent establishment of that person in the Republic.

#### **4.2.6 A controlled foreign company [proviso to section 24I(2)]**

Section 24I applies to exchange items of a CFC. Section 24I is applied in calculating the net income of a CFC<sup>12</sup> which must be included in the income of qualifying persons that are residents<sup>13</sup> (see **4.11.1**).

#### **4.2.7 Oil and gas companies (paragraph 4(1) of the Tenth Schedule)**

Special rules apply in determining exchange differences of oil and gas companies.<sup>14</sup> Currency gains or losses of an oil and gas company during any year of assessment (regardless of whether those gains or losses are realised or unrealised) must be determined solely with reference to –

- the functional currency of that company; and
- the translation method used by that company for purposes of financial reporting.

#### **4.3 Inclusion in or deduction from income of an exchange difference, or a premium or consideration in respect of a foreign currency option contract [section 24I(3)]**

The following amounts must be included in or deducted from the income of any person referred to in section 24I(2) (see **4.2**):

- Subject to section 24I(7)<sup>15</sup> and section 24I(10A),<sup>16</sup> any exchange difference on an exchange item of or in relation to that person [section 24I(3)(a)].
- Subject to section 24I(7),<sup>17</sup> any premium or like consideration received by or paid by that person under an FCOC entered into by that person [section 24I(3)(b)(i)].

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<sup>12</sup> Section 9D(2A).

<sup>13</sup> Section 9D(2).

<sup>14</sup> The term “oil and gas company” is defined in paragraph 1 of the Tenth Schedule.

<sup>15</sup> See **4.7** for a discussion of section 24I(7) which deals with exchange differences linked to specified assets that arise before the asset is brought into use.

<sup>16</sup> See **4.9** for a discussion of section 24I(10A) which deals with certain exchange differences arising between companies forming part of the same group of companies and between connected persons.

<sup>17</sup> See **4.7** for a discussion of section 24I(7) which deals with exchange differences linked to specified assets that arise before the asset is brought into use.

- Subject to section 24I(7),<sup>18</sup> any consideration paid for an FCOC acquired by that person from another person [section 24I(3)(b)(ii)].

An exchange difference must be calculated on each exchange item. For example, when trading stock is purchased on credit in foreign currency and the taxpayer enters into an FEC to hedge the debt, exchange differences must be calculated on two exchange items, namely, the debt and the FEC.

#### 4.4 Key terms [sections 1(1) and 24I(1)]

##### 4.4.1 “Exchange difference” [section 24I(1)]

An exchange difference is calculated on translation date and realisation date.

The term “exchange difference” means the foreign exchange gain or foreign exchange loss on an exchange item during any year of assessment determined by multiplying such exchange item by the difference between –

- the ruling exchange rate on transaction date in respect of such exchange item during that year of assessment, and –
  - the ruling exchange rate on realisation date when the exchange item is realised during that year of assessment; or
  - the ruling exchange rate on translation date when the exchange item is not realised during that year of assessment; or
- 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 –
  - the ruling exchange rate on realisation date when the exchange item is realised during that year of assessment; or
  - the ruling exchange rate on translation date when the exchange item is not realised during that year of assessment.

For example, Company A owed a supplier \$100 at year end when the ruling exchange rate was R15: USD1. The ruling exchange rate at transaction date was R14: USD1. The exchange difference calculated at the end of the year of assessment on the \$100 loan = the foreign currency amount of the exchange item of \$100 × (14,0000 ruling exchange rate on transaction date – 15,0000 ruling exchange rate on realisation date) = R100 foreign exchange loss.

The words “or at which it would have been translated had this section been applicable at the end of that immediately preceding year of assessment”, referred to above, applied, for example, when section 24I became effective and an exchange difference had to be determined in relation to a person for a year of assessment commencing on or after 1 January 1994 on an exchange item that existed at the end of the immediately preceding year of assessment.

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<sup>18</sup> See 4.7 for a discussion of section 24I(7) which deals with exchange differences linked to specified assets that arise before the asset is brought into use.

#### 4.4.2 “Exchange item” [section 24I(1)]

The term “exchange item” of or in relation to a person means an amount in a foreign currency –

- which constitutes any unit of currency acquired and not disposed of by that person;
- owing by or to that person on a debt incurred by or payable to such person;
- owed by or to that person on an FEC; or
- when that person has the right or contingent obligation to buy or sell that amount under an FCOC.

#### 4.4.3 “Local currency” and “foreign currency” [section 24I(1)]

The term “local currency” is defined in relation to specific types of person as follows:

- Any person in respect of an exchange item<sup>19</sup> which is attributable to a permanent establishment outside the Republic – the functional currency of that permanent establishment. Under the proviso to paragraph (a) of the definition of “local currency” any exchange item shall be deemed not to be attributable to any such permanent establishment if the functional currency of that permanent establishment is the currency of a country which has an official rate of inflation of 100% or more throughout the relevant year of assessment [paragraph (a) of the definition].<sup>20</sup>
- Any resident other than a headquarter company<sup>21</sup> in respect of an exchange item which is not attributable to a permanent establishment outside the Republic – the currency of the Republic, which is the rand [paragraph (b) of the definition].
- Any person that is not a resident in respect of any exchange item which is attributable to a permanent establishment in the Republic – the currency of the Republic, which is the rand [paragraph (c) of the definition].
- Any headquarter company<sup>22</sup> in respect of an exchange item which is not attributable to a permanent establishment outside the Republic – the functional currency of that headquarter company [paragraph (d) of the definition]. A headquarter company must be a resident.
- Any domestic treasury management company<sup>23</sup> in respect of an exchange item which is not attributable to a permanent establishment outside the Republic – the functional currency of that domestic treasury management

<sup>19</sup> The use of “exchange item” in the definition of “local currency” and “foreign currency” may seem circular because it is used in those definitions and an exchange item is defined as an amount in foreign currency which constitutes one of the items listed in that definition. However, in context, the use of “exchange item” in the definition of “local currency” and “foreign currency” is referring to types of item which are relevant and not in the sense of those items if in a foreign currency.

<sup>20</sup> At the date of issue of this Note no country had an official rate of inflation of 100% or more. The Zimbabwe dollar is a historical example of a hyperinflationary currency. The use of the Zimbabwe dollar as an official currency was effectively abandoned on 12 April 2009 as a result of the Reserve Bank of Zimbabwe legalising the use of the rand and the US dollar as standard currencies for exchange.

<sup>21</sup> See also the special rules below for resident companies which are domestic treasury management companies or international shipping companies.

<sup>22</sup> As defined in section 1(1).

<sup>23</sup> As defined in section 1(1).

company [paragraph (e) of the definition]. A domestic treasury management company must be incorporated or deemed to be incorporated by or under any law in force in the Republic<sup>24</sup> and have its place of effective management in the Republic.

- Any international shipping company defined in section 12Q in respect of an amount which is not attributable to a permanent establishment outside the Republic – the functional currency of that international shipping company [paragraph (f) of the definition]. An international shipping company in this context must be a resident

The term “foreign currency” in relation to any exchange item of a person means any currency which is not local currency.

Identifying local currency is therefore critical for correctly identifying exchange items because exchange items are amounts of foreign currency for the types of item in 4.4.2 only.

#### **Example 1 – Identifying local currency, foreign currency and exchange items**

##### *Facts:*

Company A, a company incorporated and tax resident in South Africa, operates two branches – one in South Africa and one in Country X. During the year of assessment Company A bought trading stock on credit from a supplier in the USA for \$100 000. At year end the full balance of \$100 000 was outstanding.

\$60 000 of the balance related to trading stock which was delivered at the branch in South Africa and \$40 000 to trading stock delivered at the branch in Country X.

The branch in Country X functional currency is the USD.

South Africa does not have a tax treaty with Country X.

##### *Result:*

Under paragraph (a) of the definition of “local currency”, the local currency of the portion of the outstanding debt payable to the USA supplier which is attributable to the branch in Country X is USD because the branch’s functional currency is USD. Therefore, the debt of \$40 000 is in local currency and is not an exchange item.

Under paragraph (b) of the definition of “local currency”, the local currency of the portion of the outstanding debt payable to the USA supplier which is attributable to the branch in South Africa is rand. Therefore, the debt of \$60 000 is in foreign currency and is an exchange item.

Company A must calculate the exchange difference that arises in relation to the debt of \$60 000 on translation date and include it in or deduct it from income under section 24I(3)(a) when calculating taxable income.

<sup>24</sup> The requirement to be incorporated or deemed to be incorporated in the Republic was deleted by section 2(1)(c) of the Taxation Laws Amendment Act 17 of 2017 with effect from years of assessment commencing on or after 1 January 2018.

#### 4.4.4 “Functional currency” [section 1(1)]

The term “functional currency”, in relation to –

- a person, means the currency of the primary economic environment in which the business operations of that person are conducted; and
- a permanent establishment of any person, means the currency of the primary economic environment in which the business operations of that permanent establishment are conducted.

The accounting treatment of foreign currency transactions is addressed in IAS 21.<sup>25</sup> The term “functional currency”, as defined in section 1(1), corresponds closely with the definition of that term in IAS 21. As a result IAS 21 can provide useful guidance in interpreting and applying the definition of “functional currency” for income tax purposes.

The accounting definition of “functional currency” is as follows:<sup>26</sup>

“Functional currency is the currency of the primary economic environment in which the entity operates.”

IAS 21 describes the primary economic environment in which an entity operates as normally the one in which it primarily generates and expends cash. The functional currency will usually be the currency in which, amongst other things, –

- sales prices of goods and services are denominated and settled; or
- costs of providing goods or services are denominated or settled.<sup>27</sup>

Additional factors that may be considered include –

- the currency of financing activities (debt and equity instruments); and
- the currency in which receipts from operating activities are retained.<sup>28</sup>

As a practical matter, SARS will generally accept the functional currency used by a person for financial accounting purposes as its functional currency provided that the determination of that functional currency is made in accordance with IAS 21. For example, if a company primarily transacts in British pounds, its functional currency may be the British pound.

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<sup>25</sup> IAS 21 is the International Accounting Standard 21 “The Effects of Changes in Foreign Exchange Rates”. IAS 21 prescribes that when a reporting entity prepares financial statements, each individual entity included in the reporting entity – whether it is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) – must determine its functional currency and measure its results and financial position in that currency.

<sup>26</sup> IAS 21 in paragraph 8 under the heading: Definitions.

<sup>27</sup> IAS 21 in paragraph 9.

<sup>28</sup> IAS 21 in paragraph 10.

#### 4.4.5 “Transaction date” [section 24I(1)]

Depending on the facts, the term “transaction date” is relevant in the determination of an exchange difference on translation date or realisation date and is determined in relation to the following exchange items:

- A unit of currency – see **4.5.1(a)**.
- A debt owing by or to a person – see **4.5.2(a)**.
- An FEC – see **4.5.3(b)**.
- An FCOC – see **4.5.4(c)**.

#### 4.4.6 “Translate” [section 24I(1)]

The term “translate” is relevant in the determination of an exchange difference and means the restatement of an exchange item in the local currency at the end of any year of assessment in which an exchange item has not been realised, by applying the ruling exchange rate to such exchange item. The end of the year of assessment is generally the last day of the year of assessment; however, if accounts are accepted under section 66(13A) or (13C) to a different date then, in the context of the definition of “translate”, the “end of the year of assessment” refers to the agreed date for purposes of exchange items covered by those accounts.

The word “translated” as used in the definitions of “exchange difference” and “ruling exchange rate” in section 24I(1) bears a similar meaning to the definition of “translate”.

#### 4.4.7 “Realised” [section 24I(1)]

An exchange difference must be determined on the date an exchange item is “realised”. The term “realised” is defined in relation to a specific exchange item, namely:

- A unit of currency – see **4.5.1(a)**.
- A debt owing by or to a person – see **4.5.2(a)**.
- An FEC – see **4.5.3(b)**.
- An FCOC – see **4.5.4(c)**.

#### 4.4.8 “Ruling exchange rate” [section 24I(1)]

The term “ruling exchange rate” is relevant in the determination of an exchange difference and is defined in relation to a specific exchange item on a specific date, namely:

- A unit of currency – see **4.5.1(b)**.
- A debt owing by or to a person – see **4.5.2(b)**.
- An FEC – see **4.5.3(c)**.
- An FCOC – see **4.5.4(d)**.

The proviso to the definition of “ruling exchange rate” stipulates that the Commissioner may, having regard to the particular circumstances of the case, prescribe an alternative rate to any of the prescribed rates<sup>29</sup> to be applied by a person in such particular circumstances, if that alternative rate is used for the purposes of financial reporting pursuant to IFRS.

The following is stated in the *Explanatory Memorandum on the Income Tax Bill, 1994* at page 4:

“In terms of the proposed amendment the Commissioner is authorised to approve alternative ruling exchange rates for use instead of any one of the rates referred to in the definition of ‘ruling exchange rate’. The amendment accommodates taxpayers who, for accounting purposes, use exchange rates which do not agree fully with the ruling exchange rates as defined in section 24I of the principal Act, but which are based or determined on a basis which is acceptable to the Commissioner. The alternative ruling exchange rates must be exchange rates which are determined and applied in terms of generally accepted accounting practice.”

The use of an alternative rate is at the discretion of the Commissioner and is not at the election of the taxpayer. A taxpayer may submit an application requesting the Commissioner to prescribe an alternative rate, however, the Commissioner may also *mero motu*<sup>30</sup> exercise this discretion and apply an alternative rate. The Commissioner will take into account the facts and circumstances of each case and will determine whether the rates prescribed in the definition of “ruling exchange rate” in section 24I(1) are inappropriate.

See **4.5.3(f)** and **4.5.3(g)** for a discussion of the application of an alternative rate in relation to an FEC on translation date and on early termination of an FEC and **4.14** for the application of an alternative rate when a debt is written off as bad for tax purposes but is not extinguished.

The ruling exchange rate must be stated in the format of the quantity of rand for every foreign currency unit. For example, the dollar/ rand exchange rate is stated as 14,1823 (\$1 / R14,1823) and not 0,0705 (R1 / \$0,0705). The ruling exchange rate must be expressed to at least the fourth decimal (for example, 14,1823 and not 14,18).

#### **4.4.9 “Spot rate” [section 1(1)]**

The definition of “spot rate” is relevant for the definition of “ruling exchange rate” in section 24I(1).

The term “spot rate” means the appropriate quoted exchange rate at a specific time by any authorised dealer in foreign exchange for the delivery of currency.

An “appropriate” spot rate will depend on the facts and circumstances of a particular case. For example, if an amount in a foreign currency is received from a debtor for a debt denominated in a foreign currency, the foreign currency amount received must be translated to rand at the appropriate authorised dealer buying rate of exchange. In contrast, an amount in foreign currency paid to a creditor for a debt denominated in foreign currency must be translated to rand at the appropriate authorised dealer selling rate of exchange.

<sup>29</sup> The prescribed rates are the ruling exchange rates as set out in **4.5.1** to **4.5.4** as appropriate.

<sup>30</sup> Of the Commissioner’s own accord.

For purposes of applying section 25D,<sup>31</sup> SARS is aware that for practical reasons some persons do not always follow a strict technical approach regarding the application of the spot rate. For example, a person may use a closing spot rate comprising the average of the closing telegraphic transfer buying and selling rates for the particular day when translating income and expenses instead of the buy rate for income and the selling rate for expenditure. In other instances a person may use a single rate for a short period such as a week to record all transactions during that period. In Interpretation Note 63<sup>32</sup> it was noted that SARS will accept the use of an approximate spot rate<sup>33</sup> provided –

- it does not give rise to a result which differs materially from the result which would have been obtained had the correct daily spot rate been applied, for example, if the particular foreign currency in question does not fluctuate significantly over the relevant period;
- the same method is applied consistently; and
- the same approximate spot rate is used for accounting purposes.

If a person has used an approximate spot rate for the purposes of applying section 25D, that approximate spot rate will generally be the appropriate spot rate to use at transaction date for a directly related exchange item, for example, trading stock purchased from a foreign supplier on credit. It is not appropriate to use an approximate spot rate on realisation date.

#### **Example 2 – The use of spot rate**

*Facts:*

Company A's year of assessment ends on 31 May. On 15 May year 1 Company A, which exports fruit, delivered a consignment of fruit free-on-board to the harbour. The selling price of \$15 000 was payable within 30 days.

The debt was paid on 15 June year 1.

Market rates are as follows:

| <b>Date</b>                       | <b>\$ / R<br/>Spot rate</b> |
|-----------------------------------|-----------------------------|
| 15 May year 1 (transaction date)  | 11,4300                     |
| 31 May year 1 (translation date)  | 11,4500                     |
| 15 June year 1 (realisation date) | 11,7000                     |

<sup>31</sup> See the relevant paragraph in Interpretation Note 63 "Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule".

<sup>32</sup> See the relevant paragraph in Interpretation Note 63 "Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule".

<sup>33</sup> An approximate spot rate is different to and must be distinguished from the average exchange rate discussed in **4.4.10** which is an annual average calculated for a year of assessment.



**Result:**

*Year of assessment ending on 31 May year 1*

**Determination of exchange difference on translation date**

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  |     |
|--|-----|
|  | R   |
| Exchange difference [ $\$15\,000 \times (11,4300 - 11,4500)$ ] | 300 |

An exchange difference of R300 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 31 May year 2*

**Determination of exchange difference on realisation date**

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$15\,000 \times (11,4500 - 11,7000)$ ] | 3 750 |

An exchange difference of R3 750 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Notes:**

- (1) The amount of trading stock sold of R171 450 ( $\$15\,000 \times 11,4300$ ) must be included in gross income and is determined under section 25D(1) by multiplying the amount of the sale by the spot rate on the date of sale.
- (2) The net amount included in taxable income of R175 500 (foreign exchange gain of R300 + foreign exchange gain of R3 750 + gross income of R171 450) equals the amount received of \$15 000 at the spot rate on realisation date of 11,7000.

**Example 3 – The use of an approximate spot rate****Facts:**

Company A's year of assessment ends on 31 May. On 15 May year 1 Company A, which exports fruit, delivered a consignment of fruit free-on-board to the harbour. The selling price of \$15 000 was payable within 30 days.

At the beginning of each month Company A estimates an approximate exchange rate at which all export transactions are recorded on transaction date. The approximate spot rate meets the requirements of Interpretation Note 63 "Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule" and qualifies for use as the spot rate on transaction date for purposes of section 25D and section 24I.

The debt was paid on 15 June year 1.

Market rates are as follows:

| <b>Date</b>                       | <b>\$ / R<br/>Spot rate</b> |
|-----------------------------------|-----------------------------|
| 15 May year 1 (transaction date)  | 11,4300                     |
| 31 May year 1 (translation date)  | 11,4500                     |
| 15 June year 1 (realisation date) | 11,7000                     |

Approximate spot rate for the month of May year 1 as determined by Company A was 11,4000 and may be used on transaction date.

*Result:*

*Year of assessment ending on 31 May year 1*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date (approximate spot rate) and translation date as follows:

|  |     |
|--|-----|
|  | R   |
| Exchange difference [ $\$15\,000 \times (11,4000 - 11,4500)$ ] | 750 |

An exchange difference of R750 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 31 May year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$15\,000 \times (11,4500 - 11,7000)$ ] | 3 750 |

An exchange difference of R3 750 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Notes:**

- (1) The amount of trading stock sold of R171 000 ( $\$15\,000 \times 11,4000$ ) must be included in gross income and is determined under section 25D(1) by multiplying the amount of the sale by the approximate spot rate on the date of sale.
- (2) The net amount included in taxable income of R175 500 (foreign exchange gain of R750 + foreign exchange gain of R3 750 + gross income of R171 000) equals the amount received of \$15 000 at the spot rate on realisation date of 11,7000.
- (3) The net amount of R175 500 included in taxable income in Example 2 above, which used the actual spot rate on transaction date, is the same as the net amount of R175 500 included in taxable income in this example which used an approximate spot rate as the relevant spot rate on transaction date for purposes of section 25D and section 24I. This outcome will generally prevail provided the underlying income or expenditure, as the case may be, is taxable or qualifies for a deduction immediately or over time.

#### 4.4.10 “Average exchange rate” [section 1(1)]

The term “average exchange rate” in relation to a year of assessment means the average determined by using the closing spot rates at the end of daily or monthly intervals during that year of assessment which must be consistently applied within that year of assessment.

This definition is relevant when translating, amongst other things, –

- expenditure or income incurred or received in any currency other than rand in the circumstances set out in section 25D, for example, when a natural person or non-trading trust elects to use the average exchange rate in a year of assessment in accordance with section 25D(3); and
- the net income of a CFC from its functional currency to rand under section 9D(6).<sup>34</sup>

#### 4.5 Application of section 24I(1) to (3) to specific exchange items

The definition of “exchange item” (see 4.4.2) contains four separate items. The calculation of exchange differences, which must be calculated on each exchange item, is discussed in this section of the Note in relation to the different types of exchange item.

##### 4.5.1 A unit of currency acquired and not disposed of by a person

An exchange difference in respect of a unit of foreign currency acquired and not disposed of by a person (A) contemplated in section 24I(2) must be determined on translation date and realisation date.<sup>35</sup> For A, this includes the situation in which foreign currency is acquired and held by someone else on A’s behalf because A is the beneficial owner of that foreign currency.

Physical notes and coins, for example, a \$1 note and a 50 cent coin, are units of currency.

##### (a) Transaction date and realisation date in relation to a unit of foreign currency

The transaction date<sup>36</sup> for a unit of foreign currency is the date on which the amount was acquired.

A unit of foreign currency is “realised” when it is disposed of.<sup>37</sup> A unit of currency will be realised when it is, for example, –

- sold for rands;
- sold for another foreign currency, for example, when dollar notes are sold for euro notes;
- applied to acquire an asset; or
- applied to settle a liability.

<sup>34</sup> See Interpretation Note 63 “Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule” for more information on the application of the “average exchange rate”.

<sup>35</sup> Paragraph (a) of the definition of “exchange item” in section 24I(1), and section 24I(2) and (3).

<sup>36</sup> Paragraph (g) of the definition of “transaction date” in section 24I(1).

<sup>37</sup> Paragraph (d) of the definition of “realised” in section 24I(1).

Realisation date is the date on which a unit of foreign currency is disposed of.

**(b) Ruling exchange rate in relation to a unit of foreign currency**

The ruling exchange rate in relation to a unit of foreign currency is determined as the spot rate on the respective transaction, translation and realisation dates unless the proviso as discussed in 4.4.8 applies.<sup>38</sup>

**Example 4 – Exchange difference on a unit of currency determined on translation date**

*Facts:*

Individual A held foreign currency collector's coins totalling \$5 000 as trading stock at the end of a year of assessment. Individual A acquired the necessary exchange control approval. The coins were acquired during the same year of assessment.

Market rates are as follows:

| <b>Date</b>                                       | <b>\$ / R<br/>Spot rate</b> |
|---|-----------------------------|
| Date of acquisition (transaction date)            | 11,6219                     |
| Last day of year of assessment (translation date) | 11,9391                     |

*Result:*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (units of currency) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |            |
|---|------------|
| Exchange difference [ $\$5\,000 \times (11,6219 - 11,9391)$ ] | R<br>1 586 |
|---|------------|

An exchange difference of R1 586 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24(3)(a).

**Note:**

R58 110 ( $\$5\,000 \times 11,6219$ )<sup>39</sup> is allowed as a deduction under section 11(a) for the acquisition of trading stock. This amount is also reflected as closing stock at the end of the year of assessment under section 22(1) read with section 22(3)(a)(i) (see 4.13.2 for a discussion of the cost price of trading stock).

**Example 5 – Exchange difference on a unit of currency determined on realisation date**

*Facts:*

Individual A sold foreign currency collector's coins totalling \$5 000 for \$5 000 with the sales price to be settled in rand at the prevailing spot rate. Individual A had the necessary approval to hold the coins as trading stock. The acquisition and disposal of the coins took place during the same year of assessment.

<sup>38</sup> Paragraph (d) of the definition of "ruling exchange rate" in section 24(1) and the proviso to the definition.

<sup>39</sup> Application of the spot rate under section 25D(1).

Market rates are as follows:

| <b>Date</b>                            | <b>\$ / R<br/>Spot rate</b> |
|--|-----------------------------|
| Date of acquisition (transaction date) | 11,6219                     |
| Date of disposal (realisation date)    | 11,9391                     |

*Result:*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (units of currency) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|   |            |
|---|------------|
| Exchange difference [ $\$5\,000 \times (11,6219 - 11,9391)$ ] | R<br>1 586 |
|---|------------|

An exchange difference of R1 586 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Notes:**

- (1) R58 110 ( $\$5\,000 \times 11,6219$ )<sup>40</sup> is allowed as a deduction under section 11(a) for the acquisition of trading stock.
- (2) Although the amount received on disposal of the coins amounts to R59 696 ( $\$5\,000 \times 11,9391$ ),<sup>41</sup> only R58 110 (R59 696 – R1 586) is included in gross income, since section 24I(6) prevents an inclusion of the exchange difference of R1 586 under any other section (see 4.6).

#### 4.5.2 Debt in foreign currency incurred by or payable to a person

An exchange difference in respect of an amount in a foreign currency owing by or to a person on a debt incurred by or payable to that person must be determined on translation date and realisation date, when applicable.<sup>42</sup>

Examples of debt in a foreign currency which constitute an exchange item include:

- Amounts payable on a debt granted to a person in a foreign currency.<sup>43</sup>
- Amounts receivable on a debt granted by a person to another person in foreign currency.<sup>44</sup>
- Deposits in foreign bank accounts.
- Money market instruments in foreign currency.
- Bonds in foreign currency.
- Traveller's cheques.

<sup>40</sup> Application of the spot rate under section 25D(1).

<sup>41</sup> Application of the spot rate under section 25D(1).

<sup>42</sup> Paragraph (b) of the definition of "exchange item" in section 24I(1), and section 24I(2) and (3).

<sup>43</sup> The debt may be incurred directly, for example, by acquiring an asset with a purchase price denominated in foreign currency on credit or indirectly, for example, by obtaining finance denominated in foreign currency to fund an asset purchased from a third party.

<sup>44</sup> The debt may be granted directly, for example, by selling an asset with a purchase price denominated in foreign currency on credit or indirectly, for example, by granting finance denominated in foreign currency to another person.

**(a) Transaction date and realisation date in relation to a debt denominated in foreign currency owed by or to a person**

The transaction date for an amount in foreign currency –

- on a debt owed by a person is the date on which the debt was actually incurred; and
- on a debt owing to a person is the date on which the amount payable on the debt accrued to the person or the date on which the debt was acquired by the person in any other manner.

The court cases on section 11(a) dealing with the meaning of “actually incurred” are useful in determining when a debt is actually incurred. The term “actually incurred” means that the taxpayer must have a definite and absolute liability to pay an amount<sup>45</sup> and the “expenditure” underlying a liability that is conditional or contingent in any way will not be deductible.<sup>46</sup> Similarly, debt is actually incurred when there is an unconditional legal liability to repay the debt.

The court cases on gross income dealing with the meaning of “accrued” are useful in determining the meaning of “debt accrued”. In the context of gross income, “accrued to” was held by Watermeyer J (as he then was) in *WH Lategan v CIR* to mean –<sup>47</sup>

“to which he has become entitled”.

In the *Lategan* case it was also noted that the fact that an amount may be due and payable in a subsequent year of assessment did not mean that it had not accrued to a taxpayer. If an amount is subject to any conditions, a person will become entitled to it once the conditions have been fulfilled.<sup>48</sup> The entitlement must therefore be unconditional in order for an amount to be included in gross income. Similarly, for a debt to accrue, the person to whom the debt is owed must be unconditionally entitled to the amount of debt even if it is due and payable in the future.

Realisation date is the date on which a debt or part of a debt is realised. Debt in foreign currency is realised<sup>49</sup> when and to the extent that payment is received or made in respect of that debt or when and to the extent to which that debt is settled or disposed of in any other manner. If a debt is repaid in instalments, each payment will constitute part realisation of the debt.

Payment includes the repayment of the debt in rands, in the same foreign currency as the foreign currency in which the debt is denominated or in a foreign currency which differs to that in which the debt is denominated. It also includes the payment of a debt by means of set-off, for example, an amount of a debt owing by a debtor to a creditor is set-off by an amount owing by that creditor to that debtor under another financial arrangement.

<sup>45</sup> ITC 1545 (1992) 54 SATC 464 (C) at 466.

<sup>46</sup> *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55.

<sup>47</sup> 1926 CPD 203, 2 SATC 16 at 20. The correctness of the interpretation of “accrued to” in *Lategan’s* case was subsequently confirmed by Hefer JA in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 24.

<sup>48</sup> *Mooi v SIR* 1972 (1) SA 674 (AD), 34 SATC 1.

<sup>49</sup> Paragraph (a) of the definition of “realised” in section 24I(1).

The settlement or disposal of a debt “in any other manner” referred to above includes, for example:

- A change in the foreign currency in which the debt is denominated [see 4.5.2(c)].
- The waiver of a debt by the creditor.
- The prescription of a debt.
- The cession of a debt.
- The sale of a debt [see 4.5.2(d)].
- The write-off of a debt if all the associated rights have been extinguished [see 4.14 and 4.15].

**(b) Ruling exchange rates in relation to debt**

The ruling exchange rate in relation to a debt payable or receivable in a foreign currency is the spot rate on the relevant transaction, translation or realisation date,<sup>50</sup> unless the proviso as discussed in 4.4.8<sup>51</sup> or the proviso to the ruling exchange rate for debt<sup>52</sup> [see 4.5.2(d)] applies.

**Example 6 – Exchange difference on a debt incurred**

*Facts:*

Company A’s year of assessment ends on the last day of February. Company A borrowed \$100 000 on 31 January year 1. The loan was repaid on 30 June year 1.

Market rates are as follows:

|                                       | <b>\$ / R</b>    |
|---------------------------------------|------------------|
| <b>Date</b>                           | <b>Spot rate</b> |
| 31 January year 1 (transaction date)  | 11,4200          |
| 28 February year 1 (translation date) | 11,4500          |
| 30 June year 1 (realisation date)     | 11,6000          |

*Result:*

*Year of assessment ending on 28 February year 1*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |              |
|---|--------------|
| Exchange difference [ $\$100\,000 \times (11,4200 - 11,4500)$ ] | R<br>(3 000) |
|---|--------------|

An exchange difference of (R3 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

<sup>50</sup> Paragraph (a) of the definition of “ruling exchange rate” in section 24I(1).

<sup>51</sup> Proviso to the definition of “ruling exchange rate” in section 24I(1).

<sup>52</sup> Proviso to paragraph (a) of the definition of “ruling exchange rate” in section 24I(1).

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (11,4500 - 11,6000)$ ] | (15 000) |

An exchange difference of (R15 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24(3)(a).

**Note:**

The sum of the foreign exchange losses in the years of assessment ending on 28 February year 1 and year 2 of R18 000 (R3 000 + R15 000) is equal to the difference between the rand value of the loan on transaction date of R1 142 000 ( $\$100\,000 \times 11,4200$ ) and the rand value on realisation date of R1 160 000 ( $\$100\,000 \times 11,6000$ ).

**Example 7 – Exchange difference on a debt incurred that financed the acquisition of trading stock**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A purchased trading stock of \$500 000 on credit. The debt was repaid on 31 January year 2. All the trading stock was sold for a total of R6 million before 28 February year 2.

Market rates are as follows:

| <b>Date</b>                          | <b>\$ / R<br/>Spot rate</b> |
|--------------------------------------|-----------------------------|
| 1 November year 1 (transaction date) | 11,6000                     |
| 31 January year 2 (realisation date) | 11,6900                     |
| 28 February year 2                   | 11,7000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,6900)$ ] | (45 000) |

An exchange difference of (R45 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24(3)(a).



**Notes:**

- (1) The amount of trading stock acquired of R5,8 million ( $\$500\,000 \times 11,6000$ ) is deductible under section 11(a). The amount is determined under section 25D(1) by multiplying the amount of the expenditure incurred by the spot rate on the date that the expenditure is incurred.
- (2) The amount received or accrued on the disposal of the trading stock of R6 million must be included in gross income.

**Example 8 – Exchange difference on a debt arising from the sale of trading stock on credit***Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A sold trading stock for \$500 000 on credit. The debt was settled on 31 January year 2. The trading stock was purchased at a cost of R4,5 million in September year 1.

Market rates are as follows:

| <b>Date</b>                          | <b>\$ / R<br/>Spot rate</b> |
|--------------------------------------|-----------------------------|
| 1 November year 1 (transaction date) | 11,6000                     |
| 31 January year 2 (realisation date) | 11,6900                     |
| 28 February year 2                   | 11,7000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|   |             |
|---|-------------|
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,6900)$ ] | R<br>45 000 |
|---|-------------|

An exchange difference of R45 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Notes:**

- (1) The purchase price of the trading stock of R4,5 million is deductible under section 11(a).
- (2) The amount received or accrued on the disposal of the trading stock of R5,8 million ( $\$500\,000 \times 11,6000$ ) is determined under section 25D(1) by multiplying the \$ selling price by the spot rate on the date of the sale. This amount must be included in gross income.

**Example 9 – Exchange difference on a debt incurred that financed the acquisition of trading stock**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A purchased trading stock of \$500 000 on credit. The debt was repaid on 31 March year 2. The trading stock was held and not disposed of on 28 February year 2 but was disposed of in April year 2 for a total of R6 million.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 November year 1 (transaction date)  | 11,6000                     |
| 28 February year 2 (translation date) | 11,7000                     |
| 31 March year 2 (realisation date)    | 11,5000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |               |
|---|---------------|
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,7000)$ ] | R<br>(50 000) |
|---|---------------|

An exchange difference of (R50 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24(3)(a).

**Notes:**

- (1) The trading stock acquired for R5,8 million ( $\$500\,000 \times 11,6000$ ) is deductible under section 11(a). The amount is determined under section 25D(1) by multiplying the amount of the expenditure incurred by the spot rate on the date that the expenditure was incurred.
- (2) The cost price of trading stock of R5,8 million is included in closing stock under section 22(1) read with section 22(3)(a)(i) (see 4.13.2 for a discussion of the cost price of trading stock).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |              |
|---|--------------|
| Exchange difference [ $\$500\,000 \times (11,7000 - 11,5000)$ ] | R<br>100 000 |
|---|--------------|

An exchange difference of R100 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24(3)(a).

**Notes:**

- (1) The cost price of trading stock held and not disposed of on 1 March year 2 of R5,8 million is included in opening stock under section 22(2) read with section 22(3)(a)(i) (see 4.13.2 for a discussion of the cost price of trading stock).
- (2) The amounts received or accrued of R6 million on the disposal of the trading stock must be included in gross income.

**Example 10 – Exchange difference on a debt incurred that financed the acquisition of a capital asset***Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A purchased a machine for \$500 000 on credit. The debt was repaid on 31 March year 2.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 November year 1 (transaction date)  | 11,6000                     |
| 28 February year 2 (translation date) | 11,7000                     |
| 31 March year 2 (realisation date)    | 11,5000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |               |
|---|---------------|
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,7000)$ ] | R<br>(50 000) |
|---|---------------|

An exchange difference of (R50 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24(3)(a).

**Note:**

The expenditure incurred on acquisition of the machine amounts to R5,8 million ( $\$500\,000 \times 11,6000$ ) and is determined under section 25D(1) by multiplying the amount of the expenditure incurred by the spot rate on the date that the expenditure is incurred. This is the amount on which capital allowances may potentially be claimed.

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |         |
|---|---------|
|   | R       |
| Exchange difference [ $\$500\,000 \times (11,7000 - 11,5000)$ ] | 100 000 |

An exchange difference of R100 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Example 11 – Exchange difference on a debt payable to a person on disposal of a capital asset**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 October year 1 Company A sold a machine which was used in the trade carried on by Company A for \$500 000. No allowances had been claimed for tax purposes. The debt owing to Company A on the machine was paid on 31 March year 2.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 October year 1 (transaction date)   | 11,5000                     |
| 28 February year 2 (translation date) | 11,7000                     |
| 31 March year 2 (realisation date)    | 11,5000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |         |
|---|---------|
|   | R       |
| Exchange difference [ $\$500\,000 \times (11,5000 - 11,7000)$ ] | 100 000 |

An exchange difference of R100 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |           |
|---|-----------|
|   | R         |
| Exchange difference [ $\$500\,000 \times (11,7000 - 11,5000)$ ] | (100 000) |

An exchange difference of (R100 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

**Note:**

A capital gain or capital loss on disposal of the machine must be determined under paragraph 43(1A). Paragraph 43(1A) requires proceeds to be translated to local currency at the average exchange rate for the year of assessment in which an asset is disposed of or at the spot rate on the date of disposal of the asset (see 4.12.2 for a discussion of paragraph 43).

**(c) Conversion of the foreign currency in which a debt is denominated**

The conversion of the foreign currency of a debt to a new currency constitutes the settlement or disposal of debt “in any other manner” referred to in paragraph (a) of the definition of “realised” in section 24I(1).

A conversion of the currency in which a debt is denominated is an exchange of the right to claim payment in the original currency in return for a right to claim payment in a new currency. The debt in the original currency is “realised” on conversion, since there is a settlement or disposal of the right to claim payment in the original currency. An exchange difference must therefore be determined on the date that a currency is converted to another currency.

**Example 12 – Conversion of the foreign currency of a loan**

*Facts:*

Company A’s year of assessment ends on the last day of February. On 1 November year 1 Company A, a resident, borrowed 500 000 franc (F). The loan was repayable on 31 October year 2.

On 1 May year 2 Company A entered into an agreement with the lender that the loan will be repaid in dollars on 31 October year 2. The loan was converted at the \$ / F spot rate on 1 May year 2, namely, \$1 / F1,2923.

Market rates are as follows:

| <b>Date</b>                           | <b>F / R<br/>Spot rate</b> | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|----------------------------|-----------------------------|
| 1 November year 1 (transaction date)  | 8,5400                     |                             |
| 28 February year 2 (translation date) | 8,6300                     |                             |
| 1 May year 2 (conversion date)        | 8,6900                     | 11,2298                     |
| 31 October year 2 (realisation date)  |                            | 11,4850                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt in franc) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  |               |
|--|---------------|
| Exchange difference [F500 000 × (8,5400 – 8,6300)] | R<br>(45 000) |
|--|---------------|

An exchange difference of (R45 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

*Conversion of debt: 1 May year 2*

The exchange difference is determined by multiplying the amount of the exchange item (debt in franc) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |          |
|--|----------|
|  | R        |
| Exchange difference [F500 000 × (8,6300 – 8,6900)] | (30 000) |

An exchange difference of (R30 000) is determined on conversion of the debt from franc to dollars which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a). The conversion of the currency of the debt is a realisation of the debt in franc and the creation of a new exchange item, namely, the debt in dollars.

*Repayment of debt: 31 October year 2*

The amount of the debt is restated in the new foreign currency (dollars) as follows:

$F500\ 000 / 1,2923 = \$386\ 907$

The exchange difference is determined by multiplying the amount of the exchange item (debt in dollars) by the difference between the ruling exchange rates on transaction date (1 May year 2) and realisation date as follows:

|  |          |
|--|----------|
|  | R        |
| Exchange difference [F386 907 × (11,2298 – 11,4850)] | (98 739) |

An exchange difference of (R98 739) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

**Note:**

The sum of the foreign exchange losses in the years of assessment ending on 28 February year 2 and year 3 of R173 739 (R45 000 + R30 000 + R98 739) is equal to the difference of R173 739 between the rand amount paid on realisation date of R4 443 627 ( $\$386\ 907 \times 11,4850$ ) and the rand amount received on transaction date of R4 270 000 ( $F500\ 000 \times 8,5400$ ) and a rounding difference of R112.

**(d) Acquisition and disposal rates on acquisition and disposal of debt (proviso to paragraph (a) of the definition of “ruling exchange rate”)**

A rate other than the spot rate on transaction date or realisation date will be used to determine an exchange difference on debt if any consideration –

- paid or incurred for the acquisition of debt, or
- received or accrued for the disposal of debt

was determined by applying a rate other than the spot rate on transaction date or realisation date. Under these circumstances the acquisition rate or disposal rate so determined will be deemed to be the spot rate on transaction date or realisation date.

A ruling exchange rate is a particular *exchange rate* which has been specified in section 24I for the transaction date, translation date and realisation date. For example, in relation to a debt in foreign currency, the spot rate is generally prescribed as the applicable exchange rate for the transaction date, translation date and realisation date. The “spot rate” is clearly an exchange rate.

It is therefore clear that the reference to “rate” in the proviso to paragraph (a) of the definition of “ruling exchange rate” when referring to any consideration being determined “by applying a *rate* other than spot rate”, is a reference to the situation in which an exchange rate between two currencies other than the prevailing spot rate has been applied by the parties to determine the consideration for the particular acquisition or disposal of the debt. The parties must have agreed to a contractual exchange rate which differs from the spot rate quoted by authorised dealers. The contractual exchange rate is limited to an exchange rate between two currencies and would not include the extent to which the consideration is determined by taking other factors, such as concerns regarding recoverability or cash flow, into account.

Stated differently, for the proviso to apply, any consideration paid or incurred or received or accrued in respect of the acquisition or disposal of a foreign currency debt must have been determined “by applying a rate [that is, an exchange rate] other than such spot rate”. For example, the parties agree on the first day of the month that a debt of \$100 will be settled on the last day of the month by a payment of R1 125. Alternatively, the parties agree on the first day of the month that a debt of \$100 will be settled on the last day of the month by applying a rate of 11,2500 and not the prevailing spot rate, whatever that may be, on the last day of the month when settlement occurs.

As noted above, the proviso is limited to dealing with differences which arise as a result of different exchange rates being applied and does not deal with situations in which the parties to a transaction agree that less than the full amount of the debt is payable on acquisition or disposal of the debt.

For example, Company Z owes Company X \$100. Company X requires the cash and sells the debt of \$100 to Company Y for \$75 because Company Y has concerns about the recoverability of the debt and is prepared to pay Company X only \$75. The difference of \$25 (\$100 – \$75) has nothing to do with a different exchange rate being applied by Company X and Company Y and, therefore, the proviso to the ruling exchange rate for debt does not apply. In this example, the consideration between the buyer and seller for disposal of a debt was fixed in an amount of foreign currency which is the same foreign currency in which the debt was denominated. Accordingly,

it cannot be said that any rate (being an exchange rate) was applied in determining the consideration and the proviso does not apply.

The disposal of a foreign currency-denominated asset, such as a debt, will often have two elements, namely, a gain or loss as a result of the movement in exchange rates (foreign exchange transaction) and the gain or loss on the disposal of the debt itself which, depending on the facts of a particular case, could be of a revenue or capital nature. If both of these elements are present, the two elements need to be identified and dealt with separately under the appropriate provisions of the Act.

For example, Company A owes Company B \$100. The debt arose during the year of assessment when the spot rate was 11,5000. Company B requires the cash and sells the debt of \$100 to Company C for \$75. Company C has some concerns about the recoverability of the debt and plans to actively manage the debt to ensure a full recovery. Company B and Company C agree that Company C will pay Company B R844, or \$75 at a rate of 11,2533, on the last date of the month for the debt of \$100. The prevailing spot rate on the last day of the month was 11,3000. From Company B's perspective, section 24I, and more specifically the proviso to paragraph (a) of the definition of "ruling exchange rate", will deal with the exchange difference which results from the movement in the exchange rate from 11,5000 to the agreed contractual rate of 11,2533<sup>53</sup> and, assuming Company B held the debt on capital account, the Eighth Schedule read with section 25D(1) will deal with the difference between the base cost of \$100 and proceeds of \$75.

If the proviso applies, as it does in the example in the preceding paragraph, it is necessary to calculate the acquisition rate or disposal rate as appropriate. The term "acquisition rate" means "the *exchange rate* in respect of an exchange item obtained by dividing the amount of the expenditure incurred for the acquisition of such exchange item [the debt] by the foreign currency amount in respect of such exchange item".<sup>54</sup> (Emphasis added.)

The term "disposal rate" means "the *exchange rate* in respect of an exchange item obtained by dividing the amount received or accrued in respect of the disposal of such exchange item [the debt] by the foreign currency amount received or accrued for such exchange item".<sup>55</sup> (Emphasis added.)

The calculation of the disposal rate is explained by calculating it from Company B's perspective in the example above. The disposal rate is calculated as follows:

- Disposal rate in respect of an exchange item being disposed of (that is, the debt of \$100) = amount received or accrued in respect of the disposal of such exchange item (in rand, namely, R844 or  $\$75 \times 11,2533$ ) divided by the foreign currency amount (the consideration received or accrued of \$75) in respect of the disposal of such exchange item (being the debt \$100) = 11,2533. This rate accurately reflects the exchange rate which was applied to determine the rand amount obtained in respect of the disposal.
- Applying the disposal rate to calculate the exchange difference on realisation = multiply the amount of the exchange item by the difference between the ruling exchange rates on transaction date and realisation

<sup>53</sup> See discussion on the calculation of the acquisition rate and disposal rate later in this paragraph.

<sup>54</sup> Section 24I(1).

<sup>55</sup> Section 24I(1).



date =  $\$100 \times (11,5000 - 11,2533 \text{ disposal rate}) = \text{R}25$  foreign exchange loss.

The definition of “disposal rate” uses the words “dividing ... by the foreign currency amount in respect of such exchange item” and does not use the words “dividing ... by the foreign currency amount of such exchange item”. The words “in respect of” refer to the amount of foreign currency which was received for the disposal.

Accordingly, the denominator in the calculation of the disposal rate is the amount of foreign currency for which the item was disposed of and not the full amount of the exchange item just before the transaction. This treatment ensures that when applying the disposal rate in the calculation of the exchange difference arising on realisation, section 24I picks up and deals with only the gain or loss which arises as a result of the movement in the exchange rates and does not deal with a gain or loss which is attributable to other factors.

The same principles are applicable in calculating a disposal rate and an acquisition rate. In the example above, the acquisition rate is calculated as follows from Company C's perspective:

- Acquisition rate in respect of an exchange item acquired (that is, the debt of \$100) = expenditure incurred for the acquisition of such exchange item (in rand, namely, R844 or  $\$75 \times 11,2533$ ) by the foreign currency amount (the consideration paid of \$75) in respect of the acquisition of such exchange item (being the debt of \$100) = 11,2533. This rate accurately reflects the exchange rate which was applied to determine the number of rands paid in respect of the acquisition.
- The discount of \$25 ( $\$75 - \$100$ ) at which the debt was acquired is receivable in terms of or in respect of a financial arrangement and will form part of interest for purposes of section 24J.

**Example 13 – Acquisition and disposal of an amount in foreign currency owing to a person on a debt payable to that person**

*Facts:*

Company A's business involves purchasing and recovering debts. Its year of assessment ends on the last day of February. It purchased a debt receivable of \$30 000 on 31 January year 1 for R340 386 and sold it on 30 June year 1 for R385 846 which includes a 10% mark-up on the purchase price.

Market rates are as follows:

|                                       | <b>\$ / R</b>    |
|---------------------------------------|------------------|
| <b>Date</b>                           | <b>Spot rate</b> |
| 31 January year 1 (transaction date)  | 11,4200          |
| 28 February year 1 (translation date) | 11,6400          |
| 30 June year 1 (realisation date)     | 11,6600          |

*Result:*

The acquisition rate and disposal rate of the debt are determined as follows:

*Acquisition rate*

Expenditure incurred (in rand) for the acquisition of the exchange item (debt) / foreign currency amount in respect of the debt

$$= R340\,386 / \$30\,000$$

$$= 11,3462$$

*Disposal rate*

Amount received or accrued (in rand) on disposal of the exchange item (debt) / foreign currency amount received or accrued in respect of the debt

$$= R385\,846 / (\$30\,000 + 10\% \text{ mark-up of } \$3\,000)$$

$$= 11,6923$$

*Year of assessment ending on 28 February year 1**Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt receivable) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$30\,000 \times (11,3462 - 11,6400)$ ] | 8 814 |

Under the proviso to paragraph (a) of the definition of "ruling exchange rate" in section 24I(1) the acquisition rate is deemed to be the spot rate on transaction date. An exchange difference of R8 814 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Taxable income calculation*

|  |                |
|--|----------------|
|  | R              |
| Foreign exchange gain [section 24I(3)(a)]                            | 8 814          |
| Acquisition of the debt [section 11(a)]                              | (340 386)      |
| Closing stock [section 22(1) read with section 22(3)(a)(i)] (Note 2) | <u>340 386</u> |
|  | <u>8 814</u>   |

*Year of assessment ending on 28 February year 2**Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt receivable) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$30\,000 \times (11,6400 - 11,6923)$ ] | 1 569 |

Under the proviso to paragraph (a) of the definition of "ruling exchange rate" in section 24I(1) the disposal rate is deemed to be the spot rate on realisation date. An exchange difference of R1 569 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

| <i>Taxable income calculation</i>                                    | R                |
|--|------------------|
| Gross Income   | 385 846          |
| Less: Adjustment for inclusion under section 24I(3)(a) (Note 1)      | <u>(10 383)</u>  |
|  | 375 463          |
| Foreign exchange gain [section 24I(3)(a)]                            | 1 569            |
| Opening stock [section 22(2) read with section 22(3)(a)(i)] (Note 2) | <u>(340 386)</u> |
|  | <u>36 646</u>    |

**Notes:**

- (1) Under section 24I(6) the amount included in gross income must be reduced by the amount of the foreign exchange gains of R10 383 (R8 814 + R1 569) previously included in income. (see **4.6**).
- (2) Under section 22(3)(a)(i) the cost price of trading stock excludes the amount of an exchange difference (see **4.13.2**).
- (3) The net inclusion in gross income of R45 460 (R8 814 + R36 646) equals the difference between the rand amount paid on transaction date of R340 386 and the rand amount received on realisation date of R385 846.

**Example 14 – Acquisition and disposal of an amount in foreign currency owing to a person on a debt payable to that person**

*Facts:*

Company A's year of assessment ends on the last day of December. Company A lent Company B \$1 million on 1 January year 1 when the exchange rate was R8/ \$1. Company A sold the debt on 30 June year 5 for \$500 000 at an agreed exchange rate of R10/ \$1. Company A therefore received R5 million. The debt was held on capital account.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 January year 1 (transaction date)   | 8,0000                      |
| 31 December year 4 (translation date) | 9,0000                      |
| 30 June year 5 (realisation date)     | 10,5000                     |

*Result:*

*Year of assessment ending on 31 December year 5*

The disposal rate of the debt is determined as follows:

Amount received or accrued (in rand) on disposal of the exchange item (debt) / Foreign currency amount received or accrued in respect of the debt

$$= R5\,000\,000 / \$500\,000$$

$$= 10,0000$$

Under the proviso to paragraph (a) of the definition of "ruling exchange rate" in section 24I(1), the disposal rate is deemed to be the spot rate on realisation date.

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt receivable) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |           |
|---|-----------|
|   | R         |
| Exchange difference [ $\$1\,000\,000 \times (9,0000 - 10,0000)$ ] | 1 000 000 |

An exchange difference of R1 million is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Determination of capital loss on disposal of the debt*

|  |                    |
|--|--------------------|
|  | R                  |
| Proceeds on disposal of debt ( $\$500\,000 \times 10,0000$ )           | 5 000 000          |
| Less: Base cost of the debt ( $\$1\,000\,000 \times 8,0000$ ) (Note 1) | <u>(8 000 000)</u> |
| Capital loss before adjustment (Note 2)                                | (3 000 000)        |
| Less: Foreign exchange gains included in income (Note 2)               | <u>(1 000 000)</u> |
| Capital loss   | <u>(4 000 000)</u> |

**Notes:**

- (1) The base cost of the debt is determined by applying the spot rate on date of acquisition under section 25D(1). Paragraph 43(1A) does not apply to an amount of debt owed to a company in foreign currency (see 4.12.2 for a discussion of paragraph 43).
- (2) Under section 24I(6) read with paragraph 35(3)(a) the capital loss is increased by the amount of the foreign exchange gains included in income under section 24I(3)(a) and in the capital loss determined before this adjustment [see 4.6 for a discussion of section 24I(6)]. Foreign exchange gains for years of assessment 1 to 4 of R1 000 000 [ $\$1\,000\,000 \times (8,0000 - 9,0000)$ ] + the foreign exchange gain for year of assessment 5 of R1 000 000 (see above) = R2 000 000. The portion of the foreign exchange gains included in income and in the capital loss therefore increases the capital loss under section 24I(6) read with paragraph 35(3)(a), that is the capital loss is increased by R1 000 000 ( $R2\,000\,000 \times \$500\,000 / \$1\,000\,000$ ).

**4.5.3 A forward exchange contract**

An exchange difference in relation to an FEC entered into by a person contemplated in section 24I(2) must be determined on translation date and realisation date.<sup>56</sup>

**(a) Definition of “forward exchange contract” and “forward rate”**

The term “forward exchange contract”<sup>57</sup> means any agreement under which a person agrees with another person to exchange an amount of currency for another currency at some future date at a specified exchange rate. The forward rate is defined as the specified exchange rate as referred to in the definition of “forward exchange contract”.<sup>58</sup>

<sup>56</sup> Paragraph (c) of the definition of “exchange item” in section 24I(1), section 24I(2) and (3).

<sup>57</sup> As defined in section 24I(1).

<sup>58</sup> Section 24I(1) definition of “forward rate”.

A person may enter into an FEC to hedge the risk of an unfavourable movement in the exchange rate in the future on an underlying transaction. Simultaneously, the possibility of an exchange gain on a favourable movement in the exchange rate is removed. A person may also enter into an FEC for speculative purposes. Although an FEC may be held by a person for the purpose of resale at a profit, it is specifically excluded from the definition of “trading stock” in section 1(1) (see **4.13.1**).

**(b) Transaction date and realisation date for a forward exchange contract**

The transaction date<sup>59</sup> in relation to an FEC is the date when the contract was entered into and the realisation date<sup>60</sup> is the date when payment is received or made in respect of the FEC.

**(c) Ruling exchange rates in relation to a forward exchange contract**

The ruling exchange rates in relation to an FEC, unless the proviso as discussed in **4.4.8** applies, are as follows:<sup>61</sup>

- On transaction date – the forward rate under the FEC.
- On translation date in respect of an FEC which –
  - is not an affected contract, the MRFR (market-related forward rate) available for the remaining period of the FEC; or
  - is an affected contract, the forward rate under the FEC [see the definition of “affected contract” in **4.5.3(e)**].
- On realisation date – the spot rate on that date (see the definition of “spot rate” in **4.4.9**).

Under the proviso the Commissioner may, having regard to the particular circumstances of the case, prescribe an alternative rate to any of the prescribed rates to be applied by a person in such circumstances if the alternative rate was used for purposes of financial reporting pursuant to IFRS (see **4.5.3(f)** and **4.5.3(g)** below).

**(d) Determination of a market-related forward rate on translation date of a forward exchange contract**

Under paragraph (b)(ii) of the definition of “ruling exchange rate” in section 24I(1), the ruling exchange rate in relation to an FEC, that is not an affected contract, on translation date is the MRFR available for the remaining period of the contract.

The MRFR available for the remaining period of an FEC must be determined by obtaining from an authorised foreign exchange dealer the closing rate on translation date for the remaining period of the contract for the same amount of foreign currency. The MRFR is therefore the forward rate at which another FEC for the same amount of foreign currency could be entered into on the last day of the specific year of assessment that would expire on the same date as the original FEC.

<sup>59</sup> Paragraph (e) of the definition of “transaction date” in section 24I(1).

<sup>60</sup> Paragraph (b) of the definition of “realised” in section 24I(1).

<sup>61</sup> Paragraph (b) of the definition of “ruling exchange rate” in section 24I(1).

**Example 15 – Determination of exchange differences on an FEC***Facts:*

Trust A entered into an FEC on 1 January year 1 under which \$150 000 would be purchased on 30 June year 1 at a forward rate of 11,5200. The MRFR on 28 February year 1 for a similar contract was 11,5400.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> | <b>\$ / R<br/>Forward rate</b> |
|---------------------------------------|-----------------------------|--------------------------------|
| 1 January year 1 (transaction date)   | 11,4000                     | 11,5200                        |
| 28 February year 1 (translation date) | 11,4500                     | 11,5400                        |
| 30 June year 1 (realisation date)     | 11,5800                     |                                |

*Result:*

*Year of assessment ending on 28 February year 1*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the MRFR) as follows:

|   |            |
|---|------------|
| Exchange difference [ $\$150\,000 \times (11,5200 - 11,5400)$ ] | R<br>3 000 |
|---|------------|

An exchange difference of R3 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the MRFR) and realisation date (the spot rate) as follows:

|   |       |
|---|-------|
| Exchange difference [ $\$150\,000 \times (11,5400 - 11,5800)$ ] | 6 000 |
|---|-------|

An exchange difference of R6 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Example 16 – Determination of exchange differences – Hedging of a debt by an FEC***Facts:*

Company A is a resident and its year of assessment ends on the last day of February. Company A purchased trading stock of \$100 000 on 1 December year 1. The trading stock was disposed of before the end of the year of assessment ending on 28 February year 2. The debt was payable on 31 May year 2.

Company A entered into an FEC on 1 December year 1 under which \$100 000 would be purchased on 31 May year 2 at a forward rate of 11,4900. The MRFR on 28 February year 2 for a similar contract was 11,5100.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R</b>    | <b>\$ / R</b>       |
|---------------------------------------|------------------|---------------------|
|                                       | <b>Spot rate</b> | <b>Forward rate</b> |
| 1 December year 1 (transaction date)  | 11,3700          | 11,4900             |
| 28 February year 2 (translation date) | 11,4500          | 11,5100             |
| 31 May year 2 (realisation date)      | 11,5600          |                     |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt and the FEC.

*Year of assessment ending on 28 February year 2*

*Determination of exchange differences on translation date*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |              |
|---|--------------|
| Exchange difference [ $\$100\,000 \times (11,3700 - 11,4500)$ ] | R<br>(8 000) |
|---|--------------|

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the MRFR) as follows:

|   |            |
|---|------------|
| Exchange difference [ $\$100\,000 \times (11,4900 - 11,5100)$ ] | R<br>2 000 |
|---|------------|

The exchange differences of (R8 000) loss and R2 000 gain determined on translation date must be deducted from and included in income under section 24(3)(a).

*Income tax treatment of the acquisition and disposal of trading stock*

The trading stock acquired of R1 137 000 ( $\$100\,000 \times 11,3700$ ) is deductible under section 11(a). The amount is determined under section 25D(1) by multiplying the amount of the expenditure incurred by the spot rate on the date that the expenditure is incurred.

The amount received or accrued on disposal of the trading stock must be included in gross income and, if it is sold in foreign currency, is determined under section 25D(1) by multiplying the amount received or accrued in foreign currency by the spot rate on the date of receipt or accrual.

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (11,4500 - 11,5600)$ ] | (11 000) |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the MRFR) and realisation date (the spot rate) as follows:

|   |       |
|---|-------|
|   | R     |
| Exchange difference [ $\$100\,000 \times (11,5100 - 11,5600)$ ] | 5 000 |

The exchange differences of (R11 000) loss and R5 000 gain determined on realisation date must be deducted from and included in income under section 24I(3)(a).

**Note:**

The sum of the net foreign exchange losses in both years of assessment of (R12 000) [(R8 000) loss + R2 000 gain + (R11 000) loss + R5 000 gain] and the deduction under section 11(a) of R1 137 000 is equal to the rand amount paid of R1 149 000 ( $\$100\,000 \times 11,4900$ ) under the FEC and used to purchase the trading stock.

### **Example 17 – Determination of exchange differences – Hedging of units of currency by an FEC**

*Facts:*

Company A is a resident bank and its year of assessment ends on the last day of February. It entered into an FEC on 1 March year 1 under which it will sell \$50 000 on 30 June year 2 at a forward rate of 12,6500. The MRFR on 28 February year 2 for a similar contract was 12,9500.

On 1 March year 1 Company A also purchased \$50 000 at the spot rate on that date.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R</b>    | <b>\$ / R</b>       |
|---------------------------------------|------------------|---------------------|
|                                       | <b>Spot rate</b> | <b>Forward rate</b> |
| 1 March year 1 (transaction date)     | 11,0500          | 12,6500             |
| 28 February year 2 (translation date) | 11,7500          | 12,9500             |
| 30 June year 2 (realisation date)     | 12,7600          |                     |

*Result:*

Exchange differences are determined for each exchange item, namely, the units of currency and the FEC.



*Year of assessment ending on 28 February year 2*

*Determination of exchange differences on translation date*

*Units of currency*

The exchange difference is determined by multiplying the amount of the exchange item (units of currency) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  |        |
|--|--------|
|  | R      |
| Exchange difference [ $\$50\,000 \times (11,0500 - 11,7500)$ ] | 35 000 |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the MRFR) as follows:

|  |          |
|--|----------|
|  | R        |
| Exchange difference [ $\$50\,000 \times (12,6500 - 12,9500)$ ] | (15 000) |

The exchange differences of R35 000 gain and (R15 000) loss determined on translation date must be included in and deducted from income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

*Units of currency*

The exchange difference is determined by multiplying the amount of the exchange item (units of currency) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |        |
|--|--------|
|  | R      |
| Exchange difference [ $\$50\,000 \times (11,7500 - 12,7600)$ ] | 50 500 |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the MRFR) and realisation date (the spot rate) as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$50\,000 \times (12,9500 - 12,7600)$ ] | 9 500 |

The exchange differences of R50 500 gain and R9 500 gain determined on realisation date must be included in income under section 24I(3)(a).

**Example 18 – Hedging the purchase of equipment from a foreign supplier by taking out an FEC**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of December. It purchased equipment for \$1 million on 15 January year 1. The debt is payable on 15 April year 1. On 15 January year 1 Company A entered into an FEC for a three-month period.

Market rates are as follows:

| <b>Date</b>                          | <b>\$ / R</b>    | <b>\$ / R</b>       |
|--------------------------------------|------------------|---------------------|
|                                      | <b>Spot rate</b> | <b>Forward rate</b> |
| 15 January year 1 (transaction date) | 11,4000          | 11,5200             |
| 15 April year 1 (realisation date)   | 11,6000          |                     |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt and the FEC.

*Year of assessment ending on 31 December year 1*

*Determination of exchange differences on realisation date*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|  |           |
|--|-----------|
|  | R         |
| Exchange difference [ $\$1 \text{ million} \times (11,4000 - 11,6000)$ ] | (200 000) |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and realisation date (the spot rate) as follows:

|  |        |
|--|--------|
|  | R      |
| Exchange difference [ $\$1 \text{ million} \times (11,5200 - 11,6000)$ ] | 80 000 |

The exchange differences of (R200 000) loss and R80 000 gain determined on realisation date must be deducted from and included in income under section 24I(3)(a).

**(e) A forward exchange contract that is an affected contract**

The term “affected contract” as defined in section 24I(1) means any FCOC or FEC to the extent that it has been entered into by any person during any year of assessment to serve as a hedge for a debt, when that debt –

- is to be utilised by that person for the purposes of acquiring any asset or for financing any expenditure or will arise from the sale of any asset or supply of any services, under an agreement entered into by that person in the ordinary course of the person’s trade before the end of the current year of assessment; and
- that debt has not yet been incurred by such person or the amount payable in respect of such debt has not yet accrued during that current year of assessment.

The ruling exchange rate on translation date for an FEC that is an affected contract is the forward rate under the contract.<sup>62</sup> The effect of this treatment is that an exchange difference will not arise on translation date when the underlying debt has not been incurred or the amount payable on the debt has not accrued. An exchange difference

<sup>62</sup> Paragraph (b)(ii) of the definition of “ruling exchange rate” in section 24I(1).

on the FEC will arise on the earlier of realisation of the FEC, or translation date after the underlying debt is incurred or the amount payable on the debt accrues.

For example, X orders trading stock, the purchase price of which is denominated in a foreign currency, in year 1. The liability to pay for the trading stock and the incurral of the expense arises in year 2 when the trading stock is delivered. X takes out an FEC to hedge the debt in year 1 when the order is placed. The term of the FEC ends in year 2 on the delivery of the trading stock. At the end of year 1 the FEC is an affected contract as it meets all of the requirements per the definition set out above. Therefore, when calculating the exchange difference on the FEC on translation date at the end of year 1, the relevant rate for the ruling exchange rate at transaction date and translation date will be the forward rate, giving rise to an exchange difference of nil. In year 2 the relevant rates in calculating the exchange difference for the FEC are the forward rate at the previous translation date<sup>63</sup> and the spot rate<sup>64</sup> at realisation date.

A person may enter into an FEC to serve as a hedge for more than one item of debt. Some of those items of debt may not meet the requirements of an affected contract and some of the items of debt may meet the requirements of an affected contract. For example, an FEC of \$200 000 is taken out to hedge debt of \$150 000 for goods delivered before the end of the year of assessment and debt of \$50 000 for the purchase of goods which will be delivered in the following year of assessment. The FEC will be an affected contract to the extent of \$50 000.

#### **Example 19 – Definition of “affected contract”**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of February. Company A is a manufacturer that imports a number of raw materials from the USA.

In December year 1 Company A’s directors became concerned about the weakening of the rand and took out an FEC for \$100 000 at a forward rate of 11,5800 to hedge the purchase of a new machine for the factory of \$60 000 and to cover the anticipated purchase of raw materials of \$40 000 which would be required for production in June year 2.

The agreement to purchase the machine was concluded on 28 December year 1 with an expected delivery date of 31 March year 2. The machine was delivered on 31 March year 2.

Company A placed orders on 31 January year 2 for raw materials of \$70 000 to be delivered in May year 2. The goods were despatched free on board on 1 March year 2.

The FEC matured on 1 March year 3. Payment of the debt which funded the cost of the machine and the raw materials was also made on 1 March year 3.

<sup>63</sup> Per paragraph (b) of the definition of “exchange difference” in section 24I(1).

<sup>64</sup> Per paragraph (b)(iii) of the definition of “ruling exchange rate” in section 24I(1).

*Result:**Year of assessment ending on 28 February year 2*

The FEC is an affected contract because it was taken out with the purpose of hedging debts which had not been incurred by the end of the year of assessment<sup>65</sup> and the necessary agreements to purchase the hedged items had been concluded before year end. The required direct relationship between the FEC and the debt items hedged was present. The ruling exchange rate on transaction date and translation date will be the FEC's forward rate and therefore the exchange difference on the FEC will be nil.

*Year of assessment ending on 28 February year 3*

The FEC is not an affected contract because the debt items hedged were incurred during the year of assessment, namely, on 31 March year 2 for the machine-related debt and on 1 March year 2 for the raw material-related debt.

The ruling exchange rate on translation date for the FEC will be the MRFR for the remaining period of the FEC and for the debt, the relevant spot rate.

**Example 20 – Determination of an exchange difference on an FEC that is an affected contract**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of February. On 1 December year 1 Company A entered into an agreement to purchase equipment of \$100 000 for delivery on 31 March year 2. The debt was payable on 30 April year 2.

On 1 December year 1 Company A entered into an FEC to hedge the debt for a five-month period.

The debt was paid on 30 April year 2.

Market rates are as follows:

| <b>Date</b>                                     | <b>\$ / R</b>    | <b>\$ / R</b>       |
|---|------------------|---------------------|
|   | <b>Spot rate</b> | <b>Forward rate</b> |
| 1 December year 1 (date agreement entered into) | 11,4000          | 11,5800             |
| 28 February year 2 (translation date)           | 11,5000          |                     |
| 31 March year 2 (transaction date for the debt) | 11,6000          |                     |
| 30 April year 2 (realisation date)              | 11,7000          |                     |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt (in the year of assessment ending on 28 February year 3) and the FEC (in the year of assessment ending on 28 February year 2 and year 3).

<sup>65</sup> The debts in respect of the machine and the raw materials were incurred on 31 March year 2 and 1 March year 2, respectively.

*Year of assessment ending on 28 February year 2**Determination of exchange differences on translation date**Debt*

No exchange difference arose in relation to the debt, since it had not been actually incurred during the year of assessment ending on 28 February year 2 and did not exist at that date.

*FEC*

The FEC is an affected contract because it was taken out to hedge the debt which underlies the purchase of the equipment and that debt was not incurred before the end of the year of assessment, since the equipment had not been delivered. Therefore, the ruling exchange rate on translation date is the FEC's forward rate.

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the forward rate) as follows:

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$100\,000 \times (11,5800 - 11,5800)$ ] | 0 |

*Year of assessment ending on 28 February year 3**Determination of exchange differences on realisation date**Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date. The debt was actually incurred on 31 March year 2. Accordingly, the transaction date is 31 March year 2.

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (11,6000 - 11,7000)$ ] | (10 000) |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the forward rate) and realisation date (the spot rate) as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,5800 - 11,7000)$ ] | 12 000 |

The exchange differences of (R10 000) loss and R12 000 gain determined on realisation date must be deducted from and included in income under section 24(3)(a).

**Example 21 – Affected contract in respect of interest incurred***Facts:*

Company A's year of assessment ends on 31 August. Company A, which manufactures prescription medicines, concluded an agreement to purchase equipment to be used in its manufacturing process on 1 July year 1.

The purchase price of the equipment was \$300 000 and was payable in two instalments, namely \$200 000 on 1 July year 1 and \$100 000 on 31 December year 1. Interest of 12% was charged on the instalment of \$100 000 from 1 July year 1 to 31 December year 1 and was payable on 31 December year 1. The equipment was delivered on 1 July year 1.

Company A entered into an FEC on 1 July year 1. Under the contract Company A would purchase \$106 000 on 31 December year 1 at a forward rate of 11,7000.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R</b>    | <b>\$ / R</b>       |
|---------------------------------------|------------------|---------------------|
|                                       | <b>Spot rate</b> | <b>Forward rate</b> |
| 1 July year 1 (transaction date)      | 11,4000          | 11,7000             |
| 31 August year 1 (translation date)   | 11,5000          | 11,7500             |
| 31 December year 1 (realisation date) | 11,8000          |                     |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt and the FEC.

*Year of assessment ending on 31 August year 1**Determination of exchange differences on 31 August year 1**Portion of debt arising and settled on 1 July year 1*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date. The debt was actually incurred on 1 July year 1 and \$200 000 of it was paid on that date. Accordingly, the transaction date and realisation date for the debt of \$200 000 are both 1 July year 1.

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$200\,000 \times (11,4000 - 11,4000)$ ] | 0 |

*Portion of debt arising on 1 July year 1 which is to be settled on 31 December year 1*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date. The debt was actually incurred on 1 July year 1. Accordingly, the transaction date is 1 July year 1.

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (11,4000 - 11,5000)$ ] | (10 000) |

The foreign exchange loss of (R10 000) determined on translation date must be deducted from income under section 24(3)(a).

*FEC – portion related to interest not yet incurred*

The FEC was taken out to cover a future interest payment of \$6 000 ( $\$100\,000 \times 12\% \times 6 / 12$ ). Interest is calculated from 1 July year 1 and is due on 31 December year 1. However, under section 24J the interest for 1 July year 1 to 31 August year 1 ( $\$100\,000 \times 12\% \times 2 / 12 = \$2\,000$ ) is deemed to have been incurred by Company A in the year of assessment ending on 31 August year 1 and must be deducted from income.

The FEC is an affected contract to the extent of \$4 000 interest [ $\$6\,000 - \$2\,000$  deemed to have been incurred under section 24J(2) in the year of assessment ending on 31 August year 1] because it is to that extent that it was taken out to hedge a debt that has not been incurred before the end of the year of assessment and which will be used to finance an expense. Accordingly, the ruling exchange rate on translation date on this portion of the FEC is the FEC's forward rate.

The exchange difference is determined by multiplying the relevant portion of the exchange item (the FEC which is an affected contract) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the forward rate). The forward rate is applied on translation date, since the FEC is an affected contract.

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$4\,000 \times (11,7000 - 11,7000)$ ] | 0 |

*Interest deemed to have been incurred under section 24J(2) and therefore giving rise to a debt on 31 August year 1*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date. Interest of \$2 000 was deemed to have been incurred in the year of assessment ending on 31 August year 1. The transaction date and translation date are both 31 August year 1.

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$2\,000 \times (11,5000 - 11,5000)$ ] | 0 |

*FEC – portion related to capital and accrued interest on 31 August year 1*

The FEC to the extent of \$102 000 ( $\$100\,000$  capital +  $\$2\,000$  interest) is not an affected contract because it was taken out to hedge a debt which was incurred before the end of the year of assessment. Accordingly, the ruling exchange rate on translation date on this portion of the FEC is the MRFR.

The exchange difference is determined by multiplying the relevant portion of the exchange item ( $\$102\,000$ ) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the MRFR) as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$102\,000 \times (11,70000 - 11,7500)$ ] | 5 100 |

An exchange difference of R5 100 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 31 August year 2*

*Determination of exchange differences on realisation date*

*Debt – capital and interest incurred under section 24J(2) in the previous year of assessment*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$102\,000 \times (11,5000 - 11,8000)$ ] | (30 600) |

*Debt – interest portion*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date. The transaction date and realisation date are both 31 December year 1.

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$4\,000 \times (11,8000 - 11,8000)$ ] | 0 |

*FEC - portion related to interest*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the forward rate) and realisation date (the spot rate) as follows:

|   |     |
|---|-----|
|   | R   |
| Exchange difference [ $\$4\,000 \times (11,7000 - 11,8000)$ ] | 400 |

*FEC – portion related to capital and interest incurred under section 24J(2) in the previous year of assessment*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the MRFR) and realisation date (the spot rate) as follows:

|   |       |
|---|-------|
|   | R     |
| Exchange difference [ $\$102\,000 \times (11,7500 - 11,8000)$ ] | 5 100 |

The exchange differences of (R30 600) loss, R400 gain and R5 100 gain determined on realisation date must be deducted from and included in income under section 24I(3)(a), as appropriate.

**(f) Alternative ruling exchange rate in relation to a forward exchange contract on translation date**

The proviso to the definition of “ruling exchange rate” in section 24I(1) stipulates that the Commissioner may, having regard to the particular circumstances of the case, prescribe an alternative rate to any of the prescribed rates to be applied by a person in particular circumstances, if that alternative rate is used for the purposes of financial reporting pursuant to IFRS.



Whether or not the use of an alternative rate is appropriate must be assessed on a case-by-case basis. That said, as a general observation, if an exchange item is required to be recognised at fair value in accordance with IFRS and that requires taking into consideration a combination of an applicable exchange rate (for example, a MRFR in the case of an FEC), a present value discounting factor, a credit risk factor and other factors to arrive at a fair value rate, it is unlikely that the fair value rate will constitute an acceptable alternative rate under the proviso.

The reason is that the proviso primarily implies the use of alternative actual exchange rates between two currencies and does not envisage the incorporation of other factors which do not represent the use of or result in actual exchange rates. For example, an alternative rate would not include an exchange rate at year-end which has been discounted to recognise the time value of money and other fair value factors for accounting purposes because those present value and other factors are outside the scope and purpose of section 24I.

**(g) Early termination, extension or cancellation of a forward exchange contract**

There are a number of reasons why a person may wish to shorten<sup>66</sup> or extend the term of an FEC or cancel it. There are also a number of ways in which these actions may be implemented and the method of implementation will determine how the provisions of section 24I apply. The consequences under section 24I must therefore be determined on a case-by-case basis taking into account the detailed facts of the particular case. An FEC which is an affected contract may also be impacted by an early termination, extension or cancellation.

The objective may, for example, in the case of an early termination, be achieved by entering into an equal and opposite position which gives rise to an additional exchange item that is treated separately under section 24I. Alternatively, the method of implementing an early termination may give rise to an immediate realisation event. If there is a realisation event, the ruling exchange rate generally requires the use of the spot rate at realisation date when calculating the exchange difference that arises. In determining the spot rate, which as noted previously is “the *appropriate* quoted exchange rate at a specific time by an authorised dealer in foreign exchange for the delivery of the currency”, the particular instrument and trade must be taken into consideration. In addition, depending on the facts of the particular case, the Commissioner may prescribe an alternative ruling exchange rate under the proviso to the definition of “ruling exchange rate” in section 24I(1) if that alternative rate is used for purposes of financial reporting under IFRS.

See Example 31 in 4.7.4, where a second “replacement” FEC was taken out to extend the period of time in which the underlying debt was covered by an FEC.

**Example 22 – Alternative ruling exchange rate on early termination of an FEC**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of March. On 1 April year 1 Company A purchased a machine on credit from a foreign supplier for use in its factory. The purchase price of \$4 million was payable on 31 March year 3. The machine was immediately brought into use.

<sup>66</sup> Also referred to as pre-delivery or early termination.

Company A also entered into an FEC on 1 April year 1 under which \$4 million would be purchased on 31 March year 3 at a forward rate of 11,3000.

As a result of unexpected favourable trading results and improved cash flow management, Company A used available resources and repaid the loan on 31 January year 2.

Company A no longer required the foreign exchange rate cover provided under the FEC and on 31 March year 2 Company A entered into an agreement with a third party under which the FEC was sold to that person at an agreed rate of 11,4000. The rate is referred to as the transfer rate. Company A applied to SARS for approval of the transfer rate as an “alternative rate” under the proviso to the definition of “ruling exchange rate” in section 24I(1).

Market rates are as follows:

| <b>Date</b>                               | <b>\$ / R<br/>Spot rate</b> | <b>\$ / R<br/>Forward rate</b> |
|---|-----------------------------|--------------------------------|
| 1 April year 1 (transaction date)         | 11,2000                     | 11,3000                        |
| 31 January year 2 (loan realisation date) | 11,3000                     |                                |
| 31 March year 2 (realisation date)        | 11,6000                     |                                |

*Result:*

Company A has two exchange items – the dollar denominated-loan and the FEC.

*Year of assessment ending on 31 March year 2*

*Determination of exchange difference on realisation date of the loan*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date. The debt was actually incurred on 1 April year 1. Accordingly, the transaction date is 1 April year 1.

|  |                |
|--|----------------|
| Exchange difference [ $\$4\,000\,000 \times (11,2000 - 11,3000)$ ] | R<br>(400 000) |
|--|----------------|

An exchange difference of (R400 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*Determination of exchange difference on realisation date of the FEC*

The disposal of the FEC and the receipt of proceeds from the third party is a realisation for purposes of section 24I.

The transfer rate (11,4000), which is also the rate Company A used for IFRS reporting purposes, differs from the spot rate (11,6000) on realisation date. The application of the spot rate on early termination of the FEC will give rise to an anomalous result, since the exchange difference determined on realisation date will differ from the amount of the foreign exchange gain actually realised.

The use of the spot rate on termination date in these circumstances is considered to be inappropriate and the transfer rate is approved as an alternative rate to be used on realisation date under the proviso to the definition of “ruling exchange rate” in section 24I(1).

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and realisation date (the alternative rate) as follows:

|  |         |
|--|---------|
|  | R       |
| Exchange difference [ $\$4\,000\,000 \times (11,3000 - 11,4000)$ ] | 400 000 |

An exchange difference of R400 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24(3)(a).

### **Example 23 – Early termination of an FEC by taking out an equal but opposite position on the FEC**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of March. On 1 April year 1 Company A purchased a machine on credit from a foreign supplier for use in its factory. The purchase price of \$4 million was payable on 31 March year 3. The machine was immediately brought into use.

Company A also entered into an FEC on 1 April year 1 under which \$4 million would be purchased on 31 March year 3 at a forward rate of 11,3000.

As a result of unexpected favourable trading results and improved cash flow management, Company A used available resources and repaid the loan on 31 January year 2.

Company A no longer required the foreign exchange rate cover provided under the FEC and on 31 March year 2 took out an FEC with a bank to sell \$4 million on 31 March year 3 at a forward rate of 11,4000.

Market rates are as follows:

| <b>Date</b>                               | <b>\$ / R</b>    | <b>\$ / R</b>       |
|---|------------------|---------------------|
|   | <b>Spot rate</b> | <b>Forward rate</b> |
| 1 April year 1 (transaction date)         | 11,2000          | 11,3000             |
| 31 January year 2 (loan realisation date) | 11,3500          |                     |
| 31 March year 2 (FEC translation date)    | 11,6000          | 11,4000             |
| 31 March year 3 (FEC realisation date)    | 11,4500          |                     |

The MRFR for both FECs on 31 March year 2 was 11,4000.

*Result:*

Company A has three exchange items – the dollar-denominated loan and the two FECs.

*Year of assessment ending on 31 March year 2*

*Determination of exchange difference on realisation date of the loan*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date. The debt was actually incurred on 1 April year 1. Accordingly, the transaction date is 1 April year 1.

|   |                |
|---|----------------|
| Exchange difference [ $\$4\,000\,000 \times (11,2000 - 11,3500)$ ]  | R<br>(600 000) |
| An exchange difference of (R600 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).  |                |
| <i>Determination of exchange difference on translation date of the FECs</i>   |                |
| The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the MRFR) as follows: |                |
| Exchange difference Buy FEC [ $\$4\,000\,000 \times (11,3000 - 11,4000)$ ]  | R<br>400 000   |
| Exchange difference Sell FEC [ $\$4\,000\,000 \times (11,4000 - 11,4000)$ ]   | 0              |
| An exchange difference of R400 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).  |                |
| <i>Year of assessment ending on 31 March year 3</i>   |                |
| <i>Determination of exchange difference on realisation date of the FECs</i>   |                |
| The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the MRFR) and realisation date (the spot rate) as follows:    |                |
| Exchange difference Buy FEC [ $\$4\,000\,000 \times (11,4000 - 11,4500)$ ]  | R<br>200 000   |
| Exchange difference Sell FEC [ $\$4\,000\,000 \times (11,4000 - 11,4500)$ ]   | (200 000)      |
| An exchange difference of R200 000 gain and (R200 000) loss is determined on realisation date that must be included in and deducted from income under section 24I(3)(a).  |                |

#### 4.5.4 A foreign currency option contract

Section 24I(3) (see 4.3) provides that, in relation to an FCOC, the following amounts must be included in or deducted from income as appropriate:

- The exchange difference determined in respect of an FCOC on translation date and realisation date.
- Any premium or like consideration received by or paid by a person under an FCOC entered into by that person.
- Any consideration paid for an FCOC acquired by a person.

##### (a) Definition of “foreign currency option contract”

The term “foreign currency option contract” as defined in section 24I(1) is an exchange item and means any agreement under which any person acquires or grants the right to buy from or to sell to any other person a certain amount of a nominated foreign currency on or before a future expiry date at a specified exchange rate. The specified exchange rate is also known as the option strike rate [see 4.5.4(g)].

Under an FCOC a person is granted the right, but is not obliged, to buy or sell foreign currency at a specified exchange rate within a specified period of time or on a fixed date.

A person who acquires the right to buy from, or to sell to, another person a certain amount of foreign currency is generally known as the holder of the contract while the person who grants the right is known as the writer of the contract. The holder of a “call option” has the right to buy an amount of foreign currency under an FCOC while the writer of that option has a contingent obligation to sell that amount of foreign currency should the option be exercised by the holder. The holder of a “put option” has the right to sell an amount of foreign currency under an FCOC while the writer of that option has a contingent obligation to buy that amount of foreign currency should the option be exercised by the holder.

An FCOC is an exchange item for both the writer and the holder.

A holder of an FCOC is covered against adverse movements in exchange rates whilst maintaining the possibility of making a profit should exchange rates fluctuate favourably. A person may enter into an FCOC for speculative purposes or to hedge an underlying transaction. Although an FCOC may be held by a person for the purpose of resale at a profit, it is specifically excluded from the definition of “trading stock” in section 1(1) (see **4.13.1**).

**(b) Premium or like consideration received by or paid by a person under a foreign currency option contract or consideration paid for a foreign currency option contract**

A premium or like consideration is often payable by a person when entering into an FCOC. The premium is the price that a person pays for obtaining the right to buy or sell an amount of foreign currency in the future. Consideration may also be payable when a person acquires an existing FCOC.

The premium or like consideration paid by a person under an FCOC or the consideration paid for an FCOC is deductible under section 24I(3)(b).

In contrast, although the premium or like consideration received by a person under an FCOC is included in income under section 24I(3)(b), the consideration received by or accrued to a person on disposal of an FCOC is not included in income under section 24I(3)(b). Such an amount is, however, indirectly included in income through the calculation of the exchange difference arising on realisation. Under the proviso to paragraph (c)(iii) of the definition of “ruling exchange rate” in section 24I(1), the ruling exchange rate on realisation date of an FCOC that is disposed of is the rate obtained by dividing the amount received or accrued as a result of the disposal of the FCOC by the foreign currency amount as specified in the FCOC.

An option holder’s loss under an FCOC is limited to the amount of the premium or like consideration paid under the FCOC or the consideration paid to acquire the FCOC. The amount of profit an option holder can make on exercising a foreign currency option is not limited. An option writer’s profit under an FCOC is limited to the amount of the premium or like consideration received under the contract, while the amount of the loss that person may incur is unlimited.

**(c) Transaction date and realisation date in relation to a foreign currency option contract**

Transaction date<sup>67</sup> in relation to an FCOC is the date when such contract was entered into or acquired.

An FCOC is realised when –

- payment is received or made in respect of the right in terms of the FCOC having been exercised;
- it expires without the right under the FCOC having been exercised; or
- it is disposed of.<sup>68</sup>

Realisation date is the date on which an FCOC is realised.

**(d) Ruling exchange rates in relation to a foreign currency option contract**

The ruling exchange rates in relation to an FCOC are as discussed below unless the proviso as discussed in **4.4.8** applies.<sup>69</sup>

*Ruling exchange rate on transaction date*

The ruling exchange rate in relation to an FCOC and an FCOC which is an affected contract, on transaction date is a nil rate.

*Ruling exchange rate on translation date*

The ruling exchange rate on translation date in relation to an FCOC –

- which is not an affected contract, is the rate obtained by dividing the market value of the FCOC on that date by the foreign currency amount as specified in the FCOC; and
- which is an affected contract, is the rate obtained by dividing any amount included in or deducted from income as a premium or like consideration or consideration under section 24I(3)(b) (see **4.5.4 (b)** above), by the foreign currency amount as specified in the affected contract.

*Ruling exchange rate on realisation date*

The ruling exchange rate in relation to an FCOC on realisation date is the rate obtained by dividing the market value of the FCOC on that date by the foreign currency amount as specified in the FCOC. The proviso to paragraph (c)(iii) of the definition of “ruling exchange rate” provides that when an FCOC is realised by disposal, the rate shall be obtained by dividing the amount received or accrued as a result of the disposal of the FCOC by the foreign currency amount as specified in the FCOC.

<sup>67</sup> Paragraph (f) of the definition of “transaction date” in section 24I(1).

<sup>68</sup> Paragraph (c) of the definition of “realised” in section 24I(1).

<sup>69</sup> Paragraph (c) of the definition of “ruling exchange rate” in section 24I(1) and the proviso to the definition of “ruling exchange rate”.

**(e) Definition of “market value”**

The term “market value” as defined in section 24I(1), in relation to an FCOC, is used to determine the ruling exchange rate in relation to that FCOC on translation date (in respect of a contract that is not an affected contract) and on realisation date, and means the following:

- When a person uses a market-related valuation method<sup>70</sup> for accounting purposes under a practice consistently applied to determine the value of all FCOCs, the market-related value so determined.
- For any other person, the intrinsic value of such FCOC [see the definition of “intrinsic value” in 4.5.4 (f)].

The market value of an FCOC is the same for the holder and for the writer of the contract except that a positive value for a holder represents a negative value (a liability) for the writer. When the market value of an FCOC increases for the holder of the contract resulting in a foreign exchange gain, the writer of such contract incurs a foreign exchange loss of the same amount.

The market value of an FCOC that expires without the right under the FCOC having been exercised will be nil.

**(f) Definition of “intrinsic value”**

For persons that do not use a market-related valuation method consistently for valuing all FCOCs, “intrinsic value”<sup>71</sup> is used to determine the market value of an FCOC –

- on translation date for a contract that is not an affected contract; and
- on realisation date (excluding realisation by way of disposal).

The term “intrinsic value” means the value for the holder or writer of the FCOC, as the case may be, determined by applying the difference between –

- the spot rate on translation date or realisation date, as the case may be; and
- the option strike rate,

to the amount of foreign currency as specified in the FCOC.

The intrinsic value represents the gain which the holder of an FCOC could realise by exercising the option at a given time when the option strike rate is more favourable than the spot rate at that time. The determination of intrinsic value is done on translation date even if the holder can only exercise the option on maturity date. If exercising the option would result in a loss for the holder, the value of the option is nil because the option would not be exercised in those circumstances. The intrinsic value is the same amount for both the holder and writer of an FCOC, however, an increase in value, which represent an exchange gain, for the holder is a decrease in value, or foreign exchange loss, for the writer.

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<sup>70</sup> A market-related valuation method would take into account the intrinsic value of the option plus other variables such as time.

<sup>71</sup> As defined in section 24I(1).

The proviso to the definition of “intrinsic value” stipulates that an FCOC shall have a nil value for the holder or writer if the holder would have sustained a loss had that person exercised the right under such FCOC on translation date or realisation date because of the unfavourable difference between the option strike rate and the spot rate on translation date or realisation date.

Should the spot rate on translation date or realisation date be better than the rate at which an option can be exercised, the holder is highly unlikely to exercise the option under the contract because the option is “out of the money”.

**(g) Definition of “option strike rate”**

For persons that do not use a market-related valuation method consistently for valuing all FCOCs, the “option strike rate”<sup>72</sup> is used to determine the intrinsic value in relation to an FCOC on translation date (in respect of a contract that is not an affected contract) and realisation date (excluding realisation by way of disposal). The term “option strike rate” means the specified exchange rate as referred to in the definition of “foreign currency option contract” in section 24I(1).

**(h) Determination of an exchange difference in relation to a foreign currency option contract that is not an affected contract**

The ruling exchange rates in relation to an FCOC that is not an affected contract are as discussed in 4.5.4(d).

**Example 24 – Determination of an exchange difference on an FCOC that is not an affected contract**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of February. On 1 March year 1 Company A entered into an FCOC under which it acquired the right to buy \$100 000 at the specified rate of 10,7000. On entering into the contract Company A paid a premium of R6 000. On 30 June year 2 Company A exercised the right under the FCOC and immediately sold the dollars at spot rate.

Company A does not use a market-related valuation method to determine the market value of the FCOC for accounting purposes.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R</b>    | <b>\$ / R</b>             |
|---------------------------------------|------------------|---------------------------|
|                                       | <b>Spot rate</b> | <b>Option strike rate</b> |
| 1 March year 1 (transaction date)     | 10,6000          | 10,7000                   |
| 28 February year 2 (translation date) | 10,8000          |                           |
| 30 June year 2 (realisation date)     | 11,3000          |                           |

<sup>72</sup> As defined in section 24I(1).



*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (FCOC) by the difference between the ruling exchange rates on transaction date (nil rate) and translation date (the rate obtained by dividing the market value of the FCOC on translation date by the foreign currency amount as specified in the FCOC).

The market value on translation date is the intrinsic value<sup>73</sup> and is determined as follows:

“(spot rate on translation date – the option strike rate) × Amount of foreign currency as specified in the FCOC”<sup>74</sup>

$$= (10,8000 - 10,7000) \times \$100\ 000$$

$$= R10\ 000$$

The ruling exchange rate on translation date is determined as follows:

“Market value of FCOC on translation date / Amount of foreign currency as specified in the FCOC”

$$= R10\ 000 / \$100\ 000$$

$$= 0,1000$$

|   |             |
|---|-------------|
| Exchange difference [ $\$100\ 000 \times (0,0000 - 0,1000)$ ] | R<br>10 000 |
|---|-------------|

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Premium paid under the FCOC*

The premium paid under the FCOC of R6 000 must be deducted from income under section 24I(3)(b)(i).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (FCOC) by the difference between the ruling exchange rates on translation date (the rate obtained by dividing the market value of the FCOC on translation date by the foreign currency amount as specified in the FCOC) and realisation date (the rate obtained by dividing the market value of the FCOC on realisation date by the foreign currency amount as specified in the FCOC).

<sup>73</sup> Definition of “market value” in section 24I(1).

<sup>74</sup> Definition of “intrinsic value” in section 24I(1).

The market value on realisation date is the intrinsic value<sup>75</sup> and is determined as follows:

“(Difference between the spot rate on realisation date and the option strike rate) × Amount of foreign currency as specified in the FCOC”<sup>76</sup>

$$= (11,3000 - 10,7000) \times \$100\,000$$

$$= R60\,000$$

The ruling exchange rate on realisation date is determined as follows:

“Market value of FCOC on realisation date / Amount of foreign currency as specified in the FCOC”

$$= R60\,000 / \$100\,000$$

$$= 0,6000$$

|   |             |
|---|-------------|
| Exchange difference [ $\$100\,000 \times (0,1000 - 0,6000)$ ] | R<br>50 000 |
|---|-------------|

An exchange difference of R50 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

**Note:**

The sum of the foreign exchange gains in years of assessment ending on 28 February year 2 and year 3 of R60 000 (R10 000 + R50 000) is equal to the difference of R60 000 between the rand amounts received and paid on realisation date of R1 130 000 ( $\$100\,000 \times 11,3000$ ) and R1 070 000 ( $\$100\,000 \times 10,7000$ ).

**Example 25 – Determination of an exchange difference on an FCOC that is not an affected contract – Market-related valuation method used for accounting purposes on translation date and realisation date**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of February. On 1 January year 1 Company A entered into an FCOC under which the right was obtained to purchase \$80 000 on 28 February year 2 at the specified rate of 11,4000. The premium paid under the FCOC amounted to R4 000. Company A applied a market-related valuation method for accounting purposes to account for the FCOC which amounted to R5 200 on 28 February year 1 and R16 000 on 28 February year 2. Company A exercised the right on 28 February year 2.

Market rates are as follows:

| Date                                  | \$ / R<br>Spot rate | \$ / R<br>Option strike<br>rate |
|---------------------------------------|---------------------|---------------------------------|
| 1 January year 1 (transaction date)   | 11,3000             | 11,4000                         |
| 28 February year 1 (translation date) | 11,4500             |                                 |
| 28 February year 2 (realisation date) | 11,6000             |                                 |

<sup>75</sup> Definition of “market value” in section 24I(1).

<sup>76</sup> Definition of “intrinsic value” in section 24I(1).

*Result:*

*Year of assessment ending on 28 February year 1*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (FCOC) by the difference between the ruling exchange rates on transaction date (nil rate) and translation date (the rate obtained by dividing the market value of the FCOC on that date by the foreign currency amount as specified in the FCOC).

The ruling exchange rate on translation date is determined as follows:

“Market value of the FCOC on translation date / Amount of foreign currency as specified in the FCOC”

$$= R5\,200 / \$80\,000$$

$$= 0,0650$$

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$80\,000 \times (0,0000 - 0,0650)$ ] | 5 200 |

An exchange difference of R5 200 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24(3)(a).

*Premium paid under the FCOC*

The premium paid under the FCOC of R4 000 must be deducted from income under section 24(3)(b)(i).

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (FCOC) by the difference between the ruling exchange rates on translation date (the rate obtained by dividing the market value of the FCOC on translation date by the foreign currency amount as specified in the FCOC) and realisation date (the rate obtained by dividing the market value of the FCOC on realisation date by the foreign currency amount as specified in the FCOC).

The ruling exchange rate on realisation date is determined as follows:

“Market value of FCOC on realisation date / Amount of foreign currency as specified in the FCOC”

$$= R16\,000 / \$80\,000$$

$$= 0,2000$$

|  |        |
|--|--------|
|  | R      |
| Exchange difference [ $\$80\,000 \times (0,0650 - 0,2000)$ ] | 10 800 |

An exchange difference of R10 800 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24(3)(a).

**Note:**

The sum of the foreign exchange gains in years of assessment ending on 28 February year 1 and year 2 of R16 000 (R5 200 + R10 800) is equal to the difference of R16 000 between the rands received and paid on realisation date of R928 000 ( $\$80\,000 \times 11,6000$ ) and R912 000 ( $\$80\,000 \times 11,4000$ ).

**(i) Determination of an exchange difference in relation to a foreign currency option contract that is an affected contract**

See **4.5.3(e)** for a discussion of the meaning of “affected contract”.

The ruling exchange rates on transaction date and realisation date in relation to an FCOC that is an affected contract are the same as the rates applicable to an FCOC that is not an affected contract [see **4.5.4(d)**]. The ruling exchange rates on translation date are different for an FCOC that is an affected contract and one that is not an affected contract.

The ruling exchange rate in relation to an FCOC that is an affected contract on translation date is the rate obtained by dividing any amount included in or deducted from income as a premium or consideration under section 24I(3)(b)<sup>77</sup> by the foreign currency amount as specified in the affected contract. The effect of this treatment is that no deduction from or inclusion in income will effectively arise on translation date of the FCOC, since the amount of the foreign exchange gain or loss in relation to the FCOC will be equal to the amount of the premium or consideration received or paid under the FCOC. An exchange difference will effectively arise on the earlier of realisation date of the FCOC, or translation date after the underlying debt is incurred or the amount payable on the debt accrues.

**Example 26 – Determination of an exchange difference on an FCOC that is an affected contract***Facts:*

Company A is a resident and its year of assessment ends on the last day of February. On 1 March year 1 Company A entered into an FCOC that is an affected contract. Under the contract Company A acquired the right to buy \$100 000 at the rate of 10,7000. On entering into the contract Company A paid a premium of R6 000. On 28 February year 3 Company A exercised the right under the FCOC.

Company A does not use a market-related valuation method to determine the market value of the FCOC for accounting purposes.

Market rates are as follows:

| <b>Date</b>                           | <b>\$/R</b>      | <b>\$/R</b>               |
|---------------------------------------|------------------|---------------------------|
|                                       | <b>Spot rate</b> | <b>Option strike rate</b> |
| 1 March year 1 (transaction date)     | 10,6000          | 10,7000                   |
| 28 February year 2 (translation date) | 10,8000          |                           |
| 28 February year 3 (realisation date) | 11,3000          |                           |

<sup>77</sup> That is, any premium or like consideration received by or paid by a person under the FCOC or the consideration paid for the FCOC.

*Result:**Year of assessment ending on 28 February year 2**Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (FCOC) by the difference between the ruling exchange rates on transaction date (nil rate) and translation date (the rate obtained by dividing the amount of the premium paid under the FCOC by the foreign currency amount as specified in the FCOC).

The ruling exchange rate on translation date is determined as follows:

Amount of the premium paid under the FCOC / Amount of foreign currency as specified in the FCOC

$$= R6\ 000 / \$100\ 000$$

$$= 0,0600$$

|   |       |
|---|-------|
|   | R     |
| Exchange difference [ $\$100\ 000 \times (0,0000 - 0,0600)$ ] | 6 000 |

An exchange difference of R6 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Premium paid under the FCOC*

The premium paid under the FCOC of R6 000 is deductible under section 24I(3)(b)(i).

The net effect is that there is a deduction from or inclusion in income of nil (R6 000 – R6 000) under section 24I(3) on translation date.

*Year of assessment ending on 28 February year 3**Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (FCOC) by the difference between the ruling exchange rates on translation date (the rate obtained by dividing the amount of the premium paid under the FCOC by the foreign currency amount as specified in the FCOC) and realisation date (the rate obtained by dividing the market value of the FCOC on realisation date by the foreign currency amount as specified in the FCOC).

The market value on realisation date is the intrinsic value and is determined as follows:

(Difference between the spot rate on realisation date and the option strike rate) × Amount of foreign currency as specified in the FCOC

$$= (11,3000 - 10,7000) \times \$100\ 000$$

$$= R60\ 000$$

The ruling exchange rate in relation to the FCOC on realisation date is determined as follows:

Market value of FCOC on realisation date / Amount of foreign currency as specified in the FCOC

= R60 000 / \$100 000

= 0,6000

|   |             |
|---|-------------|
| Exchange difference [ $\$100\ 000 \times (0,0600 - 0,6000)$ ] | R<br>54 000 |
|---|-------------|

An exchange difference of R54 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

#### 4.6 Prohibition against double deductions or inclusions [section 24I(6)]

Section 24I(6) provides that any inclusion in or deduction from income under section 24I(3) shall be *in lieu* of any deduction or inclusion which may otherwise be allowed or included under any other provision of the Act. When an exchange difference, a premium or like consideration received by or paid by a person under an FCOC or any consideration paid for the acquisition of an FCOC can be dealt with under section 24I and another provision of the Act, the inclusion or deduction must be made under section 24I(3) and not under the other provision of the Act.

For example, if a resident company carrying on a trade incurs realised foreign exchange losses during a year of assessment, the foreign exchange losses qualify for a deduction under section 24I(3)(a) and not under section 11(a).

Section 24I(6) will also apply when translating an exchange item to rand upon its disposal under section 25D. The exchange difference included in the amount received or accrued on disposal of an exchange item will be taken into account under section 24I(3)(a) and not under section 25D (see 4.12.2 and examples 5, 13, 14, 46 to 48 and 50).

#### 4.7 Exchange differences that arise before an asset is brought into use [section 24I(7)]

##### 4.7.1 The general application of section 24I(7)

Section 24I(7) applies notwithstanding section 24I(3) (see 4.3), but subject to section 36 (see 4.7.3) which deals with the deduction of capital expenditure from income derived from the working of any producing mine.

Section 24I(7) provides for the carry-forward of the inclusion in or deduction from a person's income of certain exchange differences which arose and premiums or other consideration which were paid or became payable in a year of assessment before the year of assessment during which the assets referred to in section 24I(7)(a) (see below) were or are brought into use for the purposes of the person's trade, to the year of assessment in which the assets to which they relate, were or are brought into use for purposes of that person's trade.<sup>78</sup>

<sup>78</sup> See 4.2.2 for a discussion of the meaning of "trade" and "carrying on of a trade".

The determination of when an asset is “brought into use” is one of fact. The authors of Juta’s *Commentary on the Income Tax Act* correctly note that –<sup>79</sup>

“[t]he determination of when these assets are actually brought into use is one of fact. Such assets are not brought into use merely because used once. The asset must be used in a way consistent with the intended and future use.”

The amounts carried forward to a person’s subsequent year of assessment under section 24I(7) must be taken into account in the determination of the person’s taxable income during the year of assessment in which those assets referred to in section 24I(7)(a) (see below) are brought into use for the purposes of that person’s trade unless the proviso applies. The proviso to section 24I(7) provides that the exchange difference or premium or other consideration referred to in section 24I(7)(a) to (c) (see below) shall no longer be carried forward, but must be taken into account in the determination of the person’s taxable income in any year of assessment subsequent to the year of assessment during which the exchange difference arose or the premium or other consideration was paid or became payable when during that subsequent year –

- the debt to be incurred as referred to in section 24I(7)(b) or (c) will no longer be so incurred;
- the debt has not been utilised as contemplated in section 24I(7)(a); or
- any asset, property or knowledge will no longer be brought into use for the purpose of the person’s trade.

Section 24I(7) applies to –

- any exchange difference arising from a debt used by a person for –
  - the acquisition, installation, erection or construction of any machinery, plant, implement, utensil, building or improvements to any building; or
  - the devising, developing, creation, production, acquisition or restoration of any invention, patent, design, trade mark, copyright or other similar property or knowledge contemplated in section 11(gA)<sup>80</sup> or (gC)<sup>81</sup> [section 24I(7)(a)];

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<sup>79</sup> D Davis *et al* Jutas Tax Library [online] (Jutastat e-publications: 2 April 2015) in *Commentary on Income Tax – sections 12C, 12I and 24I(7)*. See also Interpretation Note 86 “Additional Investment and Training Allowances for Industrial Policy Projects”.

<sup>80</sup> Section 11(gA) deals with deductions relating to an invention as defined in the Patents Act 57 of 1978, a design as defined in the Designs Act 195 of 1993, a trade mark as defined in the Trade Marks Act 194 of 1993, a copyright as defined in the Copyright Act 98 of 1978 or any other property which is of a similar nature, a patent under the Patents Act 57 of 1978 and any knowledge essential to the use of such patent, design, trade mark, copyright or other property or the right to have such knowledge imparted. This section does not apply to expenditure incurred in years of assessment commencing on or after 1 January 2004.

<sup>81</sup> Section 11(gC) deals with deductions relating to an invention or patent as defined in the Patents Act 57 of 1978, a design as defined in the Designs Act 195 of 1993, a copyright as defined in the Copyright Act 98 of 1978 and other property which is of a similar nature (other than a trade mark as defined in the Trade Marks Act 194 of 1993) and knowledge essential to the use of such patent, design, copyright or other property or the right to have such knowledge imparted. This section applies to expenditure incurred in years of assessment commencing on or after 1 January 2004.

- any exchange difference arising from an FEC or an FCOC which has been entered into by that person, to the extent to which such FEC or FCOC is entered into to serve as a hedge for a debt incurred or to be incurred for utilisation as contemplated in the first bullet [section 24I(7)(b)]; and
- any premium or other consideration paid or payable for or under an FCOC entered into or acquired by that person, to the extent to which such FCOC is entered into or obtained in order to serve as a hedge for a debt incurred or to be incurred for utilisation as contemplated in the first bullet [section 24I(7)(c)].

A taxpayer may be required to submit proof that the FEC or FCOC was a hedge for the debt referred to above. Factors which would be relevant include the intention of the taxpayer, the amount of the relevant exchange items and the hedging instruments, transaction dates, realisation dates and contractual agreements.

**Example 27 – Exchange difference on a debt that financed the acquisition of an asset not yet brought into use – Section 24I(7)(a)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A purchased a machine for \$500 000 on credit which was brought into use on 1 April year 2. The debt was paid on 31 May year 2.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 November year 1 (transaction date)  | 11,6000                     |
| 28 February year 2 (translation date) | 11,7000                     |
| 31 May year 2 (realisation date)      | 11,7500                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |               |
|---|---------------|
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,7000)$ ] | R<br>(50 000) |
|---|---------------|

An exchange difference of (R50 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a). However, since the asset was not brought into use by 28 February year 2, the exchange difference is carried-forward under section 24I(7)(a)(i) to the subsequent year of assessment during which the asset was brought into use.



*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$500\,000 \times (11,7000 - 11,7500)$ ] | (25 000) |

An exchange difference of (R25 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*Exchange difference carried forward from year of assessment ending on 28 February year 2 under section 24I(7)(a)(i)*

|                       |          |
|-----------------------|----------|
|                       | R        |
| Foreign exchange loss | (50 000) |

The foreign exchange loss of (R50 000) determined on translation date that was carried forward from the previous year of assessment is taken into account in the year of assessment ending on 28 February year 3, since the asset was brought into use for purposes of Company A's trade on 1 April year 2 [section 24I(3)(a) read with section 24I(7)(a)(i)].

### **Example 28 – Deferral of recognition of exchange differences under section 24I(7)**

*Facts:*

Company A is a resident conducting manufacturing activities and its year of assessment ends on the last day of February.

On 1 October year 1 Company A signed an agreement to purchase a new machine to the value of \$4 million. The machine was specifically designed and constructed for Company A.

The expected completion date was 1 February year 2. The agreement contained a penalty clause which provided that if the machine was not completed by 1 February year 2, the contract value would be reduced by 2% for every extra full month the contractor took after the expected date to complete the contract. The contract value became payable on completion of the contract and had to be settled immediately.

Company A entered an FEC on 1 October year 1 to hedge the rand cost of the machine. The FEC was for \$4 million at a forward rate of 11,3600. The period of the FEC was 4 months and ended on 1 February year 2.

The processing plant was completed on 10 March year 2 resulting in the contract value being decreased by \$80 000 ( $\$4\text{ million} \times 2\%$ ) from \$4 million to \$3 920 000. The machine was brought into use on 10 March year 2.

Market rates are as follows:

| <b>Date</b>                                | <b>\$ / R<br/>Spot rate</b> | <b>\$ / R<br/>Forward rate</b> |
|--|-----------------------------|--------------------------------|
| 1 October year 1 (transaction date)        | 11,3000                     | 11,3600                        |
| 1 February year 2 (realisation date – FEC) | 11,4000                     |                                |
| 28 February year 2 (translation date)      | 11,4500                     |                                |
| 10 March year 2 (realisation date)         | 11,4600                     |                                |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt and the FEC.

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

*Debt*

The contract had not been completed by the end of the year of assessment and as a result the debt had not been incurred under the agreement entered into by Company A. Accordingly, the debt had not been incurred by the end of the year of assessment and it did not constitute an exchange item at the end of the year of assessment.

*Determination of exchange difference on realisation date*

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and realisation date (the spot rate) as follows:

|  |         |
|--|---------|
|  | R       |
| Exchange difference [ $\$4\,000\,000 \times (11,3600 - 11,4000)$ ] | 160 000 |

The foreign exchange gain of R160 000 determined on realisation date must be included in income under section 24I(3)(a). However, since the machine was not brought into use during the year of assessment ending on 28 February year 2, a portion of this exchange difference is carried forward to the year of assessment during which the machine is brought into use for purposes of Company A's trade.

Therefore, recognition of the foreign exchange gain arising on the FEC is deferred under section 24I(7) to the extent that the FEC is entered into to serve as a hedge on a debt which will be incurred as anticipated under section 24I(7). At the end of the year of assessment it was known that at a minimum the contract would be completed one month behind schedule and the amount of the debt would be reduced by a minimum amount of \$80 000 ( $\$4\,000\,000 \times 2\%$ ).

Therefore, at the end of the year of assessment, the FEC served as a hedge on applicable debt to the extent of \$3 920 000. Accordingly, recognition of R156 800 ( $R160\,000 \times \$3\,920\,000 / \$4\,000\,000$ ) of the foreign exchange gain must be deferred under section 24I(7) and R3 200 ( $R160\,000 \times \$80\,000 / \$4\,000\,000$ ) must be included in income under section 24I(3).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date (10 March year 2) and realisation date (10 March year 2) as follows:

|  |   |
|--|---|
|  | R |
| Exchange difference [ $\$3\,920\,000 \times (11,4600 - 11,4600)$ ] | 0 |

*FEC*

Under section 24I(7) the foreign exchange gain of R156 800 carried forward from the previous year of assessment must be taken into account in the year of assessment ending on 28 February year 3.

#### **4.7.2 Apportionment of debt that funded various assets or expenses and related hedge cover**

As noted above, section 24I(7) applies to an exchange difference or premium or other consideration determined in a year of assessment on a debt, FEC or FCOC in relation to the assets referred to in section 24I(7)(a) that are not yet brought into use in that year of assessment.

It is possible that the debt, FEC or FCOC may be incurred to finance or hedge more than one asset referred to in section 24I(7)(a) which are brought into use on different dates or to finance a combination of assets and expenditure that fall within and outside the ambit of section 24I(7)(a). Section 24I(7)(a) refers to debt used in respect of assets listed in that section and section 24I(7)(b) and (c) refer to the extent to which an FEC or FCOC serve as a hedge for the debt used as contemplated in section 24I(7)(a).

It follows that if a debt, FEC or FCOC covers expenditure which does and does not fall within the ambit of section 24I(7) or covers assets falling within section 24I(7) that are brought into use in different years of assessment, an apportionment will be required to determine the portion of the exchange difference, premium or other consideration that must be taken into account under section 24I(3) and the portion that must be carried forward to a subsequent year of assessment under section 24I(7) until it is required to be included in or deducted from income under that section. Special rules apply to mining assets (see **4.7.3**).

Taxpayers often use a “pooling of funds approach” to finance businesses, for example, using a revolving credit facility to purchase assets and pay operational expenses. Repayments are made at different points in time. Section 24I(7) will apply to the extent a portion of the pooled debt was utilised in respect of the acquisition of assets listed in section 24I(7)(a). The application of section 24I(7) is not automatically excluded in situations where a “pooling of funds approach” is used.

**Example 29 – Exchange difference on a debt that financed the acquisition of various assets – Section 24I(7)(a)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A obtained a loan to finance the purchase of Machine A for \$300 000 and Machine B for \$200 000. Machine B was brought into use on 30 November year 1 and Machine A was brought into use on 1 April year 2. The debt was paid on 31 May year 2.

Market rates for purposes of the example are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 November year 1 (transaction date)  | 11,6000                     |
| 28 February year 2 (translation date) | 11,7000                     |
| 31 May year 2 (realisation date)      | 11,7500                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |          |
|---|----------|
|   | <b>R</b> |
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,7000)$ ] | (50 000) |

An exchange difference of (R50 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a). However, since Machine A was brought into use on 1 April year 2, the portion of the exchange difference relating to the debt that financed the acquisition of Machine A for \$300 000 is carried-forward under section 24I(7)(a)(i) to the subsequent year of assessment during which Machine A is brought into use. This portion of the exchange difference is calculated as follows:

Amount of exchange difference  $\times$  Amount of debt relating to Machine A / Total amount of the debt

$$= (\text{R}50\,000) \times \$300\,000 / \$500\,000$$

$$= (\text{R}30\,000)$$

Only the portion of the exchange difference relating to the debt that financed the acquisition of Machine B for \$200 000 must be deducted from income under section 24I(3)(a) in the year of assessment ending on 28 February year 2. This portion is calculated as follows:

Amount of exchange difference  $\times$  Amount of debt relating to Machine B / Total amount of the debt

$$= (\text{R}50\,000) \times \$200\,000 / \$500\,000$$

$$= (\text{R}20\,000)$$

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$500\,000 \times (11,7000 - 11,7500)$ ] | (25 000) |

An exchange difference of (R25 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a). Section 24I(7) is not applicable in the year of assessment ending on 28 February year 3 because both machines have been brought into use, one in the year of assessment ending on 28 February year 2 and one in the year of assessment ending on 28 February year 3.

The foreign exchange loss of (R30 000) relating to the portion of the debt that funded the acquisition of Machine A that was carried forward from the previous year of assessment, is taken into account in the year of assessment ending on 28 February year 3, since Machine A was brought into use for purposes of Company A's trade on 1 April year 2 [section 24I(3)(a) read with section 24I(7)(a)(i)].

#### **4.7.3 Exchange difference arising from debt that financed mining assets**

Subject to the provisos to section 24I(7), section 24I(7) generally provides for a deferral in the recognition of qualifying exchange differences, premiums and other consideration (see 4.7.1 and 4.7.2) to the year of assessment in which the underlying assets were or are brought into use for purposes of a person's trade. Section 24I(7) is, however, subject to section 36. This means that if the asset concerned is "capital development expenditure"<sup>82</sup> that qualifies or will qualify for a deduction in line with the rules in section 36, section 24I(7) does not apply and there is no deferral in the recognition of exchange differences, premiums and other consideration until the asset is brought into use. The normal timing rules in section 24I therefore apply.

#### **Example 30 – Determination of exchange differences – Hedging of a debt that financed mining assets by an FEC**

*Facts:*

Company A is a resident and its year of assessment ends on the last day of February. Company A entered into an agreement to purchase mining equipment of \$4 million. The mining equipment was shipped free on board to Company A on 1 October year 1. Ownership and risk were transferred to Company A and the expenditure was incurred on 1 October year 1. The debt was paid on delivery of the mining equipment, namely, 1 March year 2.

On 1 October year 1 Company A entered into an FEC to hedge the debt of \$4 million at a forward rate of 11,3600. The MRFR on 28 February year 2 for a similar contract was 11,4000.

<sup>82</sup> As defined in section 36(11).

Company A incurred a loss from mining activities of (R600 000) for the year of assessment ending on 28 February year 2 and derived income from mining of R1 million for the year of assessment ending on 28 February year 3.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> | <b>\$ / R<br/>Forward rate</b> |
|---------------------------------------|-----------------------------|--------------------------------|
| 1 October year 1 (transaction date)   | 11,3000                     | 11,3600                        |
| 28 February year 2 (translation date) | 11,4500                     | 11,4000                        |
| 1 March year 2 (realisation date)     | 11,4600                     |                                |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt and the FEC.

*Year of assessment ending on 28 February year 2*

*Determination of exchange differences on translation date*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  |                |
|--|----------------|
| Exchange difference [ $\$4\,000\,000 \times (11,3000 - 11,4500)$ ] | R<br>(600 000) |
|--|----------------|

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and translation date (the MRFR) as follows:

|  |              |
|--|--------------|
| Exchange difference [ $\$4\,000\,000 \times (11,3600 - 11,4000)$ ] | R<br>160 000 |
|--|--------------|

The foreign exchange loss of (R600 000) and foreign exchange gain of R160 000 determined on translation date must be deducted from and included in income under section 24(3)(a).

The capital expenditure on the mining equipment is not allowed as a deduction in the year of assessment ending on 28 February year 2, since Company A has a loss from mining activities.

*Calculation of taxable income / (assessed loss) from mining*

|   | R                    | R                    |
|---|----------------------|----------------------|
| Loss from mining before these transactions                            |                      | (600 000)            |
| Less: Foreign exchange loss on the debt                               |                      | (600 000)            |
| Foreign exchange gain on the FEC                                      |                      | <u>160 000</u>       |
| Assessed loss from mining before the deduction of capital expenditure |                      | (1 040 000)          |
| Less: Capital expenditure<br>[section 15(a) read with section 36(7C)] |                      | <u>          (0)</u> |
| Acquisition cost of plant (\$4 000 000 × 11,3000)                     | 45 200 000           |                      |
| Less: Used this year of assessment                                    | <u>          (0)</u> |                      |
| Carried forward to subsequent year of assessment                      | <u>45 200 000</u>    |                      |
| Assessed loss from mining   |                      | <u>(1 040 000)</u>   |

*Year of assessment ending on 28 February year 3**Determination of exchange difference on realisation date**Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   | R        |
|---|----------|
| Exchange difference [\$4 000 000 × (11,4500 – 11,4600)] | (40 000) |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on translation date (the MRFR) and realisation date (the spot rate) as follows:

|   | R       |
|---|---------|
| Exchange difference [\$4 000 000 × (11,4000 – 11,4600)] | 240 000 |

The foreign exchange loss of (R40 000) and foreign exchange gain of R240 000 determined on realisation date must be deducted from and included in income under section 24(3)(a).

Since Company A derived mining income of R1 million and has taxable income from mining (see calculation below) for the year of assessment ending on 28 February year 3, a portion of the mining equipment expenditure incurred will be allowed as a deduction under section 15(a) read with section 36(7C).

| <i>Calculation of taxable income / (assessed loss) from mining</i>                   |                   | R                  |
|--|-------------------|--------------------|
| Income from mining before these transactions   |                   | 1 000 000          |
| Less: Foreign exchange loss on the debt  |                   | (40 000)           |
| Foreign exchange gain on the FEC   |                   | <u>240 000</u>     |
|  |                   | 1 200 000          |
| Less: Assessed loss from mining brought forward from the previous year of assessment |                   | <u>(1 040 000)</u> |
| Taxable income from mining before capital development expenditure                    |                   | 160 000            |
| Less: Capital expenditure [section 15 read with section 36(7C)]                      |                   | <u>(160 000)</u>   |
| Acquisition cost of plant (\$4 000 000 × 11,3000)                                    | 45 200 000        |                    |
| Less: Used this year of assessment   | <u>(160 000)</u>  |                    |
| Carried forward to subsequent year of assessment                                     | <u>45 040 000</u> |                    |
| Taxable income from mining   |                   | <u>0</u>           |

#### 4.7.4 Exchange differences arising from debt, a forward exchange contract and a “replacement” forward exchange contract subject to section 24I(7)

It may happen that a person takes out more than one FEC to hedge a debt which was or will be used to acquire an asset falling within section 24I(7)(a) that has not been brought into use. For example, an FEC to hedge the relevant debt is realised but the debt is still outstanding so the person enters into another FEC, the replacement FEC, to hedge the same debt. The replacement FEC does not impact on the timing of the recognition of or the calculation of the exchange difference determined on realisation date of the first FEC. The exchange difference realised on the first FEC will, however, be carried forward to a subsequent year of assessment under section 24I(7)(b) if the relevant asset in respect of which the debt so hedged was incurred, is not brought into use in the year of assessment in which the FEC was realised.

#### **Example 31 – Determination of exchange differences – Hedging of a debt that financed an asset brought into use in a subsequent year of assessment by an FEC and a replacement FEC – Section 24I(7)**

##### *Facts:*

Company A is a resident and its year of assessment ends on the last day of February. On 1 March year 1 Company A purchased equipment of \$220 000. \$120 000 was paid on 1 March year 1 and the balance of \$100 000 on 28 February year 3.

Company A entered into an FEC on 1 March year 1 to purchase \$100 000 at a forward rate of 10,6000 on 28 February year 2. The FEC was realised on 28 February year 2. A new FEC was entered into on 5 March year 2 under which \$100 000 would be purchased on 28 February year 3 at a forward rate of 11,9200.

The equipment was brought into use on 1 March year 3.



Market rates are as follows:

| <b>Date</b>   | <b>\$ / R<br/>Spot rate</b> | <b>\$ / R<br/>Forward rate</b> |
|---|-----------------------------|--------------------------------|
| 1 March year 1 (transaction date)                             | 10,3500                     | 10,6000                        |
| 28 February year 2<br>(translation date and realisation date) | 11,6600                     |                                |
| 5 March year 2 (transaction date)                             |                             | 11,9200                        |
| 28 February year 3 (realisation date)                         | 12,8700                     |                                |

*Result:*

Exchange differences are determined for each exchange item, namely, the debt, the FEC and the replacement FEC.

*Year of assessment ending on 28 February year 2*

*Determination of exchange differences*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |           |
|---|-----------|
|   | R         |
| Exchange difference [ $\$100\,000 \times (10,3500 - 11,6600)$ ] | (131 000) |

*FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and realisation date (the spot rate) as follows:

|   |         |
|---|---------|
|   | R       |
| Exchange difference [ $\$100\,000 \times (10,6000 - 11,6600)$ ] | 106 000 |

The foreign exchange loss of (R131 000) and foreign exchange gain of R106 000 would normally be deducted from and included in income under section 24I(3)(a). However, since the equipment was not brought into use during the year of assessment ending on 28 February year 2, these exchange differences are carried forward to the year of assessment during which the equipment is brought into use [section 24I(7)].

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

*Debt*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |           |
|---|-----------|
|   | R         |
| Exchange difference [ $\$100\,000 \times (11,6600 - 12,8700)$ ] | (121 000) |

*Replacement FEC*

The exchange difference is determined by multiplying the amount of the exchange item (FEC) by the difference between the ruling exchange rates on transaction date (the forward rate) and realisation date (the spot rate) as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,9200 - 12,8700)$ ] | 95 000 |

The foreign exchange loss of (R121 000) and the foreign exchange gain of R95 000 determined on realisation date would normally be deducted from and included in income under section 24I(3)(a). However, since the equipment was not brought into use during the year of assessment ending on 28 February year 3, these exchange differences are carried forward to the year of assessment during which the equipment is brought into use [section 24I(7)].

*Determination of exchange difference on 28 February year 4*

The exchange differences of (R131 000), R106 000, (R121 000) and R95 000 carried forward from previous years of assessment must be taken into account under section 24I(3) read with section 24I(7), since the equipment was brought into use on 1 March year 3.

**Note:**

If Company A qualifies for an allowance on the equipment, the total deductions granted over the life of the asset of R2 277 000 ( $\$220\,000 \times 10,3500$ ) and the net exchange loss of (R51 000) [(R131 000) + R106 000 + (R121 000) + R95 000] will be R2 328 000 which equals the net cash flow [ $(\$120\,000 \times 10,3500) - R106\,000 - R95\,000 + (\$100\,000 \times 12,8700)$ ].

**4.8 Anti-avoidance provisions [sections 24I(8) and 80A to 80L]**

Section 24I(8) provides that any foreign exchange loss sustained on a transaction entered into by a person, or any premium or other consideration paid in respect of or under an FCOC entered into or acquired by a person, shall not be allowed as a deduction from such person's income under section 24I(3), if the transaction was entered into or the FCOC was entered into or acquired *solely or mainly* to enjoy a reduction in tax as a result of a deduction from income.

In *Glen Anil Development Corporation Ltd v SIR Botha JA* stated the following:<sup>83</sup>

"Section 103(2) uses the words 'solely or mainly for the purpose . . . ' In the *Oxford English Dictionary* 'mainly' is defined to mean 'for the most part; in the main; as the chief thing, chiefly, principally'. The word 'hoofsaaklik' is used in the Afrikaans text. . . the onus was on the appellant to show that the transactions in question were not entered into solely or mainly for the purpose of utilizing the assessed loss or balance of assessed loss in question in order to avoid or postpone liability for income tax or to reduce the amount thereof. . . That onus would be discharged if the appellant satisfied the court that the avoidance of income tax by the utilization of the assessed loss was not a more important consideration in the mind of Dr Rubenstein (acting on the advice of his auditors) than the avoidance of estate duty and undistributed profits tax."

<sup>83</sup> 1975 (4) SA 715(A), 37 SATC 319 at 325.

In *SBI v Lourens Erasmus (Edms) Bpk*<sup>84</sup> Botha JA held that, in the context of an exemption for the previously applicable undistributed profits tax, the word “mainly” prescribed a purely quantitative standard of more than 50%.

In the context of section 24I(8) “mainly” is also interpreted to mean “more than 50%” although the practical application of that criteria will generally involve a consideration of qualitative factors.

Section 24I(8) does not apply to a foreign exchange gain or premium or other consideration received or accrued under the circumstances mentioned above.

Section 102(1)(b) of the Tax Administration Act 28 of 2011 provides that a taxpayer bears the onus of proving that an amount or item is deductible or may be set off. A taxpayer therefore bears the onus of proving that section 24I(8) does not apply. All of the relevant facts and circumstances, which include a taxpayer’s *ipse dixit*, must be considered. In *C: SARS v Pretoria East Motors (Pty) Ltd*<sup>85</sup> the Supreme Court of Appeal considered what is expected of the taxpayer to discharge this onus. Ponnan JA stated the following:<sup>86</sup>

“It is so that the taxpayer’s *ipse dixit* will not lightly be regarded as decisive. But it must be considered together with all of the other evidence in the case. And, given the unfavourable position of having the *onus* resting upon it – a ‘formidable and difficult’ one to discharge (per Trollip JA; *Barnato Holdings Ltd v Secretary for Inland Revenue* 1978 (2) SA 440 (A) at 454A–B) – the interests of justice require that the taxpayer’s evidence and questions of its credibility be considered with great care...It thus remains the function of the court to make a determination of the issues that arise for decision on an objective review of all of the relevant facts and circumstances. Not the least important of the facts, according to Miller J (ITC 1185 (1972) 35 SATC 122 (N) at 124), ‘will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions. The facts in regard to those matters will form an important part of the material from which the court will draw its own inferences against the background of the general human and business probabilities’.”

The provisions of Part IIA of Chapter III of the Act (sections 80A to 80L) dealing with impermissible tax avoidance arrangements potentially apply to arrangements if, amongst other things, the sole or main purpose of an arrangement was to obtain a tax benefit. A tax benefit includes any avoidance, postponement or reduction of any liability for tax. Therefore, section 24I(8) and sections 80A to 80L may need to be considered in the same case.

<sup>84</sup> 1966 (4) SA 434 (A), 28 SATC 233 at 245.

<sup>85</sup> 2014 (5) SA 231 (SCA), 76 SATC 293.

<sup>86</sup> At SATC 303 and 304.

#### 4.9 Deferral of exchange difference on a debt between companies forming part of the same group of companies and between connected persons [section 24I(10A)]

Section 24I(10A)(a)<sup>87</sup> provides that an exchange difference arising during any year of assessment in respect of an amount in a foreign currency owing by or to a person on a debt shall not be included in or deducted from the income of that person if all of the following requirements are met:

- At the end of that year of assessment –
  - that person and the other party to the contractual provisions of the debt form part of the same group of companies<sup>88</sup> or are connected persons<sup>89</sup> in relation to each other; and
  - no FEC or FCOC must have been entered into by that person to serve as a hedge for the debt. This requirement will not be met if an FEC or FCOC has been taken out to serve as a hedge for the full amount or a portion of the debt.
- The debt in a foreign currency or any portion of the debt does not represent a current asset or a current liability for the purposes of that person's financial reporting pursuant to IFRS. This requirement will not be met and therefore section 24I(10A) will not apply to, for example, a foreign currency-denominated trade creditor balance which is reflected as a current liability. This requirement will be met if, for example, a portion of a debt is reflected as a current liability and a portion is reflected as a non-current liability. The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2014*<sup>90</sup> stated that the insertion of the words "or any portion thereof" is to clarify that section 24I(10A) applies to the entire loan, provided that a portion of the loan is classified as a long-term loan.
- The debt in a foreign currency must not be directly or indirectly funded by any debt owed to any person that does not form part of the same group of companies as that person or the other party to the contractual provisions of the debt. The words "funded by any debt" includes the situation in which the debt in a foreign currency is, for example, partly funded by a debt from a person who is not part of the same group of companies and, if this is the case, results in the full debt in a foreign currency not meeting this requirement.
- The debt in a foreign currency must not be directly or indirectly funded by any debt owed to any person that is not a connected person in relation to that person or the other party to the contractual provisions of the debt. The words "funded by any debt" have the same meaning as those words in the preceding bullet point.

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<sup>87</sup> Section 24I(10A) applies with effect from years of assessment commencing on or after 1 January 2013. This Note does not deal with section 24I(10) which, before deletion with effect from the same date, dealt with the deferral of certain exchange differences on certain exchange items.

<sup>88</sup> The term "group of companies" is defined in section 1(1).

<sup>89</sup> The term "connected person" is defined in section 1(1). See Interpretation Note 67 "Connected Persons" for a discussion of the meaning of this term.

<sup>90</sup> In the explanation dealing with clause 40 of the Taxation Laws Amendment Bill, 2014.

In assessing whether a debt in foreign currency has been directly or indirectly funded by any debt owed to a person that does not form part of the same group of companies or is not a connected person in relation to the person or the other party to the contractual provisions of that debt, the facts and circumstances of a particular case must be considered. For example, Company B and Company C form part of the same group of companies. Company B advanced a loan to Company C. Company A, which does not form part of the same group of companies and is also not a connected person in relation to Company B or Company C, advanced a loan to Company B. Company B used the loan from Company A to fund its loan to Company C. In this example it is necessary to determine if the loan between Company A and Company B is a contributing factor to the loan advanced by Company B to Company C and, if so, whether that link is sufficiently close so as to be considered direct or indirect funding or whether the link is too remote. There is a direct link between the two loans in this example. The loan advanced by Company B to Company C is therefore considered to have been directly funded by a person (Company A) which does not form part of the same group of companies or is not a connected person in relation to Company B or Company C. Accordingly, the requirement in section 24I(10A)(a)(ii)(b) has not been met, which means that the deferral rules in section 24I(10A) do not apply to the loan between Company B and Company C.

An example of indirect funding is where Company A advanced a loan to Company X which formed part of the same group of companies as Company B and Company C. Company X used the funds to advance a loan to Company B which Company B in turn advanced to Company C. The link between the loan from Company A to Company X, the loan between Company X and Company B, and the loan between Company B and Company C would be sufficiently close to constitute indirect funding of the debt in foreign currency.

It is possible that a sufficiently close link may exist only between a portion of a debt in foreign currency and a debt from a person not forming part of the same group of companies or a person who is not a connected person in relation to that person or the other party to the contractual provisions of the debt. In such a case only that portion of the debt in foreign currency to which a sufficiently close link could be established, will be considered to have been directly or indirectly funded by debt owing to a company not forming part of the same group of companies or by a person which is not a connected person, as discussed above. However, as noted above, this will result in the full amount of the debt in foreign currency not meeting the requirement in section 24I(10A)(a)(ii)(bb), meaning that the roll-over provisions of section 24I(10A) will not apply.

An assessment whether a sufficiently close link exists between certain debts must be made on a case-by-case basis taking the particular facts and circumstances of each case into account.

Section 24I(10A)(a) is subject to section 24I(10A)(b) which provides that when section 24I(10A)(a) was applied during a year of assessment resulting in the exchange difference not being included in or deducted from income under section 24I(3) and during any year of assessment subsequent to that year of assessment, section 24I(10A)(a) no longer applies to that debt or the debt is realised, an amount (see below) in respect of the debt must be included in or deducted from the income of that person in that subsequent year of assessment or in the year of assessment during which the exchange item is realised.

Section 24I(10A)(a) will no longer apply to a debt when, amongst other things, –

- at the end of the year of assessment the persons to the contractual provisions of the debt no longer form part of the same group of companies and are also not connected persons in relation to each other;
- an FEC or an FCOC has been entered by the person to hedge all or part of the debt;
- the full amount of the debt represents for the person to which section 24I(10A)(a) applied, a current asset or current liability for the purposes of financial reporting pursuant to IFRS;
- the amount of debt or any portion of the debt is directly or indirectly funded by any debt owed to any person that does not form part of the same group of companies as that person or the other party to the contractual provisions of the debt; or
- the amount of debt or any portion of the debt is directly or indirectly funded by any debt owed to any person that is not a connected person in relation to that person or the other party to the contractual provisions of the debt.

The amount to be included in or deducted from income under section 24I(10A)(b) in a subsequent year of assessment must be determined by –

- multiplying the amount of the debt that was subject to section 24I(10A)(a) by the difference between –
  - the ruling exchange rate on the last day of the year of assessment immediately preceding that subsequent year of assessment, and
  - the ruling exchange rate on transaction date; and
- deducting any exchange differences that had been included in or deducted from the income of a person under section 24I on that debt for all years of assessment preceding the subsequent year of assessment during which the person was a party to the contractual provisions of that debt.

A debt that is subject to the application of section 24I(10A)(b) because section 24I(10A)(a) no longer applies, will be subject to the normal rules of section 24I commencing from the year of assessment in which the provisions of section 24I(10A)(a) are not met.

**Example 32 – Deferral of exchange differences on a debt between companies forming part of the same group of companies – Section 24I(10A)**

*Facts:*

Company A's year of assessment ends on the last day of February. It borrowed \$100 000 on 31 January year 1 from its holding company, Company B. The loan was reflected as a long-term liability in the financial statements, since it was initially repayable on 30 June year 6. Company A and Company B formed part of the same group of companies for the full period of the loan agreement.

On 15 June year 4 Company A and Company B agreed that the loan would be repaid earlier than originally agreed. The loan was repaid on 30 June year 4.

Company B funded the loan to Company A from surplus cash resources arising from its operations.

Market rates are as follows:

| <b>Date</b>   | <b>\$ / R<br/>Spot rate</b> |
|---|-----------------------------|
| 31 January year 1 (transaction date)                | 10,4200                     |
| 28 February year 1 (translation date)               | 10,9500                     |
| 28 February year 2 (translation date)               | 11,1000                     |
| 28 February year 3 (translation date)               | 11,8000                     |
| 29 <sup>91</sup> February year 4 (translation date) | 12,1000                     |
| 30 June year 4 (realisation date)                   | 12,6000                     |

*Result:*

*Years of assessment ending on the last day of February year 1 to year 4*

Under section 24I(10A)(a) no exchange differences are included in or deducted from income for these years of assessment, since Company A and Company B formed part of the same group of companies as at the end of the years of assessment, the debt was not hedged by an FEC or FCOC, it was reflected as a long-term liability for financial reporting purposes and was not directly or indirectly funded by the type of debt mentioned in section 24I(10A)(a)(ii)(bb).

*Year of assessment ending on 28 February year 5 (the year of assessment during which the debt is realised)*

Two amounts must be determined in relation to the debt that is realised:

*1. Amount determined under section 24I(10A)(b)*

An amount as calculated under section 24I(10A)(b) must be determined because the debt has been realised. The calculation is as follows:

- (a) Multiply the amount of the exchange item (debt) by the difference between the ruling exchange rates on the last day of the year of assessment (28 February year 4) immediately preceding the year of assessment during which the debt was realised and the transaction date.
- (b) Deduct any exchange differences previously included in or deducted from income in previous years of assessment.

|  |                  |
|--|------------------|
|  | R                |
| Exchange difference [ $\$100\,000 \times (12,1000 - 10,4200)$ ]                  | (168 000)        |
| Less: Exchange differences previously included in income in relation to the debt | <u>(0)</u>       |
| Deduction from income  | <u>(168 000)</u> |

The amount of (R168 000) determined under section 24I(10A)(b) is equal to the total amount of exchange differences that would have been deducted from income under section 24I(3)(a) had section 24I(10A)(a) not applied during the years of assessment ending on the last day of February year 1, 2, 3 and 4. The amount of R168 000 must be deducted from income under section 24I(10A)(b).

<sup>91</sup> Every fourth year is a leap year.

2. *Exchange difference on realisation date to be taken into account under section 24I(3)(a)*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date (29 February year 4) and realisation date, as follows:

|   |               |
|---|---------------|
| Exchange difference [ $\$100\,000 \times (12,1000 - 12,6000)$ ] | R<br>(50 000) |
|---|---------------|

An exchange difference of (R50 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

**Example 33 – Deferral of exchange differences on a debt between companies that are connected persons in relation to each other – Section 24I(10A)**

*Facts:*

Company A's year of assessment ends on the last day of February. It borrowed \$100 000 on 31 January year 1 from Company B. The loan was reflected as a long-term liability in the financial statements, since it was initially repayable on 30 June year 6. Company B held 20% of the equity shares and voting rights in Company A as at the end of the years of assessment ending on 28 February year 1, 2 and 3. The remaining 80% of the equity shares and voting rights in Company A were held equally by four other holders of shares. During the year of assessment ending on 29 February year 4, Company B disposed of 10% of the equity shares and voting rights held in Company A to an unconnected person.

On 15 June year 4 Company A and Company B agreed that the loan would be repaid earlier than originally agreed. The loan was repaid on 30 June year 4.

Company B funded the loan to Company A from surplus cash resources arising from its operations.

Market rates are as follows:

| <b>Date</b>   | <b>\$ / R<br/>Spot rate</b> |
|---|-----------------------------|
| 31 January year 1 (transaction date)                | 10,4200                     |
| 28 February year 1 (translation date)               | 10,9500                     |
| 28 February year 2 (translation date)               | 11,1000                     |
| 28 February year 3 (translation date)               | 11,8000                     |
| 29 <sup>92</sup> February year 4 (translation date) | 12,1000                     |
| 30 June year 4 (realisation date)                   | 12,6000                     |

<sup>92</sup> Every fourth year is a leap year.



*Result:**Years of assessment ending on 28 February year 1 to year 3*

Under section 24I(10A)(a) no exchange differences are included in or deducted from income in these years of assessment, since Company A and Company B were connected persons<sup>93</sup> in relation to each other as at the end of these years of assessment, the debt was not hedged by an FEC or FCOC, it was reflected as a long-term liability for financial reporting purposes and was not directly or indirectly funded by the type of debt mentioned in section 24I(10A)(a)(ii)(bb).

*Year of assessment ending on 29 February year 4*

Section 24I(10A)(b) is applied, since Company A and Company B ceased to be connected persons in relation to each other during the year of assessment ending on 29 February year 4 as a result of Company B disposing of 10% of its equity shares and voting rights in Company A.

Two amounts must be determined in relation to the debt:

*1. Amount determined under section 24I(10A)(b)*

An amount as calculated under section 24I(10A)(b) must be determined because section 24I(10A)(a) no longer applies. The calculation is as follows:

- (a) Multiply the amount of the exchange item (debt) by the difference between the ruling exchange rates on the last day of the year of assessment (28 February year 3) immediately preceding the year of assessment during which section 24I(10A)(a) no longer applied and the transaction date.
- (b) Deduct any exchange differences previously included in or deducted from income in previous years of assessment.

|   |                      |
|---|----------------------|
|   | R                    |
| Exchange difference [ $\$100\,000 \times (11,8000 - 10,4200)$ ]                     | (138 000)            |
| Less: Exchange differences previously included in income<br>in relation to the debt | <u>          (0)</u> |
| Deduction from income   | <u>(138 000)</u>     |

The amount of (R138 000) determined under section 24I(10A)(b) is equal to the total amount of exchange differences that would have been deducted from income under section 24I(3)(a) had section 24I(10A)(a) not applied during the years of assessment ending on 28 February year 1, 2 and 3. The amount of R138 000 must be deducted from income under section 24I(10A)(b).

*2. Exchange difference on translation date (29 February year 4) to be taken into account under section 24I(3)(a)*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on the previous translation date (28 February year 3) and translation date (29 February year 4) as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (11,8000 - 12,1000)$ ] | (30 000) |

<sup>93</sup> Under paragraph (d)(v) of the definition of "connected person" in section 1(1).

An exchange difference of (R30 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*Year of assessment ending on 28 February year 5*

*Determination of exchange difference on realisation date (30 June year 4)*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date (29 February year 4) and realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (12,1000 - 12,6000)$ ] | (50 000) |

An exchange difference of (R50 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

#### **4.10 Deemed acquisition or disposal of an exchange item [section 24I(12)]**

Section 24I(12) determines that when a person holds any exchange item and section 24I at any time during a year of assessment –

- becomes applicable to that person, that exchange item shall be deemed to have been acquired at that time for the purposes of section 24I; or
- ceases to apply to that person, that exchange item shall be deemed to have been realised at that time for the purposes of section 24I.

Section 24I(12) will apply, for example, when –

- a natural person acquires a unit of foreign currency or a debt denominated in foreign currency as trading stock. Under these circumstances all other exchange items (see **4.2.3** and **4.4.2**) held by that person at that time also become subject to section 24I. Those other exchange items must be deemed to be acquired at the time of acquisition of that exchange item for purposes of section 24I;<sup>94</sup>
- a natural person disposes of all units of foreign currency and debt denominated in a foreign currency, which were held as trading stock, and section 24I ceases to apply. Under these circumstances all other exchange items held by that person must be deemed to be realised at that time for purposes of section 24I;<sup>95</sup>
- a trust commences the carrying on of a trade during a year of assessment and holds exchange items at that time. Under these circumstances those exchange items must be deemed to be acquired at that time for purposes of section 24I;
- a trust ceases the carrying on of a trade during a year of assessment and holds exchange items at that time. Under these circumstances those exchange items must be deemed to be realised at that time for purposes of section 24I;

<sup>94</sup> See the *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002* at page 17.

<sup>95</sup> See the *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002* at page 17.

- a foreign company relocates its place of effective management to South Africa and becomes a resident. Under these circumstances section 24I will become applicable to that company at that time on all exchange items in relation to that company. The company must be deemed to have acquired those exchange items at the time that section 24I becomes applicable to the company;
- a person referred to in section 24I(2) that is a non-resident commences to have a permanent establishment in South Africa to which exchange items are attributable. Under these circumstances section 24I will become applicable to that person at that time on all exchange items that are attributable to that permanent establishment. That person must be deemed to have acquired those exchange items at the time that section 24I becomes applicable to that person;
- a permanent establishment in South Africa of a person referred to in section 24I(2) that is a non-resident to which exchange items are attributable ceases to be a permanent establishment in South Africa. Under these circumstances section 24I will cease to apply. All exchange items attributable to the permanent establishment must be deemed to have been realised at the time that section 24I ceases to apply;
- a person ceases to be a resident. Under these circumstances section 24I will generally cease to apply.<sup>96</sup> All exchange items in relation to that person must be deemed to have been realised at the time that section 24I ceases to apply. Section 9H applies when a person ceases to be a resident. Under section 9H<sup>97</sup> a person that ceases to be a resident must be treated as having disposed of each of that person's assets to a person that is a resident on the date immediately before the day that the person ceased to be a resident. Under section 9H<sup>98</sup> the year of assessment of a person during which that person ceased to be a resident must be deemed to have ended on the date immediately before the day on which that person ceased to be a resident. An exchange difference on an exchange item in relation to a person that ceases to be a resident must therefore be determined on the date immediately before the day that the person ceases to be a resident;
- a CFC ceases to be a CFC and does not become a resident, or have a permanent establishment in South Africa to which the exchange items are attributable. Under these circumstances section 24I will cease to apply. All exchange items in relation to that CFC must be deemed to have been realised at the time that section 24I ceases to apply. Section 9H applies when a CFC ceases to be a CFC. Under section 9H(3)(b)(i) a CFC that ceases to be a CFC, otherwise than by way of becoming a resident, must be treated as having disposed of each of its assets to a person that is a resident on the date immediately before the day that it ceased to be a CFC. Under section 9H(3)(d)(i) the year of assessment of a CFC during which it ceased to be a CFC must be deemed to have ended on the date immediately before the day on which it ceased to be a CFC. An exchange difference on an exchange item in relation to a CFC that ceases to be a CFC must therefore be

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<sup>96</sup> Section 24I applies to a non-resident, which is not a CFC, that has a permanent establishment in South Africa to which exchange items are attributable.

<sup>97</sup> Section 9H(2)(a)(i) for a person other than a company and section 9H(3)(a)(i) for a company.

<sup>98</sup> Section 9H(2)(b) for a person other than a company and section 9H(3)(c)(i) for a company.

determined on the date immediately before the day that the CFC ceases to be one; and

- a foreign company commences to be a CFC. Under these circumstances section 24I will become applicable to that company at that time on all exchange items in relation to that CFC. The CFC must be deemed to have acquired those exchange items at the time that section 24I becomes applicable to that company.

**Example 34 – Exchange item becomes subject to section 24I – Application of section 24I(12) to a natural person**

*Facts:*

Individual A held foreign collector's coins totalling \$5 000 as trading stock at the end of 28 February year 1 that were acquired on 15 January year 1. At the date of acquisition of the coins and at the end of the year of assessment, Individual A owed \$10 000 to a foreign company for the acquisition of a personal asset.

Market rates are as follows:

|  | <b>\$ / R</b>    |
|--|------------------|
| <b>Date</b>  | <b>Spot rate</b> |
| 15 January year 1 (transaction date and deemed transaction date) | 11,6000          |
| 28 February year 1 (translation date)                            | 11,6500          |

*Result:*

*Determination of exchange difference on translation date*

Exchange differences are determined for each exchange item, namely, the units of currency and the debt.

*Units of currency*

The exchange difference is determined by multiplying the amount of the exchange item (units of currency) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |     |
|---|-----|
|   | R   |
| Exchange difference [ $\$5\,000 \times (11,6000 - 11,6500)$ ] | 250 |

*Debt*

Under section 24I(12) read with section 24I(2)(c) the amount of \$10 000 owing to the foreign company became subject to section 24I on the date that the units of currency were acquired and held as trading stock by Individual A.

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on the deemed transaction date and the translation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$10\,000 \times (11,6000 - 11,6500)$ ] | (500) |

Exchange differences of R250 gain and (R500) loss determined on translation date must be included in and deducted from income under section 24I(3)(a).

**Example 35 – Application of section 24I(12) to a company that ceases to be a resident**

*Facts:*

Company A's year of assessment ends on the last day of February. Company A changed its place of effective management from South Africa to a foreign country on 30 June year 1. On that date Company A was deemed to become exclusively a resident of the foreign country for purposes of the tax treaty between South Africa and the other country. On 30 June year 1 Company A owed \$1 million to Foreign Company B that was incurred on 1 March year 1.

Market rates for purposes of the example are as follows:

| <b>Date</b>  | <b>\$ / R<br/>Spot rate</b> |
|--|-----------------------------|
| 1 March year 1 (transaction date)                                  | 11,7000                     |
| 29 June year 1 (deemed realisation date)                           | 11,7900                     |
| 30 June year 1 (date of transfer of place of effective management) | 11,8000                     |

*Result:*

*Determination of exchange difference on deemed realisation date*

Under section 9H(3)(a)(i) read with section 24I(12)(b) section 24I ceased to apply to Company A on 29 June year 1 (the date immediately before the day that it ceased to be a resident).

Under section 9H(3)(c)(i) the year of assessment of Company A must be deemed to have ended on 29 June year 1. An exchange difference on the debt must be determined on 29 June year 1 (the deemed realisation date).

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on the transaction date and the deemed realisation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [\$1 million × (11,7000 – 11,7900)] | (90 000) |

An exchange difference of (R90 000) is determined on deemed realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

**4.11 Determining foreign exchange gains and losses of controlled foreign companies [paragraphs (c)(ii) and (iii) of the proviso to section 9D(2A), section 9D(6), section 9D(9)(fA)(ii) and (iii) and section 9D(9A)(a)(iii)]**

**4.11.1 The interaction between sections 9D and 24I**

The term “controlled foreign company” (CFC) is defined in sections 1(1) and 9D(1). These definitions are quoted in **Annexure A**. A foreign company is a CFC if more than 50% of its total participation rights are directly or indirectly held, or more than 50% of its voting rights are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies. A foreign company is also a CFC if its financial results are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident.

Under section 9D(2) a portion of the net income of a CFC is included in the income of a resident<sup>99</sup> that, directly or indirectly, together with a connected person, holds at least 10% of the participation rights and voting rights in the CFC. Special rules apply in the case of the participation rights of a resident in a foreign company which is a CFC only as a result of its financial results being included in that resident company's consolidated financial results.

Net income is, broadly speaking, the CFC's taxable income calculated in accordance with the Act as if the CFC was a taxpayer and was a resident for certain provisions including the definition of "gross income" in section 1(1).<sup>100</sup>

The inclusion of exchange differences in the net income of a CFC results in the inclusion of an amount equal to a proportion of these exchange differences in the income of a resident holding directly or indirectly, together with a connected person, at least 10% of the participation rights and voting rights in the CFC. The amount to be attributed to the resident under section 9D(2) does not, therefore, constitute the amount of an exchange difference, it is an amount constituting a percentage of the CFC's net income which is included in income.

#### 4.11.2 Local and foreign currency of a controlled foreign company

##### (a) An exchange item of a controlled foreign company which is attributable to a permanent establishment in the Republic

The definition of "local currency" in section 24I(1) provides that in relation to any person which is not a resident, the local currency of any exchange item which is attributable to that person's permanent establishment in South Africa is the rand.<sup>101</sup> This provision potentially applies to a CFC which is a foreign company and therefore "not a resident". Foreign currency in relation to a CFC's exchange items attributable to a permanent establishment in the Republic is any currency which is not local currency and therefore any currency other than rand.<sup>102</sup>

#### **Example 36 – Local currency and foreign currency in relation to a CFC on an exchange item that is attributable to a permanent establishment in South Africa**

##### *Facts:*

CFC A's functional currency is the US dollar. CFC A has a permanent establishment in South Africa.

CFC A entered into a loan agreement in relation to transactions directly related to the permanent establishment in South Africa. The loan, which is denominated in peso, is therefore directly attributable to the permanent establishment in South Africa.

##### *Result:*

Under paragraph (c) of the definition of "local currency" in section 24I(1), local currency in relation to the debt which is attributable to the permanent establishment in South Africa is the rand. Under the definition of "foreign currency" in section 24I(1), foreign currency in relation to the debt is the peso.

<sup>99</sup> Other than a resident that is a headquarter company.

<sup>100</sup> Section 9D(2A).

<sup>101</sup> Paragraph (c) of the definition of "local currency" in section 24I(1).

<sup>102</sup> Definition of "foreign currency" in section 24I(1).

The loan is denominated in a foreign currency in relation to the permanent establishment in South Africa and therefore it represents an exchange item for which an exchange difference must be calculated on translation date and realisation date.

**(b) An exchange item of a controlled foreign company which is attributable to a permanent establishment outside South Africa**

Local currency in relation to a CFC on an exchange item which is attributable to a permanent establishment outside South Africa is the functional currency of that permanent establishment.<sup>103</sup> The proviso to paragraph (a) of the definition of “local currency” in section 24I(1) provides that if the functional currency of the permanent establishment is the currency of a country which has an official inflation rate of 100% or more<sup>104</sup> throughout the relevant year of assessment, the exchange item is deemed not to be attributable to that permanent establishment.

Foreign currency in relation to a CFC on an exchange item which is attributable to a permanent establishment outside South Africa is any currency which is not local currency,<sup>105</sup> that is, any currency which is not that permanent establishment’s functional currency. A CFC may have permanent establishments in different countries outside South Africa and those permanent establishments’ functional currencies may be different foreign currencies because functional currency, and therefore local and foreign currency, is determined in relation to a permanent establishment and not at the company level of the CFC.

**Example 37 – Local currency and foreign currency in relation to a CFC on an exchange item which is attributable to a permanent establishment outside South Africa**

*Facts:*

CFC A enters into a loan agreement denominated in US dollars with a foreign company as well as a loan agreement denominated in rand with a resident company. Both loan agreements are attributable to CFC A’s permanent establishment in Mexico. The functional currency of CFC A’s permanent establishment in Mexico is the peso.

*Result:*

Under paragraph (a) of the definition of “local currency” in section 24I(1) the local currency in relation to CFC A on both debts is the functional currency of CFC A’s permanent establishment, namely, the peso. Under the definition of “foreign currency” in section 24I(1) the foreign currency in relation to the debt denominated in US dollar is the US dollar and in relation to the debt denominated in rand is the rand.

<sup>103</sup> Paragraph (a) of the definition of “local currency” in section 24I(1).

<sup>104</sup> At the time of issuing this Note there were no currencies with an inflation rate of 100% or more. The Zimbabwe dollar is a historical example of a hyperinflationary currency. The use of the Zimbabwe dollar as an official currency was effectively abandoned on 12 April 2009 as a result of the Reserve Bank of Zimbabwe legalising the use of the rand and the US dollar as standard currencies for exchange.

<sup>105</sup> Definition of “foreign currency” in section 24I(1).

**(c) An exchange item of a controlled foreign company which is not attributable to a permanent establishment in or outside South Africa**

For a person who is not a resident, which includes a CFC, the definition of “local currency” in section 24I(1) specifically covers an exchange item which is attributable to a permanent establishment in South Africa<sup>106</sup> and attributable to a permanent establishment outside South Africa.<sup>107</sup> A third alternative is possible, namely, an exchange item which is not attributable to a permanent establishment in or outside South Africa. For example, the proviso to paragraph (a) of the definition of “local currency” in section 24I(1) deems an exchange item not to be attributable to a permanent establishment outside South Africa if the functional currency of that permanent establishment has an official inflation rate of 100% or more. The proviso does not deem the exchange item to be attributable to a permanent establishment in South Africa and it is therefore necessary to consider local currency in the context of an exchange item which is not attributable to a permanent establishment in or outside South Africa.

The treatment of exchange items which are not attributable to a permanent establishment in or outside South Africa is not directly dealt with in the definition of “local currency”. However, application of the proviso to paragraph (a) of the definition of “local currency” leads to the conclusion that if a CFC’s exchange item is not attributable to a permanent establishment in or outside South Africa, local currency is the rand.

The reason for this conclusion is that under that proviso any exchange item denominated in a currency other than the functional currency of a permanent establishment outside South Africa is deemed not to be attributable to that permanent establishment if the functional currency represents a currency of a country which has an official rate of inflation of 100% or more for that year. The proviso does not deem the exchange item to be attributable to another permanent establishment in or outside South Africa. It, therefore, follows that neither paragraph (a) or paragraph (b) of the definition of “local currency” in section 24I(1) can be applied directly. However, the clear purpose of the proviso was to avoid translating amounts from, for example, USD to a hyperinflationary currency (for example, currency A which is the functional currency) before translating taxable income in the hyperinflationary currency (currency A) to rand. Otherwise stated, the purpose was to translate amounts expressed in a currency other than the functional currency of the permanent establishment (USD in this scenario) directly to rand at the spot rate. This is achieved by making local currency in this scenario the rand even if this is arguably not clearly stated in the proviso. This is consistent with the position of a resident. Under paragraph (b) of the definition of “local currency” in section 24I(1), for a resident other than a headquarter company, if an exchange item is not attributable to a permanent establishment outside South Africa, then local currency for purposes of section 24I is the currency of South Africa, namely the rand.

In summary, if a CFC’s exchange item is not attributable to a permanent establishment in or outside South Africa the local currency is the rand.

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<sup>106</sup> Paragraph (c) of the definition of “local currency” in section 24I(1) [see **4.11.2(a)**].

<sup>107</sup> Paragraph (a) of the definition of “local currency” in section 24I(1) [see **4.11.2(b)**].



**Example 38 – Local currency and foreign currency in relation to a CFC on exchange items which are not attributable to a permanent establishment in or outside South Africa**

*Facts:*

CFC A enters into a loan agreement, denominated in rand, with a resident company and a loan agreement, denominated in US dollar, with a non-resident. CFC A does not have a permanent establishment in or outside South Africa. CFC A's functional currency is the US dollar.

*Result:*

Under the proviso to paragraph (a) of the definition of "local currency" in section 24I(1), the local currency in relation to CFC A on both debts is the rand.

The loan from the resident company is denominated in rand and is therefore not an amount in a foreign currency and not an "exchange item" as defined in section 24I(1). Section 24I does not apply to CFC A in respect of this loan.

The loan from the non-resident is denominated in US dollar which is an amount in a foreign currency owing by CFC A. This loan constitutes an "exchange item" as defined in section 24I(1). Section 24I applies to CFC A in respect of this loan.

**4.11.3 Disregarding of foreign exchange gains or foreign exchange losses between controlled foreign companies forming part of the same group of companies**

Under the circumstances discussed below, exchange differences determined on exchange items of a CFC must not be allowed as a deduction or taken into account in determining its net income under section 9D(2A).

**(a) Exchange differences on exchange items between controlled foreign companies which are part of the same group of companies [paragraph (c)(ii) of the proviso to section 9D(2A) and section 9D(9)(fA)(ii)]**

Paragraph (c)(ii) of the proviso to section 9D(2A) provides that in determining net income no deduction must be allowed for any exchange difference on an exchange item to which a CFC and any other CFC, forming part of the same group of companies, are parties, unless the exchange difference is taken into account in determining the net income of the other CFC.

Section 9D(9)(fA)(ii) provides that in determining the net income of a CFC there must not be taken into account any exchange difference on an exchange item to which the CFC and any other CFC forming part of the same group of companies are parties. This treatment means that a foreign exchange gain on an applicable exchange item must not be included in income and a foreign exchange loss on that exchange item must not be deducted from income. Depending on the facts, there could be other reasons why an exchange difference is not taken into account, for example, the exchange difference could be attributable to the CFC's foreign business establishment such that it also qualifies for exclusion from net income under section 9D(9)(a). An amount can "not be taken into account" only once.

**Example 39 – Exchange differences on an exchange item in relation to CFCs forming part of the same group of companies**

*Facts:*

CFC A and CFC B form part of the same group of companies, since CFC A holds 100% of the participation rights and voting rights in CFC B. CFC A advanced a loan of \$1 million to CFC B. CFC A and CFC B's functional currency is rand.

CFC A determined a foreign exchange gain of R200 000 on the loan for its year of assessment ending on 28 February year 1.

CFC B determined a foreign exchange loss of (R200 000) on the loan for its year of assessment ending on 28 February year 1.

*Result:*

Under section 9D(9)(fA)(ii) the foreign exchange gain of R200 000 must not be taken into account in determining the net income of CFC A.

Under paragraph (c)(ii) of the proviso to section 9D(2A) and section 9D(9)(fA)(ii), the foreign exchange loss of (R200 000) must not be allowed as a deduction in determining the net income of CFC B.

**(b) Foreign exchange difference on a forward exchange contract or a foreign currency option contract entered into to hedge an exchange item between controlled foreign companies which are part of the same group of companies [paragraph (c)(iii) of the proviso to section 9D(2A) and section 9D(9)(fA)(iii)]**

Paragraph (c)(iii) of the proviso to section 9D(2A) provides that in determining net income no deduction must be allowed for any exchange difference on an FEC or FCOC entered into to hedge an exchange item to which a CFC and any other CFC, which are part of the same group of companies, are parties,<sup>108</sup> unless the exchange difference is taken into account in determining the net income of the other CFC.

Section 9D(9)(fA)(iii) provides that in determining the net income of a CFC there must not be taken into account any exchange difference on any FEC or FCOC entered into to hedge an exchange item to which the CFC and any other CFC forming part of the same group of companies are parties. This requirement means that a foreign exchange gain on an applicable FEC or FCOC must not be included in income and a foreign exchange loss on that FEC or FCOC must not be deducted from income.

**Example 40 – Foreign exchange loss on an FEC entered into to hedge an exchange item in relation to CFCs forming part of the same group of companies**

*Facts:*

CFC A and CFC B form part of the same group of companies, since CFC A holds 100% of the participation rights and voting rights in CFC B. CFC A advanced a loan of \$1 million to CFC B. CFC B entered into an FEC to hedge the loan. CFC A and CFC B's functional currency is rand.

<sup>108</sup> That is, to hedge one of the exchange items discussed in 4.11.3(a) above.

CFC A determined a foreign exchange loss of (R200 000) on the loan for its year of assessment ending on 28 February year 1.

CFC B determined a foreign exchange gain of R200 000 on the loan and a foreign exchange loss of (R150 000) on the FEC for its year of assessment ending on 28 February year 1.

*Result:*

*CFC A*

Under paragraph (c)(ii) of the proviso to section 9D(2A) and section 9D(9)(fA)(ii), the foreign exchange loss of (R200 000) must not be allowed as a deduction in determining the net income of CFC A [see 4.11.3(a)].

*CFC B*

Under paragraph (c)(iii) of the proviso to section 9D(2A) and section 9D(9)(fA)(iii), the foreign exchange loss of (R150 000) on the FEC must not be allowed as a deduction in determining the net income of CFC B.

In addition, under section 9D(9)(fA)(ii) the foreign exchange gain of R200 000 on the debt must not be taken into account in determining the net income of CFC B [see 4.11.3(a)].

**Example 41 – Foreign exchange gain on an FEC entered into to hedge an exchange item in relation to CFCs forming part of the same group of companies**

*Facts:*

CFC A and CFC B form part of the same group of companies, since CFC A holds 100% of the participation rights and voting rights in CFC B. CFC A advanced a loan of \$1 million to CFC B. CFC B entered into an FEC to hedge the loan. CFC A and CFC B's functional currency is rand.

CFC A determined a foreign exchange gain of R200 000 on the loan for its year of assessment ending on 28 February year 1.

CFC B determined a foreign exchange loss of (R200 000) on the loan and a foreign exchange gain of R150 000 on the FEC for its year of assessment ending on 28 February year 1.

*Result:*

*CFC A*

Under section 9D(9)(fA)(ii) the foreign exchange gain of R200 000 in relation to the debt must not be taken into account in determining the net income of CFC A.

*CFC B*

Under paragraph (c)(ii) of the proviso to section 9D(2A) and section 9D(9)(fA)(ii), the foreign exchange loss of (R200 000) in relation to the debt must not be allowed as a deduction in determining the net income of CFC B.

Under section 9D(9)(fA)(iii) the foreign exchange gain of R150 000 in relation to the FEC must not be taken into account in determining the net income of CFC B.

**(c) Exchange difference attributable to a foreign business establishment of a controlled foreign company [section 9D(9A)(a)(iii)]**

Section 9D(9)(b) provides that, subject to section 9D(9A) (see below), in determining the net income of a CFC there must *not* be taken into account any amount which is attributable to a CFC's foreign business establishment.<sup>109</sup> An amount required to be included in or deducted from income under section 24I(3) may be attributable to a CFC's foreign business establishment in which case section 9D(9)(b) effectively overrides section 24I and excludes that amount from the calculation of net income.

Section 9D(9A), however, overrides the exclusion in section 9D(9)(b) and provides that specified amounts, which section 9D(9)(b) excluded, must be included in the calculation of net income *unless* those amounts meet additional requirements.<sup>110</sup>

Section 9D(9A)(a)(iii) deals with one of the specified amounts that must potentially be included in income. Under section 9D(9A)(a)(iii) amounts which are attributable to a foreign business establishment<sup>111</sup> and arise in respect of a financial instrument<sup>112</sup> must, except in the three instances discussed below, be taken into account in determining the net income of a CFC.

The three exceptions (the effect of which is that the amounts are not included in determining the net income of a CFC) are as follows:

- The amount is attributable to the principal trading activities of a foreign business establishment which comprises the activities of a bank, financial service provider or insurer and those activities do not constitute the activities of a treasury operation or captive insurer [section 9D(9A)(a)(iii)(aa)].
- The amount is attributable to any exchange difference determined under section 24I on that financial instrument and it arises in the ordinary course of business of the principal trading activities of that foreign business establishment and those activities do not constitute the activities of a treasury operation or captive insurer [section 9D(9A)(a)(iii)(bb)].

<sup>109</sup> The term "foreign business establishment" is defined in section 9D(1).

<sup>110</sup> In other words, if the additional requirements in section 9D(9A) are not met, section 9D(9A) applies and the specified amounts, which are attributable to the foreign business establishment, are included in net income. In contrast, if the additional requirements are met, section 9D(9A) is not applicable and those amounts, which are attributable to the foreign business establishment, are excluded from net income.

<sup>111</sup> See section 9D(9)(b) for the requirements in determining that amount and whether it is attributable to the foreign business establishment.

<sup>112</sup> The term "financial instrument" is defined in section 1(1) and includes, amongst other things, loans, advances, debts, bonds, debentures, bank deposits, shares, participatory interests in portfolios of collective investment schemes, forward purchase agreements, forward sale agreements and option contracts.

- To the extent the total of the following amounts (other than amounts to which section 9D(9)(c) to (fB) apply<sup>113</sup> and amounts derived from the activities of a treasury operation or captive insurer) does not exceed 5% of the relevant total indicated below:
  - Amounts arising in respect of financial instruments attributable to activities of that foreign business establishment.
  - Amounts arising from exchange gains determined under section 24I attributable to activities of that foreign business establishment.

The total of these two amounts is not included in the net income of the CFC to the extent that the total does not exceed 5% of the total of all amounts received by or accrued to the CFC which are attributable to that foreign business establishment, other than amounts to which section 9D(9)(c) to (fB) apply<sup>114</sup> and amounts derived from the activities of a treasury operation or captive insure [section 9D(9A)(a)(iii)(cc)].<sup>115</sup>

Amounts in respect of financial instruments which are derived from the activities of a treasury operation or a captive insurer must be taken into account in calculating the net income of a CFC for purposes of attribution to resident holders of shares, unless the amounts fall within one of the exclusions in section 9D(9)(c) to (fB).

Although the Act does not define what constitutes the activities of a treasury operation or a captive insurer, section 9D(9A)(b)(iii) and (iv) define specified circumstances in which the principal trading activities of a foreign business establishment, which do not constitute the activities of a treasury operation or a captive insurer, must be deemed to be the activities of a treasury operation or a captive insurer, as appropriate.

If an amount, which is attributable to a foreign business establishment and arises in respect of a financial instrument, is solely excluded from inclusion in net income as a result of falling within the ambit of one of the three exceptions in section 9D(9A)(a)(iii) discussed above, that amount must nevertheless be taken into account in net income under the proviso to section 9D(9A)(a) –

- to the extent that a deduction is allowed for any other amount incurred by a resident connected person in relation to that CFC; and
- that amount is attributable to that other amount.

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<sup>113</sup> This means that exchange differences calculated under section 24I which were excluded from net income under section 9D(9)(fA)(ii) and (iii), see **4.11.3(a)** and **4.11.3(b)**, are excluded from the determination of this total.

<sup>114</sup> This means that exchange differences calculated under section 24I which were excluded from net income under section 9D(9)(fA)(ii) and (iii), see **4.11.3(a)** and **4.11.3(b)**, are excluded from the determination of this total.

<sup>115</sup> To the extent the amount of 5% is exceeded, those amounts are included in net income.

**Example 42 – Exchange difference attributable to a foreign business establishment of a CFC**

*Facts:*

CFC A conducts the business of a bank in a foreign country, which constitutes a foreign business establishment. In its year of assessment ending on 28 February year 1 CFC A made a foreign exchange gain of \$300 000 in the ordinary course of the business of operating the bank.

*Result:*

Under section 9D(9)(b) read with section 9D(9A)(a)(iii)(aa) the foreign exchange gain of \$300 000 must not be taken into account in determining the net income of CFC A under section 9D(2A) because the foreign exchange gain arises in respect of a financial instrument that is attributable to the principal trading activities of CFC A's foreign business establishment and the principal trading activities constitute the activities of a bank. The requirements of section 9D(9A)(a)(iii)(bb) are also met.

**Example 43 – Exchange difference attributable to a foreign business establishment of a CFC**

*Facts:*

CFC A conducts a business in a foreign country, which constitutes a foreign business establishment. In its year of assessment ending on 28 February year 1 the following amounts were received by or accrued to CFC A in respect of the foreign business establishment:

|   |                  |
|---|------------------|
|   | \$               |
| Gross income from business operations   | 2 000 000        |
| Passive income on financial instruments attributable to the foreign business establishment  | 50 000           |
| Foreign exchange gain on a debt which is attributable to the foreign business establishment | <u>15 000</u>    |
| Total amounts received or accrued in respect of the foreign business establishment          | <u>2 065 000</u> |

*Result:*

The foreign exchange gain of \$15 000 must not be taken into account in determining the net income of CFC A under section 9D(2A) because section 9D(9)(b) and section 9D(9A)(a)(iii)(bb) apply.

The total amount derived in respect of financial instruments is \$65 000 (\$50 000 + \$15 000). The maximum amount that qualifies for exemption under section 9D(9A)(a)(iii)(cc) is \$103 250 (\$2 065 000 × 5%). Therefore, the passive income of \$50 000 must not be taken account in determining the net income of CFC A under section 9D(2A) because section 9D(9)(b) and section 9D(9A)(a)(iii)(cc) apply.

#### 4.11.4 Translation of a controlled foreign company's exchange differences and net income to rand [section 9D(6)]

Under section 9D(6), the net income of a CFC for a foreign tax year must be determined in its functional currency and translated to rand by applying the average exchange rate for the foreign tax year. This treatment is required for purposes of determining the amount of net income to be included in the income of residents holding a qualifying interest in the CFC under section 9D(2) (see 4.11.1). The net income of a CFC may include exchange differences determined under section 24I.

Under the proviso to section 9D(6), any exchange item denominated in any currency other than the functional currency of a CFC shall be deemed not to be attributable to any permanent establishment of the CFC if the functional currency is the currency of a country which has an official rate of inflation of 100% or more for that foreign tax year.<sup>116</sup> The effect is that, if the functional currency is a hyperinflationary currency, any amount in a currency other than the functional currency must be translated directly to rand at the spot rate.

See the relevant paragraph in Interpretation Note 63 "Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule" for more detail on section 9D(6).

#### Example 44 – Translation of a CFC's exchange difference and net income to rand

##### *Facts:*

CFC A's foreign tax year ends on the last day of December. On 1 June year 1 CFC A borrowed F100 000 from an unconnected foreign company. The functional currency of CFC A is the peso (P). The full amount of the loan remained payable as at 31 December year 1. CFC A received other income of P20 000 during the year of assessment ending on 31 December year 1. The average exchange rate for the year of assessment ending on 31 December year 1 was P1 = R5,0000.

Market rates are as follows:

| <b>Date</b>                           | <b>P / F<br/>Spot rate</b> |
|---------------------------------------|----------------------------|
| 1 June year 1 (transaction date)      | 2,0000                     |
| 31 December year 1 (translation date) | 1,7000                     |

##### *Result:*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  | <b>P</b> |
|--|----------|
| Exchange difference [F100 000 × (2,0000 – 1,7000)] | 30 000   |

<sup>116</sup> At the date of issue of this Note no country had an official rate of inflation of 100% or more. The Zimbabwe dollar is a historical example of a hyperinflation currency. The use of the Zimbabwe dollar as an official currency was effectively abandoned on 12 April 2009 as a result of the Reserve Bank of Zimbabwe legalising the use of the rand and the US dollar as standard currencies for exchange.

An exchange difference of P30 000 is determined on translation date which represents a foreign exchange gain that must be included in CFC A's net income under sections 9D(2) and 24I(3)(a).

Under section 9D(2A) CFC A's net income for the year of assessment ending on 31 December year 1 amounts to P50 000 (exchange difference of P30 000 + other taxable income of P20 000). Under section 9D(6) the net income of P50 000 is translated to rand by applying the average exchange rate for the year of assessment ending on 31 December year 1, that is R250 000 (P50 000 × 5,0000). A proportional amount of the CFC's net income of R250 000 must be attributed to residents holding a qualifying interest in CFC A.

#### **4.12 Interaction between section 24I and sections 24J, 25D and paragraph 43**

A number of sections in the Act deal with the receipt or accrual of amounts and the incurral of expenditure or losses in foreign currency, and the translation of these amounts to rand. These sections interact with section 24I, which deals with exchange items, to varying degrees. The interaction between some of these sections and section 24I is discussed below.

Under section 24I foreign exchange differences on exchange items are determined on translation and realisation of the exchange items. As discussed in **4.6**, the amount of an exchange difference or premium or like consideration taken into account under section 24I(3) must not be taken into account under any other provision of the Act.

##### **4.12.1 Determination of taxable income in foreign currency [section 25D]**

Amounts received or accrued and expenditure incurred in a foreign currency must generally be translated under section 25D to an amount in rand using either a spot rate or an average exchange rate on the appropriate dates in determining the taxable income of a person. Section 25D generally prescribes which rate must be used depending upon the type of person involved.

Although section 25D and section 24I deal with different "items" there is often an inter-relationship and harmony between the two sections.

For example, if goods are purchased from a supplier on credit, the date the expenditure is incurred for purposes of section 25D(1) is generally the same date as the date the exchange item was actually incurred for purposes of the transaction date under section 24I. Thus the spot rate for the expenditure under section 25D(1) will generally be the same rate as the spot rate for the ruling exchange rate of the exchange item on transaction date. See the discussion on the spot rate in **4.4.9** for circumstances when an approximate spot rate is used. Harmony is not always achieved because in some instances, for example, if a natural person is subject to section 24I as a result of section 24I(2)(c), that person may elect to use the average exchange rate for purposes of section 25D in translating the expenditure incurred but be required to use the spot rate in relation to exchange items under section 24I.



This lack of harmony can also be found in the inter-relationship with other sections, for example, in section 6quat(4) and section 24I when dealing with the translation of foreign tax and a foreign tax debt (the amount owed to the foreign tax authority).<sup>117</sup>

For more detail on section 25D and other provisions of the Act dealing with translation requirements see Interpretation Note 63 “Rules for the Translation of Amounts Measured in Foreign Currencies other than Exchange Differences Governed by Section 24I and the Eighth Schedule”. Interpretation Note 63 deals with the translation of the underlying income or expenditure as required under sections 6quat(4) and (4A), 9A, 9D(6), 25D, 35A(5), 47J, 49H, 50H, 51H and 64N(4) which is distinct from the treatment of the exchange items under section 24I.

#### **Example 45 – Application of sections 24I and 25D(1)**

##### *Facts:*

Company A, a resident, purchased stationery on 1 June year 1 on credit from a non-resident supplier. The stationery, which cost \$10 000, had been used in the business by the end of its year of assessment ending on 31 December year 1. Company A paid the supplier on 31 December year 1.

Market rates are as follows:

|                                       | <b>\$ / R</b>    |
|---------------------------------------|------------------|
| <b>Date</b>                           | <b>Spot rate</b> |
| 1 June year 1 (transaction date)      | 12,6000          |
| 31 December year 1 (realisation date) | 13,7000          |

##### *Result:*

*Year of assessment ending on 31 December year 1*

The expenditure was incurred on 1 June year 1 and, for purposes of determining the deduction under section 11(a), section 25D(1) requires the amount of \$10 000 to be translated to rand at the spot rate on that date. The amount of the deduction under section 11(a) is therefore R126 000 ( $\$10\,000 \times 12,6000$ ).

The exchange difference that must be taken into account under section 24I(3)(a) is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|  |          |
|--|----------|
|  | <b>R</b> |
| Exchange difference [ $\$10\,000 \times (12,6000 - 13,7000)$ ] | (11 000) |

An exchange difference of (R11 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from Company A's income under section 24I(3)(a).

<sup>117</sup> See 4.18.1 and the relevant paragraph in Interpretation Note 18 “Rebates and Deduction for Foreign Taxes on Income” for more detail on the rebate and deduction.

#### 4.12.2 Assets disposed of or acquired in foreign currency [paragraph 43]

Paragraph 43 deals with the determination of a capital gain or capital loss when an asset is acquired or disposed of in a foreign currency.<sup>118</sup> It contains rules for translating the proceeds and base cost of an asset to local currency.<sup>119</sup>

Paragraph 43 applies to an “asset” as defined in paragraph 1. The term “asset” excludes currency and therefore does not apply to bank notes and coins. The term “asset”, however, includes debt denominated in a foreign currency such as foreign bank accounts, treasury bonds and loans.

Generally there are two ways of translating a capital gain or capital loss to rand, namely, a simple method under paragraph 43(1) and a more comprehensive method under paragraph 43(1A). Under the simple method, the capital gain or capital loss is determined in the foreign currency and translated to local currency at the time of disposal. Under the comprehensive method, the expenditure is translated to local currency at the time it is incurred while the proceeds are translated to local currency at the time the asset is disposed of. The comprehensive method reflects the effect of currency appreciation or depreciation on the base cost of the asset. Thus in times of a depreciating rand the comprehensive method will result in a lower base cost and higher capital gain or lower capital loss while the converse will be true in times of an appreciating rand when compared to the simple method.

Paragraph 43(1) applies when a natural person or non-trading trust disposes of an asset for proceeds in a foreign currency after having incurred expenditure in respect of the asset in the same foreign currency. In these circumstances the natural person or non-trading trust must translate the capital gain or capital loss to the local currency by applying the average exchange rate for the year of assessment in which the asset was disposed of or by applying the spot rate on the date of disposal of the asset.

Paragraph 43(1A) applies when paragraph 43(1) does not apply. It applies when an asset is disposed of during a year of assessment and the proceeds are in a foreign currency or when the expenditure in respect of that asset has been incurred in a foreign currency. It applies to the disposal of an asset by –

- a company;
- a trading trust; or
- a natural person or non-trading trust that buys and sells an asset in different currencies.

When paragraph 43(1A) applies the person must determine a capital gain or capital loss by translating –

- the proceeds to the local currency at the average exchange rate for the year of assessment in which that asset was disposed of or at the spot rate on the date of disposal of that asset; and
- the expenditure incurred on that asset to the local currency at the average exchange rate for the year of assessment during which that expenditure was incurred or at the spot rate on the date on which that expenditure was incurred.

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<sup>118</sup> See paragraph 19 of the *Comprehensive Guide to Capital Gains Tax* which deals with paragraph 43 in detail.

<sup>119</sup> The terms “foreign currency” and “local currency” are defined in paragraph 43(7).

Paragraph 43(6A) determines that paragraph 43(1A) does not apply to the disposal of –

- any amount of a debt owed to a person denominated in a foreign currency [paragraph 43(6A)(b)]; or
- any right of that person arising from any contractual agreement or arrangement to which that person and another person are parties when –
  - that contractual agreement or arrangement gives rise to that right and to a corresponding obligation of the other party; and
  - the value of that right and the amount of that obligation are determined directly or indirectly with reference to a debt owed to a person that is denominated in a foreign currency [paragraph 43(6A)(c)].

A person falling outside paragraph 43(1A) must determine a capital gain or capital loss on disposal of a debt denominated in a foreign currency or a right as specified above under section 25D and, if appropriate, taking into account section 24I(6).

In summary, debt assets denominated in foreign currency such as foreign bank accounts, treasury bonds and loans held by natural persons and non-trading trusts fall within paragraph 43(1) when acquired and disposed of in the same foreign currency. In all other situations, for example, for natural persons and non-trading trusts when the debt is acquired and disposed of in different currencies, or companies and trading trusts, paragraph 43(1A) is not applicable as a result of paragraph 43(6A). Under these circumstances the translation of the foreign currency amounts (proceeds and base cost) must be dealt with under section 25D taking section 24I(6) into account when applicable.

**Example 46 – Exchange difference on a debt payable to a natural person – Interaction between section 24I and paragraph 43(1)**

*Facts:*

Individual A holds US dollar bonds as trading stock. On 1 March year 1 Individual A lent \$100 000 to Foreign Company A on capital account. Foreign Company A was subsequently liquidated resulting in Individual A writing off the full amount of the loan on 28 February year 2 when the company was finally liquidated and Individual A's right to recover the amount was extinguished.<sup>120</sup> Under paragraph 43(1) Individual A elected to use the spot rate on 28 February year 2 to translate the capital loss on disposal of the loan to rand.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 March year 1 (transaction date)     | 11,5000                     |
| 28 February year 2 (realisation date) | 11,7000                     |

<sup>120</sup> See 4.14 for a discussion of the consequences when a debt is written off for tax purposes before the right to recover is finally extinguished.

*Result:**Determination of exchange difference on realisation date*

Individual A must determine an exchange difference on the debt owing by Foreign Company A because even though that debt was not held as trading stock, the bonds are held as trading stock which results in all exchange items falling within the ambit of section 24I(2)(c).

The right to recover the debt was extinguished on 28 February year 2 as a result of Foreign Company A being finally liquidated. This was also the date on which Individual A wrote off the debt as bad. The extinction of the right constitutes a disposal of the debt and therefore a realisation event for the purposes of paragraph (a) of the definition of "realised" in section 24I(1).

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,5000 - 11,7000)$ ] | 20 000 |

An exchange difference of R20 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

Under section 24I(4)(a) (see **4.14.1**) the amount of R20 000 must be deducted from income.

*Determination of capital loss on disposal of the debt*

A capital loss on disposal of the debt is determined under paragraph 43(1) for CGT purposes because the taxpayer is a natural person and the acquisition and disposal of the debt was in the same foreign currency. The capital loss is calculated as follows:

|   |                  |
|---|------------------|
|   | \$               |
| Proceeds                                | 0                |
| Less: Base cost                         | <u>(100 000)</u> |
| Capital loss on termination of the loan | <u>(100 000)</u> |

The capital loss of \$100 000 is translated to rand under paragraph 43(1) by applying the spot rate on 28 February year 2. The capital loss is equal to (R1 170 000) ( $\$100\,000 \times 11,7000$ ). The exchange difference of R20 000 is not included in the capital loss determined under paragraph 43(1) and therefore no adjustment is required to the capital loss.

**Example 47 – Exchange difference and a capital gain on disposal of a debt payable to a company – Interaction between section 24I, section 25D(1) and paragraph 43(6A)(b)**

*Facts:*

Company A's year of assessment ends on the last day of February.

On 1 April year 1 Company A acquired a foreign bond as a long-term investment for \$100 000. Company A disposed of the foreign bond on 30 June year 2 for \$120 000.

Ignore interest on the bond for purposes of this example.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R</b><br><b>Spot rate</b> |
|---------------------------------------|-----------------------------------|
| 1 April year 1 (transaction date)     | 11,0000                           |
| 28 February year 2 (translation date) | 11,3000                           |
| 30 June year 2 (realisation date)     | 11,4000                           |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,0000 - 11,3000)$ ] | 30 000 |

An exchange difference of R30 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Determination of a capital gain or capital loss on disposal of the debt*

Paragraph 43(6A)(b) specifically excludes the capital gain or capital loss on the disposal of a debt by a company from being calculated under paragraph 43(1A). Section 25D(1) must be applied to translate the amounts in foreign currency and therefore to calculate the capital gain or capital loss.

The translation of proceeds and base cost at spot rate on the date of accrual of the proceeds and incurral of the expenditure under section 25D will result in the foreign exchange gains previously recognised under section 24I(3) and included in income, also being included in the capital gain or capital loss calculated.

Therefore, section 24I(6) and paragraph 35(3)(a) must be applied to exclude the exchange differences calculated and recognised under section 24I from the capital gain or capital loss.

The capital gain is calculated as follows:

|  |                    |
|--|--------------------|
|  | R                  |
| Proceeds (\$120 000 × 11,4000)   | 1 368 000          |
| Less: Base cost (\$100 000 × 11,0000)  | <u>(1 100 000)</u> |
| Capital gain on disposal of the debt before adjustment   | 268 000            |
| Less: Amounts of exchange differences included in income under section 24I(3)(a) and in the capital gain before adjustment (R30 000 + R10 000) [section 24I(6) and paragraph 35(3)(a)] | <u>(40 000)</u>    |
| Capital gain   | <u>228 000</u>     |

**Example 48 – Exchange difference and a capital loss on disposal of a debt payable to a company – Interaction between section 24I, section 25D(1) and paragraph 43(6A)(b)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 April year 1 Company A acquired a foreign bond as a long-term investment for \$100 000. Company A disposed of the foreign bond on 30 June year 2 for \$80 000.

Ignore interest on the bond for purposes of this example.

Market rates are as follows:

| Date                                  | \$ / R<br>Spot rate |
|---------------------------------------|---------------------|
| 1 April year 1 (transaction date)     | 11,0000             |
| 28 February year 2 (translation date) | 11,3000             |
| 30 June year 2 (realisation date)     | 11,4000             |

*Result:*

*Year of assessment ending on 28 February year 2*

*Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [\$100 000 × (11,0000 – 11,3000)] | 30 000 |

An exchange difference of R30 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Determination of a capital loss on disposal of the debt*

Paragraph 43(6A)(b) specifically excludes the capital gain or capital loss on the disposal of a debt by a company from being calculated under paragraph 43(1A). Section 25D(1) must be applied to translate the amounts in foreign currency and therefore to calculate the capital gain or capital loss. The translation of proceeds and base cost at spot rate on the date of accrual of the proceeds and incurral of the expenditure under section 25D will result in the foreign exchange gains previously recognised under section 24I(3) and included in income being included in the capital gain or capital loss calculated. Section 24I(6) and paragraph 35(3)(a) must therefore be applied to exclude from the capital gain or capital loss, any foreign exchange differences calculated and recognised under section 24I, which are also included in the capital gain or capital loss.

The capital loss is calculated as follows:

|  |                    |
|--|--------------------|
|  | R                  |
| Proceeds ( $\$80\,000 \times 11,4000$ )  | 912 000            |
| Less: Base cost ( $\$100\,000 \times 11,0000$ )  | <u>(1 100 000)</u> |
| Capital loss on disposal of the debt before adjustment   | (188 000)          |
| Less: Amounts of foreign exchange differences included in income under section 24I(3)(a) and in the capital loss [ $(R30\,000 + R10\,000) \times \$80\,000 / \$100\,000$ ] [section 24I(6) and paragraph 35(3)(a)] | <u>(32 000)</u>    |
| Capital loss   | <u>(220 000)</u>   |

#### **4.12.3 Incurral and accrual of interest under section 24J and the determination of exchange differences in relation to an interest-bearing debt under section 24I**

Section 24J regulates the timing of the accrual and incurral of interest on an instrument and provides for the inclusion of accrued interest in gross income and a deduction of incurred interest from income. The recognition of the interest is generally spread over the term of the instrument. The term "instrument" as defined in section 24J(1) includes any interest-bearing arrangement or debt.<sup>121</sup>

<sup>121</sup> Paragraph (c) of the definition of "instrument".

Under section 24J(2) an issuer in relation to an instrument is deemed for purposes of the Act to have incurred an amount of interest during the year of assessment which must be deducted from that person's income derived from carrying on any trade, if that amount was incurred in the production of income.<sup>122</sup> The amount of interest that is deemed to have been incurred is equal to –

- the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
- an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument.

Under section 24J(3) an amount of interest is deemed to have accrued to the holder of an income instrument and must be included in the gross income of that person during that year of assessment (whether or not that amount constitutes a receipt or accrual of a capital nature). The amount of interest that is deemed to have accrued is equal to –

- the sum of all accrual amounts in relation to all accrual periods falling, whether in part or in whole, within such year of assessment in respect of such income instrument; or
- an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such income instrument.<sup>123</sup>

If interest is incurred or accrues in a foreign currency, the calculation of the amount of interest which is deemed to have been incurred or accrued under section 24J must be calculated in that foreign currency. For purposes of determining taxable income, the foreign currency amounts must then be translated to an amount in rand using either the spot rate or an average exchange rate as required under section 25D (see **4.12.1**).

When section 24J deems an amount of interest to have been incurred by or to have accrued to a person for purposes of the Act, it is treated as an amount of interest which was actually incurred by or actually accrued to that person for purposes of the Act. An amount of interest in a foreign currency which was actually incurred by or actually accrued to a person represents an amount which is owed by or to that person and therefore constitutes an exchange item. Similarly, an amount which is deemed to have been incurred by or to have accrued to a person under section 24J is treated as if it is an actual incurral or accrual, and, as such, is treated as if it is an amount owing by or to that person for purposes of the Act. Therefore, the deemed amount of interest in a foreign currency owing by or to a person on a debt under section 24J constitutes an exchange item under paragraph (b) of the definition of “exchange item” in section 24I(1) (see **4.4.2**) and exchange differences must be determined on translation date and realisation date under section 24I.

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<sup>122</sup> The terms “accrual amount”, “accrual period”, “alternative method”, “instrument”, “interest” and “issuer” are defined in section 24J(1). These terms are not discussed in this Note.

<sup>123</sup> The terms “accrual amount”, “accrual period”, “alternative method”, “holder”, “income instrument”, and “interest” are defined in section 24J(1). These terms are not discussed in this Note.



Section 24J overrides the actual position, for example, when a person lends a fixed sum of money to a borrower for a fixed period at a fixed rate of interest and the borrower undertakes to repay the capital and pay the interest to the taxpayer on a fixed date. Even though the full amount of interest on the loan would accrue as soon as the person makes the funds available to the borrower,<sup>124</sup> only the portion which is deemed to have accrued under section 24J will be treated as having been accrued and as giving rise to an exchange item under section 24I. Depending on the facts, the exchange difference calculated may be nil. For example, an exchange difference of nil is determined in relation to the interest debt on translation date (for example, 28 February year 2) which is the same date as the transaction date (for example, 28 February year 2) and therefore the ruling exchange rates on transaction date and translation date are the same. See Examples 49 and 50 below. This situation is not always the case because the transaction date often differs from the translation date and therefore different ruling exchange rates apply.

The transaction date in relation to an amount of interest owing in foreign currency by a person will be the date on which the amount of interest was actually incurred. The transaction date in relation to an amount of interest owing to a person is the date on which the amount of interest accrued to that person.

Section 24J(4)(a) and (b) provide that the adjusted gain or loss on transfer or redemption of an instrument is deemed to have accrued to or been incurred by the taxpayer during the year of assessment in which the instrument is transferred or realised. This section does not state that the adjusted gain or loss on redemption must be included in gross income or deducted from income. Thus, whether it must be dealt with on revenue or capital account depends on the facts of the particular case. See Example 50, dealing with the interaction between sections 24I, 24J, 25D(1) and the Eighth Schedule, when an instrument disposed of was held on capital account.

**Example 49 – Exchange difference on an interest-bearing debt payable to a company – Interaction between sections 24I, 24J and 25D(1)**

*Facts:*

Company A's year of assessment ends on the last day of February.

On 1 June year 1 Company A acquired a foreign bond of \$500 000 with a maturity date of 31 May year 2. The bond bore interest at 10% per annum payable on 31 May year 2. Company A elected an accrual period of 12 months for purposes of section 24J.<sup>125</sup>

Market rates are as follows:

|  | <b>\$ / R</b>    |
|--|------------------|
| <b>Date</b>  | <b>Spot rate</b> |
| 1 June year 1 (transaction date for the capital portion of the bond) | 11,0000          |
| 28 February year 2 (translation date)                                | 11,3000          |
| 31 May year 2 (realisation date)                                     | 11,4000          |

<sup>124</sup> See *Cactus Investments (Pty) Ltd v CIR* [1999] 1 All SA 345(A), 61 SATC 43 at 48.

<sup>125</sup> See the definition of "accrual period" in section 24J(1).

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date on the capital portion of the debt (\$500 000)*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |         |
|---|---------|
|   | R       |
| Exchange difference [ $\$500\,000 \times (11,0000 - 11,3000)$ ] | 150 000 |

An exchange difference of R150 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Determination of the amount of interest to be included in gross income*

Even though the accrual period ends on 31 May year 2, section 24J(3)(a) requires that the portion of interest in respect of the part of the accrual period ending on 28 February year 2 must be included in gross income. Interest of \$37 500 ( $\$500\,000 \times 10\% \times 9/12$ ) is therefore deemed to have accrued to Company A during the year of assessment ending on 28 February year 2 and must be included in gross income. This amount must be translated to rand under section 25D(1) at the spot rate at 28 February year 2.\* R423 750 ( $\$37\,500 \times 11,3000$ ) is therefore included in Company A's gross income.

\* For the purposes of this example, this date is based on the assumption that although interest is calculated from 1 June year 1, it accrued to Company A on 28 February year 2 and this date is therefore the transaction date for purposes of section 24I.

*3. Determination of exchange difference on translation date: Interest owing on the debt (1 June year 1 to 28 February year 2) (\$37 500)*

The interest of \$37 500, deemed to have accrued on the foreign bond and therefore owing to Company A, is an exchange item under paragraph (b) of the definition of "exchange item" in section 24I(1). An exchange difference must therefore be determined on translation date.

The transaction date in relation to a debt owing to a person is the date on which the amount payable in respect of the debt accrued to the person. Since interest of \$37 500 is deemed to have accrued on 28 February year 2, this date is the transaction date for this exchange item.

The exchange difference is determined by multiplying the amount of the exchange item (interest owing on the foreign bond) by the difference between the ruling exchange rates on transaction date (28 February year 2) and translation date (28 February year 2) as follows:

|  |   |
|--|---|
|  | R |
| Exchange difference [ $\$37\,500 \times (11,3000 - 11,3000)$ ] | 0 |

An exchange difference of nil is determined on translation date, since the transaction date and translation date are the same date and therefore the same spot rate is used for purposes of the ruling exchange rate at transaction date and realisation date.

*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on realisation date*

*Capital portion of the foreign bond of \$500 000 plus interest accrued of \$37 500*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$537\,500^* \times (11,3000 - 11,4000)$ ] | 53 750 |

\* Capital portion of the debt of \$500 000 plus interest accrued of \$37 500 in the year of assessment ending on 28 February year 2.

An exchange difference of R53 750 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a). R50 000 [ $\$500\,000 \times (11,3000 - 11,4000)$ ] relates to the capital portion of the foreign bond and R3 750 [ $\$37\,500 \times (11,3000 - 11,4000)$ ] relates to the interest portion of the debt that accrued on 28 February year 2.

*2. Determination of the amount of interest to be included in gross income*

Under section 24J(3) interest of \$12 500 ( $\$500\,000 \times 10\% \times 3/12$ ) is deemed to have accrued to Company A during the year of assessment in respect of the part of the accrual period ending on 31 May year 2. R142 500 ( $\$12\,500 \times 11,4000^*$ ) must therefore be included in Company A's gross income.

\* For the purposes of this example, this rate is based on the assumption that although interest is calculated from 1 March year 2, it accrued to Company A on 31 May year 2. 31 May year 2 is therefore the transaction date for purposes of section 24I.

*3. Determination of exchange difference on realisation date: Interest owing on the debt (1 March year 2 to 31 May year 2) (\$12 500)*

The transaction date in relation to a debt owing to a person is the date on which the amount payable in respect of the debt accrued to the person. Since interest of \$12 500 is deemed to have accrued on 31 May year 2, this date is the transaction date for this exchange item.

The exchange difference is determined by multiplying the amount of the exchange item (interest owing on the foreign bond) by the difference between the ruling exchange rates on transaction date (31 May year 2) and realisation date (31 May year 2) as follows:

|  |   |
|--|---|
|  | R |
| Exchange difference [ $\$12\,500 \times (11,4000 - 11,4000)$ ] | 0 |

An exchange difference of nil is determined on realisation date because the transaction date and realisation date are the same date and, therefore, the same spot rate is used for purposes of the ruling exchange rate at transaction date and realisation date.

**Example 50 – Exchange difference on an interest-bearing debt payable to a company – Interaction between sections 24I, 24J, 25D(1) and the Eighth Schedule including paragraphs 43(1A) and 43(6A)(b)**

*Facts:*

Company A's year of assessment ends on the last day of February.

On 1 June year 1 Company A acquired a foreign bond of \$500 000 which Company A intended to hold as a capital asset. The bond bore interest at 10% per annum payable on 31 May year 2. The bond is held on capital account.

As a result of unexpected circumstances Company A disposed of the foreign bond on 30 April year 2 for \$620 000.

Market rates are as follows:

| <b>Date</b>  | <b>\$ / R</b>    |
|--|------------------|
|  | <b>Spot rate</b> |
| 1 June year 1 (transaction date for the capital portion of the bond) | 11,0000          |
| 28 February year 2 (translation date)                                | 11,3000          |
| 30 April year 2 (realisation date)                                   | 11,4000          |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on the principal amount of the bond on translation date*

*Capital portion of the debt (\$500 000)*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |          |
|---|----------|
|   | <b>R</b> |
| Exchange difference [ $\$500\,000 \times (11,0000 - 11,3000)$ ] | 150 000  |

An exchange difference of R150 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Determination of the amount of interest to be included in gross income*

Under section 24J(3) interest of \$37 500 ( $\$500\,000 \times 10\% \times 9/12$ ) is deemed to have accrued to Company A during the year of assessment in respect of the part of the accrual period ending on 28 February year 2. R423 750 ( $\$37\,500 \times 11,3000^*$ ) must therefore be included in Company A's gross income.

\* For the purposes of this example, this rate is based on the assumption that although interest is calculated from 1 June year 1, it accrued to Company A on 28 February year 2. 28 February year 2 is therefore the transaction date.

*3. Determination of exchange difference: Interest owing on the debt (1 June year 1 to 28 February year 2) (\$37 500)*

Since the interest owing to Company A is an exchange item under paragraph (b) of the definition of "exchange item" in section 24I(1), an exchange difference must be determined on translation date.

The transaction date in relation to a debt owing to a person is the date on which the amount payable in respect of the debt accrued to the person. Since interest of \$37 500 is deemed to have accrued on 28 February year 2, this date is the transaction date for this exchange item.

The exchange difference is determined by multiplying the amount of the exchange item (interest owing on the foreign bond) by the difference between the ruling exchange rates on transaction date (28 February year 2) and translation date (28 February year 2) as follows:

|  |   |
|--|---|
|  | R |
| Exchange difference [ $\$37\,500 \times (11,3000 - 11,3000)$ ] | 0 |

An exchange difference of nil is determined on translation date because the transaction date and translation date are the same date and, therefore, the ruling exchange rates on transaction date and translation date are the same.

*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on realisation date*

*Capital portion of the foreign bond of \$500 000 plus interest accrued of \$37 500*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$537\,500 \times (11,3000 - 11,4000)$ ] | 53 750 |

An exchange difference of R53 750 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a). R50 000 [ $\$500\,000 \times (11,3000 - 11,4000)$ ] relates to the capital portion of the foreign bond and R3 750 [ $\$37\,500 \times (11,3000 - 11,4000)$ ] relates to the interest portion of the debt that accrued on 28 February year 2.

*2. Determination of the amount of interest to be included in gross income*

Under section 24J(3) interest of \$8 333 ( $\$500\,000 \times 10\% \times 2 / 12$ ) is deemed to have accrued to Company A during the year of assessment in respect of the part of the accrual period ending on 30 April year 2. R94 996 ( $\$8\,333 \times 11,4000^*$ ) must therefore be included in Company A's gross income.

\* For the purposes of this example, this rate is based on the assumption that although interest is calculated from 1 March year 2, it accrued on 30 April year 2. The 30 April year 2 is therefore the transaction date for purposes of section 24I.

*3. Determination of exchange difference: Interest owing on the debt (1 March year 2 to 30 April year 2) (\$8 333)*

Since the interest owing to Company A is an exchange item under paragraph (b) of the definition of "exchange item" in section 24I(1), an exchange difference must be determined on realisation date. The interest of \$8 333 is deemed to have accrued on 30 April year 2 and this date is therefore the transaction date for this exchange item.

The exchange difference is determined by multiplying the amount of the exchange item (interest owing on the foreign bond) by the difference between the ruling exchange rates on transaction date (30 April year 2) and realisation date (30 April year 2) as follows:

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$8\,333 \times (11,4000 - 11,4000)$ ] | 0 |

An exchange difference of nil is determined on realisation date, since the ruling exchange rate on transaction date and realisation date is the same.

#### 4. Determination of an adjusted gain or loss on transfer of the bond

Under section 24J(4)(a) the adjusted gain on transfer of the bond is deemed to accrue to Company A on 30 April year 2.

The adjusted gain on transfer = [transfer price (\$620 000) + other amounts received during the period in which transferred (\$0)] – [adjusted initial amount (\$500 000 + \$37 500) + current period accrual (\$8 333) + other current period payments (\$0)] = \$74 167.

Section 24J(4)(a) does not stipulate that the adjusted gain on transfer must be included in gross income and therefore, because the bond was acquired and held on capital account, the treatment of a capital gain or capital loss on realisation falls within the ambit of the Eighth Schedule.

#### 5. Determination of a capital gain on disposal of the debt

In dollar terms, the amount of the capital gain of \$74 167 [proceeds of \$620 000 – base cost of \$545 833 (\$500 000 + \$37 500 + \$8 333)] is the same as the adjusted gain on transfer as calculated above. However, this amount needs to be translated to rand under the provisions of the Act and adjusted for any exchange differences already taken into account under section 24I.

Paragraph 43(6A)(b) provides that paragraph 43(1A) must not be applied to calculate the capital gain or capital loss on the disposal of a debt owed to a person in foreign currency. Consequently, the disposal of the foreign bond is specifically excluded from paragraph 43(1A). Section 25D(1) must therefore be applied to translate proceeds and base cost to rand. In addition, section 24I(6) and paragraph 35(3)(a) apply to adjust for any exchange differences taken into account under section 24I.

The capital gain is therefore calculated as follows:

|  |                    |
|--|--------------------|
|  | R                  |
| Proceeds ( $\$620\,000 \times 11,4000$ )   | 7 068 000          |
| Less: Base cost [ $(\$500\,000 \times 11,0000) +$ interest of R423 750<br>+ interest of R94 996, see interest calculations above]*   | <u>(6 018 746)</u> |
| Capital gain on disposal of the debt before adjustment   | 1 049 254          |
| Less: Amounts of foreign exchange differences included in<br>income under section 24I(3)(a) and in the capital gain before<br>adjustment (R150 000 + R53 750) [section 24I(6) and<br>paragraph 35(3)(a)] | <u>(203 750)</u>   |
| Capital gain   | <u>845 504</u>     |

\* Company A did not receive any payments from the issuer of the bond before disposing of it and therefore there are no reductions to base cost in this regard.

**Note:**

On a net basis the amounts taken into account for income tax purposes of R1 568 000 [the capital gain of R845 504, the exchange differences of R203 750 (R150 000 + R53 750) and the interest of R518 746 (R423 750 + R94 996)] equal the net cash flow of R1 568 000 [R7 068 000 ( $\$620\,000 \times 11,4000$ ) – R5 500 000 ( $\$500\,000 \times 11,0000$ )].

**4.13 Trading stock [section 1(1) – definition of “trading stock” and section 22(3)(a)(i)]**

**4.13.1 Exclusion of a forward exchange contract and a foreign currency option contract from the definition of “trading stock” [paragraph (b) of the definition of “trading stock” in section 1(1)]**

The definition of “trading stock” in section 1(1) does not include an FCOC or an FEC as defined in section 24I(1). The cost price of any FCOC or FEC held by a person for speculative purposes must therefore not be included in closing stock under section 22(1) and opening stock under section 22(2).

**4.13.2 Exclusion of an exchange difference from the cost price of trading stock [section 22(3)(a)(i)]**

Section 22(3)(a)(i) provides that for the purposes of section 22 the cost price at any date of any trading stock in relation to any person shall, subject to section 22(3)(a)(iA) and (ii), be the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus any further costs incurred by such person, under IFRS (in the case of a company), up to and including the said date in getting such trading stock into its then existing condition and location, but excluding any exchange difference as defined in section 24I(1) relating to the acquisition of such trading stock.

**Example 51 – Exclusion of the amount of an exchange difference from the cost price of trading stock – Section 22(3)(a)(i)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 November year 1 Company A purchased trading stock of \$500 000 on credit. The debt was paid on 31 March year 2. The trading stock was held and not disposed of on 28 February year 2 but was all disposed of in April year 2.

Market rates are as follows:

|                                       | <b>\$ / R</b>    |
|---------------------------------------|------------------|
| <b>Date</b>                           | <b>Spot rate</b> |
| 1 November year 1 (transaction date)  | 11,6000          |
| 28 February year 2 (translation date) | 11,7000          |
| 31 March year 2 (realisation date)    | 11,5000          |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$500\,000 \times (11,6000 - 11,7000)$ ] | (50 000) |

An exchange difference of (R50 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*2. Treatment of trading stock*

The trading stock acquired for R5,8 million ( $\$500\,000 \times 11,6000$ ) is deductible under section 11(a) and is determined under section 25D(1) by multiplying the amount of the expenditure incurred in dollars by the spot rate on the date that the expenditure is incurred.

The cost price of trading stock of R5,8 million is included in closing stock under section 22(1). Under section 22(3)(a)(i) the exchange difference of R50 000 related to the acquisition of the trading stock is not included in the cost price of trading stock for the purposes of section 22.

*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |         |
|---|---------|
|   | R       |
| Exchange difference [ $\$500\,000 \times (11,7000 - 11,5000)$ ] | 100 000 |

An exchange difference of R100 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Treatment of trading stock*

The trading stock held and not disposed of on 1 March year 2 of R5,8 million is included in opening stock under section 22(2) read with section 22(3)(a)(i).

The amounts received or accrued on the disposal of the trading stock must be included in gross income.



#### 4.14 Bad and doubtful debts and subsequent recoupment [sections 11(a), (i) and (j), 8(4)(a) and 24I(4)]

##### 4.14.1 Bad and doubtful debts [sections 11(i) and (j) and 24I(4)]

Bad debts in respect of exchange items must be determined after providing for adjustments as a result of fluctuations in underlying exchange rates. This means that when an exchange item becomes bad or its recovery becomes doubtful, the loss, bad debt or doubtful debt allowance for the creditor under sections 11(a), 11(i) or 11(j)<sup>126</sup> is based on an amount which takes into account all exchange differences which were, or will be, included in or deducted from the taxpayer's income in any previous or current year of assessment. This outcome is achieved by basing the loss, bad debt or doubtful debt allowance on an amount calculated by multiplying the foreign currency amount of the exchange item that is bad or doubtful by the spot rate on the date of the write-off or allowance.<sup>127</sup>

In summary, an exchange difference on debt written off, calculated from transaction or translation date to write-off date, must be deducted from or included in income and the amount of the debt translated to rand at write-off date will be considered for deduction under section 11(a) or (i).

The write-off of a bad debt under section 11(a) or section 11(i) does not necessarily constitute a repayment, settlement or disposal of the debt and therefore does not necessarily constitute a realisation of the exchange item. The debt exists until all its rights have been extinguished and that point in time may, depending on the facts of a particular case, arise after the deduction was permitted under the above sections for tax purposes.

In *Malone & another v FX Africa Foreign Exchange (Pty) Ltd & others*<sup>128</sup> the applicant argued that a respondent creditor had abandoned a debt because it had written it off in its financial statements. A Chartered Accountant submitted an affidavit to the court that "impairment" or "writing-off" of a loan receivable does not, in accounting terms, amount to its abandonment (that is, discharge). The accountant explained that the management of FX Africa can and often does continue to try and recover a debt subsequent to treating it as being fully impaired. If any portion of the debt is recovered, the amount recovered is written back and recognised as profit or income in the year in which the recovery is made. After weighing up the evidence, the court concluded that the relevant debt was still valid and had not been abandoned (discharged).

However, even if the debt still exists, to the extent that the foreign currency amount of an exchange item is irrecoverable and is allowed as a deduction under section 11(a) or section 11(i), it is effectively treated as realised and no further exchange differences are subsequently taken into account, except to the extent any portion of the amount written off is subsequently recouped or recovered. Otherwise stated, exchange differences are calculated up to and including the time when the deduction under section 11(a) or section 11(i) is granted, and although calculated subsequently until and including the date the debt is realised, the subsequent exchange differences

<sup>126</sup> See the Act for detail on the requirements which must be met under these sections before a taxpayer is entitled to the relevant deduction or allowance.

<sup>127</sup> If the deduction claimed is an allowance for a doubtful debt under section 11(j), section 11(j) requires that the same amount must be included in income in the succeeding year of assessment.

<sup>128</sup> Case 1056 / 2014, Western Cape Division, 27 June 2014, unreported. See also N van Vuuren "Impairment is not Abandonment" (November 2014) *Werksmans Legal Brief* 042009.

will generally be nil as a result of using a prescribed alternative rate as provided for in the proviso to the definition of “ruling exchange rate” in section 24I(1). See Example 52 below.

See 4.14.2 for tax consequences under section 24I when a debt which was allowed as a deduction under section 11(i) is subsequently recovered.

**Example 52 – Determination of an exchange difference – Section 24I and determination of a deduction for bad debts – Section 11(a)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 April year 1 Company A, a money lender, lent \$100 000 to Foreign Company B. Company A and Company B were not connected persons and did not form part of the same group of companies.

The debt was repayable on 30 June year 2.

Foreign Company B's financial position unexpectedly deteriorated to the extent that the debt was considered bad at 28 February year 2. Company A was entitled to a deduction under section 11(a) in the year of assessment ending on 28 February year 2.

Foreign Company B was finally liquidated on 1 February year 3 and all rights to the debt were extinguished on this date.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 April year 1 (transaction date)     | 11,3000                     |
| 28 February year 2 (translation date) | 11,4000                     |
| 1 February year 3 (realisation date)  | 11,6000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |             |
|---|-------------|
| Exchange difference [ $\$100\ 000 \times (11,3000 - 11,4000)$ ] | R<br>10 000 |
|---|-------------|

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

## 2. Bad debt deduction

The amount of the debt of \$100 000 that was written off on 28 February year 2 is allowed as a deduction under section 11(a) because Company A is a money lender and the loan is floating capital. This amount is translated to rand under section 25D(1) by applying the spot rate on 28 February year 2. The amount that is deductible under section 11(a) is therefore R1 140 000 ( $\$100\,000 \times 11,4000$ ). The amount of R1 140 000 equals the sum of the loan granted on 1 April year 1 of R1 130 000 ( $\$100\,000 \times 11,3000$ ) and the foreign exchange gain of R10 000 that was included in income under section 24I(3)(a).

### *Year of assessment ending on 28 February year 3*

When the debt is extinguished and the exchange item is realised for purposes of section 24I, an exchange difference of nil should arise. Given the circumstances of the bad debt under consideration, an exchange difference of nil can be achieved by prescribing an alternative ruling exchange rate under the proviso to the definition of "ruling exchange rate" in section 24I(1) which is equal to the ruling exchange rate at the previous translation date, if that alternative rate was used for financial reporting purposes pursuant to IFRS. Arguably if the debt was written off for accounting purposes in the previous financial year, there may not be a debt to translate for accounting purposes and therefore no alternative rate applied pursuant to IFRS. In the circumstances of this example, if this situation prevails, SARS will accept that the above alternative rate was used pursuant to IFRS.

### *Determination of capital gain for CGT purposes*

A capital gain of nil is determined as follows on extinguishment of the debt:

|   |          |
|---|----------|
|   | R        |
| Proceeds  | 0        |
| Less: Base cost [ $(\$100\,000 \times 11,3000)$ – section 11(a) bad debt deduction of R1 130 000] | (0)      |
| Capital gain  | <u>0</u> |

Exchange items which qualify for a doubtful debt allowance under section 11(j) remain exchange items until realised through repayment, settlement or disposal. Exchange differences arising on exchange items qualifying for a doubtful debt allowance under section 11(j) are calculated and taken into account in the normal manner as discussed in this Note. The amount of the allowance under section 11(j) will, in turn, be based on the foreign currency amount of the debt multiplied by the spot rate at the date of the allowance or the average exchange rate for the relevant year of assessment if a natural person or trust elected such rate to apply under section 25D(3).

**Example 53 – Determination of exchange difference – Section 24I, doubtful debt allowance – Section 11(j) and deduction for bad debts – Section 11(i)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 April year 1 Company A sold trading stock for \$100 000 to Foreign Company B.

The debt was payable on 30 June year 1. However, Foreign Company B was unable to pay the debt on the due date. Company A considered the debt to be doubtful and provided for it in its financial accounts for the year ended 28 February year 2. Company A also claimed a doubtful debt allowance under section 11(j) in its return of income.

On 31 January year 3 Foreign Company B was finally liquidated and all rights to the debt were extinguished on this date. Company A also wrote the debt off as bad on this date.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 1 April year 1 (transaction date)     | 11,3000                     |
| 28 February year 2 (translation date) | 11,4000                     |
| 31 January year 3 (realisation date)  | 11,6000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Gross income inclusion (sale of trading stock)*

The amount that must be included in gross income is determined under section 25D by multiplying the foreign currency amount of \$100 000 by the spot rate on transaction date of 11,3000.

|   |           |
|---|-----------|
| Inclusion in gross income ( $\$100\,000 \times 11,3000$ ) | 1 130 000 |
|---|-----------|

### 3. Doubtful debt allowance

Company A claimed a deduction under section 11(j), which is calculated as follows:

|  |           |
|--|-----------|
|  | R         |
| Doubtful debt allowance ( $\$100\,000 \times 11,4000 \times 25\%$ <sup>129</sup> ) | (285 000) |

*Year of assessment ending on 28 February year 3*

#### 1. Determination of exchange difference on realisation date

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,4000 - 11,6000)$ ] | 20 000 |

An exchange difference of R20 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24l(3)(a).

#### 2. Reversal of the prior year doubtful debt allowance

|                                    |         |
|------------------------------------|---------|
|                                    | R       |
| Included in income – section 11(j) | 285 000 |

#### 3. Bad debt deduction

The debt of \$100 000 that was written off on 31 January year 3 is allowed as a deduction under section 11(i). This amount is translated to rand under section 25D(1) by applying the spot rate on 31 January year 3. The amount deductible under section 11(i) is therefore R1 160 000 ( $\$100\,000 \times 11,6000$ ).

The amount of R1 160 000 equals the sum of the amount included in gross income of R1 130 000 and the foreign exchange gains of R30 000 (R10 000 + R20 000) that were included in income under section 24l(3)(a).

#### 4. Determination of capital gain for CGT purposes

A capital gain of nil is determined as follows on extinguishment of the debt:

|  |          |
|--|----------|
|  | R        |
| Proceeds   | 0        |
| Less: Base cost [ $(\$100\,000 \times 11,3000) - \text{section } 11(i) \text{ R1 } 130\,000$ ] | (0)      |
| Capital gain   | <u>0</u> |

Section 11(i) provides for a deduction of any debt owing to the taxpayer that has gone bad during the year provided that this amount is or was included in the taxpayer's income. Similarly, section 11(j) provides for an allowance for so much of any debt due to the taxpayer which is considered to be doubtful, provided that the debt would have been allowed as a deduction under the Act if it had been bad. As noted above, the amount of the deduction or allowance is based on the foreign currency amount of the debt multiplied by the spot rate on the date of write-off or the average exchange rate for the relevant year of assessment if a natural person or trust elected such rate to apply.

<sup>129</sup> It is SARS's practice to allow a deduction of 25% of the value of the list of doubtful debts, unless the circumstances of a specific case justify the application of a different formula.

Not all debt will qualify for a deduction or allowance under the Act when a debt goes bad or recoverability of the debt is doubtful. For example, if the foreign currency-denominated loan advanced by a taxpayer, not being a money-lender, to another person became irrecoverable, that taxpayer would not qualify for a deduction under section 11(*i*), since the amount had not previously been included in income. The debt would also not qualify for a deduction under section 11(*a*), since the loan is of a fixed capital nature, not of a floating capital nature. In this situation, the exchange differences, being foreign exchange gains or the excess of foreign exchange gains over foreign exchange losses, which may have arisen on that loan and been included in income under section 24I, will not qualify for a deduction under section 11(*i*). Although the foreign exchange gain was previously included in income, it is not a debt due to the taxpayer. In addition, no deduction is available under section 11(*a*) because the exchange differences arise on a loan which is of a fixed capital nature and they bear that same nature.

This tax treatment of exchange differences changed with effect from years of assessment ending after 1 January 2017 with the insertion of section 24I(4) in the Act.<sup>130</sup>

Section 24I(4) stipulates that in determining the taxable income of any person contemplated in section 24I(2) (see 4.2) in respect of a debt owing to that person that constitutes an exchange item,<sup>131</sup> to the extent that it has become bad –

- the amount of any foreign exchange gain, relating to that debt, that is or was included in the income of that person in the current or any previous year of assessment must be deducted from the income of that person [section 24I(4)(a)]; and
- the amount of any foreign exchange loss, relating to that debt, that is or was deducted from the income of that person in the current or any previous year of assessment must be included in the income of that person [section 24I(4)(b)].

Section 24I(4) is subject to section 11, which means that a foreign exchange gain previously included in income under section 24I(3)(a), which qualifies for a deduction under section 11(*a*) or (*i*) when the debt becomes bad, is not deductible under section 24I(4)(a). Stated differently, if the requirements of section 11(*a*) or (*i*) and 24I(4)(a) are met in relation to a foreign exchange gain previously included in income on a debt that is bad, section 11(*a*) or (*i*) takes precedence.

**Example 54 – Determination of exchange difference – Section 24I and deduction for bad debts and exchange differences – Section 11(*i*)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 30 November year 1 Company A sold goods for \$100 000 to Foreign Company B. Company A and Company B were not connected persons and did not form part of the same group of companies. The debt was payable on 31 January year 2.

<sup>130</sup> Section 24I(4) was inserted by section 44(1) of the Taxation Laws Amendment Act 15 of 2016.

<sup>131</sup> Paragraph (b) of the definition of "exchange item" in section 24I(1).

Foreign Company B was placed in liquidation and initial indications were that the debt would not be repaid. Company A wrote off the debt of \$100 000 as bad for accounting and tax purposes on 28 February year 3 because of concerns over its recoverability. Company A did not waive its rights to recover the debt.

Market rates are as follows:

|                                       | <b>\$ / R</b>    |
|---------------------------------------|------------------|
| <b>Date</b>                           | <b>Spot rate</b> |
| 30 November year 1 (transaction date) | 11,3000          |
| 28 February year 2 (translation date) | 11,4000          |
| 28 February year 3 (translation date) | 11,5000          |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Inclusion of turnover in gross income*

The amount of \$100 000 accruing on the sale of the goods must be included in Company A's gross income. It is translated to rand under section 25D(1) by applying the spot rate on 30 November year 1. R1 130 000 ( $\$100\,000 \times 11,3000$ ) must therefore be included in gross income.

*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on the previous translation date (28 February year 2) and the current translation date (28 February year 3) as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,4000 - 11,5000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Deduction of bad debts and exchange differences*

The debt of \$100 000 that was written off for accounting and tax purposes on 28 February year 3 is allowed as a deduction under section 11(j). This amount is translated to rand under section 25D(1) by applying the spot rate on 28 February year 3. The amount deductible under section 11(j) amounts to R1 150 000 ( $\$100\,000 \times 11,5000$ ).

The amount of R1 150 000 is equal to the sum of the amount included in gross income of R1 130 000 and the amount of the foreign exchange gains of R20 000 (R10 000 + R10 000) included in income under section 24I(3)(a).

Section 24I(4) does not apply because section 11(i) takes precedence and the foreign exchange gains of R20 000 previously included in income are allowed as a deduction under the latter section.

### 3. CGT implications

The debt was not waived and therefore there is no disposal for CGT purposes.

### **Example 55 – Determination of exchange difference – Section 24I and deduction of foreign exchange gain previously included in income and inclusion of foreign exchange loss previously claimed as a deduction when debt of a capital nature is written off – Section 24I(4)**

#### *Facts:*

Company A's year of assessment ends on the last day of February. On 30 November year 1, Company A advanced a loan of \$100 000 to Foreign Company B on capital account. Company A and Company B were not connected persons and did not form part of the same group of companies. The loan was payable on 30 November year 2.

Foreign Company B was placed in liquidation and initial indications were that the loan would not be repaid. Company A wrote off the loan of \$100 000 as bad for accounting purposes on 28 February year 3 because of concerns over its recoverability. Company A did not waive its rights to recover the loan.

Market rates are as follows:

| <b>Date</b>                           | <b>\$ / R<br/>Spot rate</b> |
|---------------------------------------|-----------------------------|
| 30 November year 1 (transaction date) | 11,3000                     |
| 28 February year 2 (translation date) | 11,4000                     |
| 28 February year 3 (translation date) | 11,2000                     |

#### *Result:*

*Year of assessment ending on 28 February year 2*

#### *1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   | <b>R</b> |
|---|----------|
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000   |

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

#### *2. Inclusion of turnover in gross income*

No amount is included in Company A's gross income, since the loan is of a capital nature.



*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on the previous translation date (28 February year 2) and the current translation date (28 February year 3) as follows:

|   |          |
|---|----------|
|   | R        |
| Exchange difference [ $\$100\,000 \times (11,4000 - 11,2000)$ ] | (20 000) |

An exchange difference of (R20 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*2. Deduction of and inclusion in income of exchange differences – bad debt written off*

The debt of \$100 000 that was written off on 28 February year 3 is not allowed as a deduction under section 11(i), since this amount was not included in Company A's gross income. A deduction is also not available under section 11(a), since the loan is of a capital nature. The foreign exchange gain of R10 000, included in income in the year of assessment ending on 28 February year 2 under section 24I(3)(a), is therefore not allowed as a deduction under section 11(i) or section 11(a). This amount is, however, allowed as a deduction under section 24I(4)(a).

The foreign exchange loss of (R20 000), allowed as a deduction in the year of assessment ending on 28 February year 3 under section 24I(3)(a), is included in income under section 24I(4)(b).

The net inclusion in income over the two years of assessment is nil (R10 000 foreign exchange gain – R20 000 foreign exchange loss – R10 000 section 24I(4)(a) deduction + R20 000 section 24I(4)(b) inclusion in income).

*3. CGT implications*

The debt was not waived and therefore there is no disposal for CGT purposes.

**Example 56 – Determination of exchange difference – Section 24I and deduction of foreign exchange gain previously included in income and inclusion of foreign exchange loss previously claimed as a deduction when debt of a capital nature is partly written off – Section 24I(4)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 30 November year 1, Company A advanced a loan of \$100 000 to Foreign Company B on capital account. Company A and Company B were not connected persons and did not form part of the same group of companies. The loan was payable on 28 February year 2 and Company B repaid \$40 000 on that date.

Foreign Company B was placed in liquidation and initial indications were that there would be no further repayments on the loan. Company A wrote off the balance of \$60 000 as bad for accounting purposes on 28 February year 3. Company A did not waive its rights to recover the loan.

Market rates are as follows:

| <b>Date</b>  | <b>\$ / R<br/>Spot rate</b> |
|--|-----------------------------|
| 30 November year 1 (transaction date)                      | 11,3000                     |
| 28 February year 2 (translation date and realisation date) | 11,4000                     |
| 28 February year 3 (translation date)                      | 11,2000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*Debt of \$40 000 repaid on 28 February year 2*

*Determination of exchange difference on realisation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt of \$40 000) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$40\,000 \times (11,3000 - 11,4000)$ ] | 4 000 |

An exchange difference of R4 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*Debt outstanding of \$60 000*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt of \$60 000) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$60\,000 \times (11,3000 - 11,4000)$ ] | 6 000 |

An exchange difference of R6 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Inclusion of turnover in gross income*

No amount is included in Company A's gross income, since the loan was of a capital nature.

*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on translation date*

The exchange difference is determined by multiplying the amount of the exchange item (debt of \$60 000) by the difference between the ruling exchange rates on the previous translation date (28 February year 2) and the current translation date (28 February year 3) as follows:

|  |          |
|--|----------|
|  | R        |
| Exchange difference [ $\$60\,000 \times (11,4000 - 11,2000)$ ] | (12 000) |

An exchange difference of (R12 000) is determined on translation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

## *2. Deduction of and inclusion in income of exchange differences – bad debt written off*

The debt of \$60 000 that was written off as bad for accounting purposes on 28 February year 3 is not allowed as a deduction under section 11(i), since this amount was not included in Company A's gross income. A deduction is also not available under section 11(a), since the loan is of a capital nature. If Company A's rights to the debt are extinguished in the future, depending on the facts a capital loss may be determined under the Eighth Schedule.

Section 24I(4) is applicable only to the extent that the debt has become bad. Therefore under section 24I(4)(a) and (b) the deduction from income of current and previous foreign exchange gains included in income and the inclusion in income of current and previous foreign exchange losses deducted from income are calculated with reference to the balance of the debt of \$60 000 which went bad. Exchange differences which arose under section 24I on the portion of the debt which has been realised are not relevant under section 24I(4).

The foreign exchange gain of R6 000, included in income in the year of assessment ending on 28 February year 2 under section 24I(3)(a), is not allowed as a deduction under section 11(i) or section 11(a). This amount is, however, allowed as a deduction under section 24I(4)(a).

The foreign exchange loss of (R12 000), allowed as a deduction in the year of assessment ending on 28 February year 3 under section 24I(3)(a), is included in income under section 24I(4)(b).

The net inclusion in income over the two years of assessment is R4 000 (R4 000 foreign exchange gain + R6 000 foreign exchange gain – R12 000 foreign exchange loss – R6 000 section 24I(4)(a) deduction for the foreign exchange gain previously recognised on the portion of the debt which went bad + R12 000 section 24I(4)(b) inclusion in income for the foreign exchange loss previously recognised on the portion of the debt that went bad) which is the foreign exchange gain realised on the portion of the debt that was recovered.

## *3. CGT implications*

The debt was not waived and therefore there is no disposal for CGT purposes.

See **4.12.2** for a discussion of the CGT consequences for assets disposed of or acquired in a foreign currency. These assets include exchange items denominated in a foreign currency which fall under section 24I and therefore include foreign currency-denominated debts.

### **4.14.2 Recoupment of bad debts previously written off [section 8(4)(a)]**

When a taxpayer recovers or recoups any amount in relation to an exchange item in respect of which a loss or bad debt was claimed and deducted under section 11(a), section 11(i) or section 24I(4)(a), the total amount recovered or recouped is included in income in the year of assessment in which it is recouped under section 8(4)(a). Section 8(4)(a) provides for a recoupment of amounts previously allowed as deductions under, amongst others, section 11(a), section 11(i) and section 24I.

The recoupment can be divided into two parts, namely:

- The portion of the amount which was written off under section 11(a), section 11(i) or section 24I(4)(a) and which is now recouped under section 8(4)(a).
- The exchange difference in respect of that portion of the exchange item which was written off but is now recouped. The debt remains an exchange item until the debt is settled or disposed of.

A recoupment of a debt previously written off constitutes a settlement, meaning that the debt is realised for purposes of section 24I(1).<sup>132</sup> Assume, for example, that a debt written off in year 2 is fully recovered in year 4. Before the recoupment in year 4, an exchange difference would not be taken into account subsequent to the end of the year of assessment in which the debt was written off if, taking into account the bad debt circumstances, the Commissioner prescribed an alternative rate to be used subsequent to the write-off.<sup>133</sup> A cumulative exchange difference from the end of the year of assessment in which the debt was written off, up to and including realisation date, will be brought into account when the debt is recouped. The exchange difference brought to account is relative to the portion of the debt that is recouped. See 4.14.1 and the examples below.

**Example 57 – Determination of exchange difference – Section 24I, deduction for bad debts – Section 11(i) and recoupment of bad debts – Section 8(4)(a)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 April year 1 Company A sold goods for \$100 000 to Foreign Company B. Company A and Company B were not connected persons and did not form part of the same group of companies. The debt was payable on 30 June year 1.

Foreign Company B was placed in liquidation and initial indications were that there would not be any repayment on the debt. Company A did not waive its rights to recover the debt, however, because of the issues with recoverability, Company A wrote the debt of \$100 000 off as bad for accounting and tax purposes on 28 February year 2.

Company B's liquidators located and realised previously unrecognised assets and as a result on 1 May year 3 Company A received a liquidation distribution of \$100 000.

Market rates are as follows:

|   | <b>\$ / R</b>    |
|---|------------------|
| <b>Date</b>                                     | <b>Spot rate</b> |
| 1 April year 1 (transaction date)               | 11,3000          |
| 28 February year 2 (translation date)           | 11,4000          |
| 28 February year 3 (translation date)           | 11,5000          |
| 1 May year 3 (date of liquidation distribution) | 11,6000          |

<sup>132</sup> Paragraph (a) of the definition of "realised" in section 24I(1).

<sup>133</sup> Proviso to the definition of "ruling exchange rate" in section 24I(1) (see 4.14.1 and Example 57).

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date*

The debt payable to Company A was written off as bad on 28 February year 2. However, Company A has not waived its rights and therefore the exchange item has not been disposed of and still exists. The write-off in this case does not mean that the debt has been “realised” for purposes of section 24I(1).

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Inclusion of turnover in gross income*

The \$100 000 that accrued on the sale of the goods must be included in Company A’s gross income. It is translated to rand under section 25D(1) by applying the spot rate on 1 April year 1. R1 130 000 ( $\$100\,000 \times 11,3000$ ) must therefore be included in gross income.

*3. Deduction of bad debts*

The debt of \$100 000 that was written off on 28 February year 2 is allowed as a deduction under section 11(i). This amount is translated to rand under section 25D(1) by applying the spot rate on 28 February year 2. The amount deductible under section 11(i) amounts to R1 140 000 ( $\$100\,000 \times 11,4000$ ).

The amount of R1 140 000 is equal to the sum of the amount included in gross income of R1 130 000 and the amount of the foreign exchange gain of R10 000 included in income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*Determination of exchange difference on translation date*

Although the debt payable to Company A was written off as bad on 28 February year 2 for accounting and tax purposes, Company A did not waive its rights and therefore the exchange item has not been settled or disposed of. The exchange item still exists and an exchange difference must be calculated on translation date.

The ruling exchange rate on translation date (11,5000) is normally the spot rate on that date. However, given the circumstances of the bad debt, the Commissioner may prescribe that an alternative rate equal to spot rate at the previous translation date (11,4000) must be used as the ruling exchange rate under the proviso to the definition of “ruling exchange rate” in section 24I(1) provided this alternative rate is used for financial reporting purposes under IFRS.

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on the previous translation date (28 February year 2) and the current translation date (28 February year 3) as follows:

|   |   |
|---|---|
|   | R |
| Exchange difference [ $\$100\,000 \times (11,4000 - 11,4000)$ ] | 0 |

An exchange difference of nil is determined on translation date.

*Year of assessment ending on 29 February year 4*

*1. Determination of exchange difference on realisation date*

To the extent a debt, which was previously written off as bad under section 11(i), is recovered it constitutes a realisation because the debt has been "settled".

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date (28 February year 3) and realisation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,4000 - 11,6000)$ ] | 20 000 |

An exchange difference of R20 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Recoupment of bad debt*

Company A received a liquidation distribution of R 1 160 000 ( $\$100\,000 \times 11,6000$ ). It follows that the deduction of R1 140 000 previously claimed under section 11(i) has been fully recouped and must be included in gross income under section 8(4)(a).

**Note:**

In total an amount of R1 160 000 is included in taxable income (gross income of R1 130 000 + exchange differences of R30 000 (R10 000 + 20 000) – bad debt deduction of R1 140 000 + recoupment of R1 140 000). The amount of R1 160 000 equals the rand amount received ( $\$100\,000 \times 11,6000$  spot rate at realisation date).

**Example 58 – Determination of exchange difference – Section 24I, deduction for bad debts – Section 11(i) and recoupment of bad debts – Section 8(4)(a)**

*Facts:*

Company A's year of assessment ends on the last day of February. On 1 April year 1 Company A sold goods for \$100 000 to Foreign Company B. Company A and Company B were not connected persons and did not form part of the same group of companies. The debt was payable on 30 June year 1.

Foreign Company B went into liquidation. Company A wrote off the debt of \$100 000 as bad on 28 February year 2 for accounting and tax purposes because of concerns over its irrecoverability. Company A did not waive its rights to recover the debt. On 1 May year 2 Company A received a liquidation distribution of 50 cents in the dollar from the liquidators of Company B. The liquidation process was then concluded and Company A was liquidated.

Market rates are as follows:

| <b>Date</b>                                     | <b>\$ / R<br/>Spot rate</b> |
|---|-----------------------------|
| 1 April year 1 (transaction date)               | 11,3000                     |
| 28 February year 2 (translation date)           | 11,4000                     |
| 1 May year 2 (date of liquidation distribution) | 11,5000                     |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on translation date*

The debt payable to Company A was written off as bad on 28 February year 2 for accounting and tax purposes. However, Company A has not waived its rights and therefore the exchange item has not been settled or disposed of. The exchange item still exists and in this case the write-off does not mean it has been "realised" under section 24I(1).

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and translation date as follows:

|   |        |
|---|--------|
|   | R      |
| Exchange difference [ $\$100\,000 \times (11,3000 - 11,4000)$ ] | 10 000 |

An exchange difference of R10 000 is determined on translation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Inclusion of turnover in gross income*

The amount of \$100 000 accruing on disposal of the goods must be included in Company A's gross income. The amount is translated to rand under section 25D(1) by applying the spot rate on 1 April year 1 and therefore R1 130 000 ( $\$100\,000 \times 11,3000$ ) must be included in gross income.

*3. Deduction of bad debts*

The debt of \$100 000 that was written off on 28 February year 2 is allowed as a deduction under section 11(i). This amount is translated to rand under section 25D(1) by applying the spot rate on 28 February year 2. The amount deductible under section 11(i) therefore amounts to R1 140 000 ( $\$100\,000 \times 11,4000$ ). The amount of R1 140 000 equals the sum of the amount included in gross income of R1 130 000 and the amount of the foreign exchange gain of R10 000 included in income under section 24I(3)(a).

*Year of assessment ending on 28 February year 3*

*1. Determination of exchange difference on realisation date – portion recouped*

To the extent a debt, which was previously written off as bad under section 11(i), is recovered it constitutes a realisation because the debt has been “settled”.

The exchange difference is determined by multiplying the amount of the exchange item (debt) which has been settled by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |       |
|--|-------|
|  | R     |
| Exchange difference [ $\$50\,000 \times (11,4000 - 11,5000)$ ] | 5 000 |

An exchange difference of R5 000 is determined on realisation date which represents a foreign exchange gain that must be included in income under section 24I(3)(a).

*2. Determination of exchange difference on realisation date – portion not recouped*

To the extent a debt, which was previously written off as bad under section 11(i), is not recovered but the rights underlying it are finally extinguished it constitutes a realisation because the debt has been “disposed of”.

The ruling exchange rate on realisation date is normally the spot rate on that date (11,5000). However, the Commissioner may, taking into account the circumstances of the bad debt, prescribe that an alternative rate equal to spot rate at the previous translation date (11,4000) must be used as the ruling exchange rate under the proviso to the definition of “ruling exchange rate” in section 24I provided this alternative rate is used for financial reporting purposes under IFRS.

The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on translation date and realisation date as follows:

|  |   |
|--|---|
|  | R |
| Exchange difference [ $\$50\,000 \times (11,4000 - 11,4000)$ ] | 0 |

An exchange difference of nil is determined on realisation date on the portion of the debt which was not recouped.

*3. Recoupment of bad debt*

Company A received a liquidation distribution of \$575 000 ( $\$50\,000 (\$100\,000 \times 50\%) \times 11,5000$ ). It follows that the deduction of R570 000 ( $R1\,140\,000 \times 50\%$ ) previously claimed under section 11(i) has been recouped and must be included in gross income under section 8(4)(a).

**Note:**

In total an amount of R575 000 is included in taxable income [gross income year 1 of R1 130 000 + exchange difference of R15 000 (R10 000 + 5 000) – bad debt deduction of R1 140 000 + recoupment of R570 000]. This amount equals the distribution payment of R575 000 at the spot rate on the date of receipt ( $\$50\,000 \times 11,5000$ ).



#### 4.15 Reduction of debt (section 19 and paragraph 12A)

Section 19 and paragraph 12A deal with income tax and CGT consequences of the reduction of debt.<sup>134</sup> Section 19(1) and paragraph 12A(1) do not indicate how the reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be determined. This determination should therefore be made under section 25D.

The reduction amount or debt benefit, as appropriate,<sup>135</sup> applicable to a debt denominated in a currency other than the currency of the Republic may include amounts of foreign exchange gains or losses that were included in or deducted from income under section 24I(3)(a). Foreign exchange losses cannot be recouped under section 19(5), since these losses are not “expenditure” as contemplated in section 19(2). However, foreign exchange losses claimed as a deduction under section 24I(3)(a) before or as a result of the reduction of a debt are recouped under section 8(4)(a).

Foreign exchange gains included in the income of a debtor before or as a result of the reduction of a debt remain taxable. Section 24I(4)(a) will not apply (see **4.14.1**) because a reduction of debt in section 19 and paragraph 12A deals with a debt owed by a person and not to a debt owed to a person.

#### **Example 59 – Debt reduction of an amount denominated in a currency other than the currency of the Republic – Debt funding acquisition of an allowance asset**

##### *Facts:*

Company A and Company B do not form part of the same group of companies. Company A's year of assessment ends on the last day of February.

On 1 April 2017 Company A purchased a second-hand machine for \$100 000 from Company B on credit. Company A claimed a capital allowance of R200 000 (20% × R1 million) under section 12C(1) for the year of assessment ending on 28 February 2018.

The debt was payable on 31 May 2017 but remained unpaid and was eventually waived by Company B on 31 January 2018 because of Company A's inability to pay.

The machine was held and not disposed of by Company A on 31 January 2018.

Market rates are as follows:

| <b>Date</b>                        | <b>\$ / R<br/>Spot rate</b> |
|------------------------------------|-----------------------------|
| 1 April 2017 (transaction date)    | 10,0000                     |
| 31 January 2018 (realisation date) | 12,0000                     |

<sup>134</sup> See Interpretation Note 91 “Reduction of Debt” for more detail.

<sup>135</sup> Section 19 and paragraph 12A were amended by the Taxation Laws Amendment Act 17 of 2017. The amendments, which are effective for years of assessment commencing on or after 1 January 2018, include substantive changes and changes in the terminology used.

*Result:*

*Year of assessment ending on 28 February 2018*

*1. Capital allowance claimed*

Under section 25D(1) the expenditure incurred by Company A on acquisition of the machine is translated to rand by applying the spot rate on date of acquisition. The cost price of the machine on date of acquisition therefore amounts to R1 million ( $\$100\,000 \times 10,0000$ ).

Company A claimed a capital allowance of R200 000 (R1 million  $\times$  20%) under section 12C(1).

*2. Determination of exchange difference on realisation date*

The debt was realised by Company A on 31 January 2018, since it was waived by Company B on that date. The exchange difference is determined by multiplying the amount of the exchange item (debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|   |           |
|---|-----------|
|   | R         |
| Exchange difference [ $\$100\,000 \times (10,0000 - 12,0000)$ ] | (200 000) |

An exchange difference of (R200 000) was determined on realisation date which represents a foreign exchange loss that must be deducted from Company A's income under section 24I(3)(a).

*3. Reduction of the debt [Application of paragraph 12A(3) and sections 8(4)(a) and 19(6)]*

The reduction of the debt by Company B on 31 January 2018 results in the application of paragraph 12A(3) and sections 8(4)(a) and 19(6).

The reduction amount of a debt that is denominated in a currency other than the currency of the Republic must be translated by Company A to the currency of the Republic (the rand) on the date on which the debt is reduced by applying the spot rate under section 25D(1). On 31 January 2018 the debt amounted to R1,2 million ( $\$100\,000 \times 12,0000$ ). The amount of the debt of R1,2 million is reconciled as follows:

|  |                  |
|--|------------------|
|  | R                |
| Rand amount of debt incurred on 1 April 2017 that funded the acquisition of an allowance asset | 1 000 000        |
| Increase in rand value of debt because of exchange movement                                    | <u>200 000</u>   |
| Rand amount of debt on 31 January 2018   | <u>1 200 000</u> |

Reduction amount = Amount by which the debt is reduced /less amount applied as consideration for that reduction = R1,2 million /less nil = R1,2 million.

*Application of paragraph 12A(3)*

Since R1 000 000 of the debt of R1 200 000 funded the expenditure incurred on acquisition of the machine (R1 000 000), the amount of the expenditure incurred on acquisition of the machine must for purposes of paragraph 20 (base cost) be reduced by the reduction amount relating to that expenditure, namely, R1 000 000. However, since the base cost of the machine has already been reduced under paragraph 20(3)(a)(i) by the capital allowance claimed of R200 000, it is only the remaining base cost of R800 000 that must be reduced under paragraph 12A(3). The base cost of the machine is therefore reduced to nil (R800 000 base cost – R800 000 reduction amount).

*Application of section 19(6)*

Under section 19(6) the balance of the reduction amount that was used to fund the expenditure on acquisition of the machine of R200 000 (R1 million – R800 000) to which paragraph 12A did not apply is deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped, since this amount was claimed as a capital allowance under section 12C(1).

*Application of section 8(4)(a)*

Under section 8(4)(a) the excess reduction amount of R200 000 [reduction amount of R1,2 million less R800 000 applied under paragraph 12A(3), less R200 000 applied under section 19(6)] is recouped under section 8(4)(a). In this regard the waiver of the debt triggers a recoupment under section 8(4)(a), since the foreign exchange loss of R200 000 was allowed as a deduction under section 24I(3)(a).

**4.16 Assessed losses [section 20(2)]**

Foreign exchange losses, premiums or like consideration paid under an FCOC or any consideration paid to acquire an FCOC, which are taken into account under section 24I(3) in determining a person's taxable income, may give rise to or increase a person's assessed loss.

The term "assessed loss" as defined in section 20(2) means any amount by which the deductions under section 11 exceed the income in respect of which they are admissible. Under section 24I(3), read with section 11(x), the above exchange losses, premiums or like consideration and other consideration are deducted from income. These amounts must therefore be taken into account in calculating a person's assessed loss for a particular trade.<sup>136</sup>

**4.17 Source of foreign exchange gains and losses [section 9(2)(f) and 9(4)(e)]**

Section 9(2)(f) determines that an amount is received by or accrues to a person from a source within the Republic if that amount is attributable to any exchange difference determined under section 24I on any exchange item to which that person is a party if –

- that person is a resident and –
  - the exchange item is not attributable to a permanent establishment of that person which is situated outside the Republic; and

<sup>136</sup> See section 20 for further detail, including the possible ring-fencing of certain assessed losses.

- that amount is not subject to any taxes on income payable to any sphere of government of any country other than the Republic; or
- that person is not a resident and that exchange item is attributable to a permanent establishment of that person which is situated in the Republic.

Under section 9(4)(e) an amount is received by or accrues to a person from a source outside the Republic if that amount is attributable to any exchange difference determined under section 24I on any exchange item to which that person is a party and is not from a source within the Republic under section 9(2)(f).

The source of an exchange difference may be relevant for purposes of tax treaties to determine which contracting state has the right to tax an amount of an exchange difference. Tax treaties to which South Africa is a party do not necessarily deal specifically with the taxing rights applicable to exchange differences. In most cases it is necessary to apply another article dealing with business profits or other income.

#### **4.18 Translation of foreign taxes to rand and the determination of an exchange difference on a foreign tax debt**

##### **4.18.1 Translation of foreign taxes to rand for purposes of section 6quat [section 6quat(4)]**

A person's liability for normal tax is determined in rand. For purposes of this determination any amount of foreign tax, which qualifies either for a foreign tax rebate<sup>137</sup> or a deduction in determining taxable income,<sup>138</sup> must be translated to rand.

Any foreign taxes proved to be payable as contemplated in section 6quat(1A) or any amount paid or proved to be payable as contemplated in section 6quat(1C) on any amount included in the taxable income of a resident during any year of assessment must be translated to rand on the last day of that year of assessment by applying the average exchange rate for that year of assessment under section 6quat(4).<sup>139</sup>

##### **4.18.2 Determination of an exchange difference on a foreign tax debt**

An amount of foreign tax payable by a person contemplated in section 24I(2) to a foreign tax authority is an amount in a foreign currency owing by that person on a debt incurred by that person and it therefore constitutes an "exchange item" under paragraph (b) of the definition of "exchange item" in section 24I(1).

When there is a difference in the exchange rates between the date on which a foreign tax debt is incurred (transaction date) and the date that it is paid (realised), an exchange difference must generally be calculated by multiplying the amount of the exchange item (the foreign tax debt) by the difference between the spot rates on transaction date and translation date or realisation date, as appropriate. The amount of the exchange difference so calculated must be included in or deducted from a person's income under section 24I(3)(a).

The difference between the spot rate on transaction date and the average exchange rate for the year of assessment that was applied to translate the amount of the foreign tax to rand under section 6quat(4) for purposes of determining the applicable

<sup>137</sup> Under section 6quat(1).

<sup>138</sup> Under section 6quat(1C).

<sup>139</sup> See Interpretation Note 18 "Rebates and Deduction for Foreign Taxes on Income" for more detail on the rebate and deduction.

rebate or deduction (see 4.18.1) is a permanent difference. The permanent difference is not an “exchange difference” as defined in section 24I(1) and must not be included in or deducted from income under section 24I(3)(a).<sup>140</sup>

**Example 60 – Translation of foreign taxes to rand for purposes of section 6quat and determination of an exchange difference on a foreign tax debt**

*Facts:*

Company A’s year of assessment ends on the last day of February. Company A incurred a foreign tax debt of \$10 000 on 1 November year 1 which was paid on 31 December year 1. The average exchange rate for the year of assessment ending on 28 February year 2 was 11,5000.

Market rates are as follows:

|                                       | <b>\$ / R</b>    |
|---------------------------------------|------------------|
| <b>Date</b>                           | <b>Spot rate</b> |
| 1 November year 1 (transaction date)  | 11,3000          |
| 31 December year 1 (realisation date) | 11,4000          |
| 28 February year 2                    | 11,4500          |

*Result:*

*Year of assessment ending on 28 February year 2*

*1. Determination of exchange difference on realisation date*

The foreign tax debt of \$10 000 constitutes an amount in a foreign currency owing by Company A on a debt incurred by it and is therefore an “exchange item” under paragraph (b) of the definition of “exchange item” in section 24I(1).

The exchange difference is determined by multiplying the amount of the exchange item (foreign tax debt) by the difference between the ruling exchange rates on transaction date and realisation date as follows:

|  |              |
|--|--------------|
| Exchange difference [ $\$10\,000 \times (11,3000 - 11,4000)$ ] | R<br>(1 000) |
|--|--------------|

An exchange difference of (R1 000) is determined on realisation date which represents a foreign exchange loss that must be deducted from income under section 24I(3)(a).

*2. Translation of foreign taxes to rand for purposes of section 6quat*

The foreign taxes of \$10 000 must be translated to rand on 28 February year 2 by applying the average exchange rate for that year of assessment under section 6quat(4). R115 000 ( $\$10\,000 \times 11,5000$ ) will therefore qualify for a foreign tax rebate under section 6quat(1) or a deduction in determining taxable income under section 6quat(1C) if all the requirements of those sections are met.

<sup>140</sup> See Interpretation Note 18 “Rebates and Deduction for Foreign Taxes on Income” for more detail on the rebate and deduction.

#### 4.19 Objections and appeals [section 3(4)(b)]

Section 3(4)(b) provides that the decisions of the Commissioner under section 24I(1) and section 24I(7)<sup>141</sup> are subject to objection and appeal in accordance with Chapter 9 of the Tax Administration Act 28 of 2011.

An example of a decision which is subject to objection and appeal is the prescription by the Commissioner, having regard to the particular circumstances of a case, of an alternative rate to any of the prescribed ruling exchange rates under the proviso to the definition of “ruling exchange rate” in section 24I(1) if such alternative rate is used for the purposes of financial reporting pursuant to IFRS (see 4.4.8, 4.5.3(f), 4.5.3(g) and 4.14).

#### 5. Conclusion

Section 24I(3) provides for an inclusion in or deduction from income of an exchange difference on an exchange item as well as any premium or like consideration received by or paid by a person under an FCOC entered into by that person or any consideration paid for an FCOC acquired by a person. The term “exchange item” of or in relation to a person means an amount in a foreign currency –

- which constitutes any unit of currency acquired and not disposed of by that person;
- owing by or to that person on a debt incurred by or payable to such person;
- owed by or to that person in respect of an FEC; or
- when that person has the right or contingent obligation to buy or sell that amount under an FCOC.

Section 24I applies to the following persons indicated in section 24I(2):

- Any company.
- Any trust carrying on any trade.
- Any natural person who holds any amount in a foreign currency which constitutes a unit of currency, or which is owing to that person on a debt payable to that person, as trading stock.
- Any natural person or trust in respect of any amount in foreign currency –
  - owed by or to that person in respect of an FEC; or
  - when that person has the right or contingent obligation to buy or sell that amount under an FCOC.
- Any of the persons referred to above that are non-resident in relation to an exchange item that is attributable to a permanent establishment of that person in the Republic.
- Any CFC for purposes of determining its net income under section 9D(2A) that must be included in the income of persons that are residents under section 9D(2).

<sup>141</sup> Section 1(1) of the Tax Administration Laws Amendment Act 23 of 2015 deletes the reference to section 24I(7) from a date still to be determined by the Minister of Finance in the *Gazette*.

An exchange difference is determined on each exchange item for the year of assessment in which such exchange item arose and every subsequent year of assessment until and including the year of assessment in which such exchange item is realised.

The exchange difference for a specific year of assessment is determined by multiplying the foreign currency amount of the exchange item by the difference between the ruling exchange rate on the commencement date in that year of assessment and the ruling exchange rate on the final date in that year of assessment.

Section 24I(4) provides that, subject to section 11, to the extent that a debt owing to a person has become bad, the amount of any foreign exchange gain relating to that debt that is or was included in the income of a person in the current or any previous year of assessment must be deducted from the income of that person, and the amount of any foreign exchange loss relating to that debt that is or was deducted from the income of that person in the current or any previous year of assessment must be included in the income of that person.<sup>142</sup>

Section 24I(6) prohibits the deduction from or inclusion in income of an amount referred to in section 24I(3) under any other provision of the Act.

Section 24I(7) provides for the carry-forward of the inclusion in, or deduction from, a person's income of certain exchange differences and premiums or other consideration which arose or were paid or became payable in a year of assessment before the year of assessment during which the assets referred to in section 24I(7)(a) were or are brought into use for the purposes of the person's trade. The foreign exchange gain or loss is generally carried forward to the year of assessment in which the assets to which they relate are brought into use for purposes of that person's trade. In certain circumstances the carried forward exchange difference may be recognised in a year of assessment before the year of assessment in which the relevant asset is brought into use. Special rules apply to mining assets.

Section 24I(8) provides that any foreign exchange loss sustained on a transaction entered into by a person, or any premium or other consideration paid in respect of or under an FCOC entered into or acquired by a person, shall not be allowed as a deduction from such person's income under section 24I(3), if the transaction was entered into or the FCOC was entered into or acquired solely or mainly to enjoy a reduction in tax as a result of a deduction from income.

Under section 24I(10A)(a) an exchange difference arising during any year of assessment in respect of an amount in a foreign currency owing by or to a person on a debt shall not be included in or deducted from the income of that person if at the end of that year of assessment that person and the other party to the contractual provisions of the debt form part of the same group of companies or are connected persons in relation to each other and if certain requirements are met.

Section 24I(12) determines that when a person holds any exchange item and section 24I at any time during a year of assessment –

- becomes applicable to that person, that exchange item shall be deemed to have been acquired at that time for the purposes of section 24I; or

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<sup>142</sup> With effect from years of assessment ending after 1 January 2017.

- ceases to apply to that person, that exchange item shall be deemed to have been realised at that time for the purposes of section 24I.

In applying section 24I, regard must be had to other provisions of the Act, amongst others, the definition of “trading stock” in section 1(1), sections 3(4)(b), 6*quat*, 8(4)(a), 9(2)(l), 9(4)(e), 9D, 11(a), 11(i), 11(j), 19, 20(2), 22(3)(a)(i), 24J and 25D, paragraphs 12A and 43 of the Eighth Schedule, and paragraph 4(1) of the Tenth Schedule.

**Legal Counsel**  
**SOUTH AFRICAN REVENUE SERVICE**



## Annexure A – The law

### Section 1(1) – Definition of “controlled foreign company”

“**controlled foreign company**” means a controlled foreign company as defined in section 9D, and includes any reference in this Act, prior to the amendment thereof by the Revenue Laws Amendment Act, 2002, to a controlled foreign entity;

### Section 1(1) – Definition of “permanent establishment”

“**permanent establishment**” means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;

### Section (1) – Definition of “trading stock”

“**trading stock**”—

(a) includes—

- (i) anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer;
- (ii) anything the proceeds from the disposal of which forms or will form part of the taxpayer’s gross income, otherwise than—
  - (aa) in terms of paragraph (j) or (m) of the definition of “gross income”;
  - (bb) in terms of paragraph 14(1) of the First Schedule; or
  - (cc) as a recovery or recoupment contemplated in section 8(4) which is included in gross income in terms of paragraph (n) of the definition of “gross income”; or
- (iii) any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer’s trade; but

(b) does not include—

- (i) a foreign currency option contract; or
  - (ii) a forward exchange contract,
- as defined in section 24I(1);

### Section 3(4)(b)

(4) Any decision of the Commissioner under the following provisions of this Act is subject to objection and appeal in accordance with Chapter 9 of the Tax Administration Act, namely—

- (b) section 10(1)(cA) and (e)(i)(cc), section 11(e), (j) and (l), section 12J(6), (6A) and (7), section 15, section 18A(5), (5A) and (5B), section 22(1), section 23K, section 24(2), section 24A(6), section 24I(1), section 24J(9), section 28(9), section 30, section 30A, section 30B, section 30C, section 37A, section 44(13)(a), section 47(6)(c)(i), section 62(1)(c)(iii) and (d) and (2)(a) and (4), section 80B and section 103(2);

**Section 6quat(4)**

(4) For the purposes of this section the amount of any foreign tax proved to be payable as contemplated in subsection (1A) or any amount paid or proved to be payable as contemplated in subsection (1C) in respect of any amount which is included in the taxable income of any resident during any year of assessment, shall be translated to the currency of the Republic on the last day of that year of assessment by applying the average exchange rate for that year of assessment.

**Section 8(4)(a)**

(4)(a) There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, section 24D, section 24F, section 24G, section 24I, section 24J, section 27(2)(b) and section 37B(2) of this Act, except section 11(k), (n), (p) and (q), section 11F, section 12(2) or section 12(2) as applied by section 12(3), section 12A(3), section 13(5), or section 13(5) as applied by section 13(8), or section 13bis(7), section 15(a) or section 15A, or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment: Provided that the provisions of this paragraph shall not apply in respect of any such amount so recovered or recouped which has been—

- (i) included in the gross income of such taxpayer in terms of paragraph (jA) of the definition of "gross income";
- (ii) applied to reduce any cost or expenditure incurred by such taxpayer in terms of section 19; or
- (iii) previously taken into account as an amount that is deemed to have been recovered or recouped in terms of section 19(4), (5) or (6).

**Section 9(2)(l)**

(2) An amount is received by or accrues to a person from a source within the Republic if that amount—

- (l) is attributable to any exchange difference determined in terms of section 24I in respect of any exchange item as defined in that section to which that person is a party if—
  - (i) that person is a resident and—
    - (aa) that exchange item is not attributable to a permanent establishment of that person which is situated outside the Republic; and
    - (bb) that amount is not subject to any taxes on income payable to any sphere of government of any country other than the Republic; or
  - (ii) that person is not a resident and that exchange item is attributable to a permanent establishment of that person which is situated in the Republic.

**Section 9(4)(e)**

(4) An amount is received by or accrues to a person from a source outside the Republic if that amount—

- (e) is attributable to any exchange difference determined in terms of section 24I in respect of any exchange item as defined in that section to which that person is a party and is not from a source within the Republic in terms of subsection (2)(l).

**Section 9D(1) – Definition of “controlled foreign company”**

“controlled foreign company” means—

(a) any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies: Provided that—

- (i) no regard must be had to any voting rights in any foreign company—
  - (aa) which is a listed company; or
  - (bb) if the voting rights in that foreign company are exercisable indirectly through a listed company;
- (ii) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and
- (iii) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—
  - (aa) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or
  - (bb) in the case of a scheme or arrangement contemplated in paragraph (e)(ii) of the definition of “company” in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—
    - (A) holds less than five per cent of the participation rights of that scheme or arrangement; and
    - (B) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other; and

(b) any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident;

**Paragraphs (c)(ii) and (iii) of the proviso to section 9D(2A)**

(2A) For the purposes of this section the “net income” of a controlled foreign company in respect of a foreign tax year is an amount equal to the taxable income of that company determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer, and as if that company had been a resident for purposes of the definition of “gross income”, sections 7(8), 10(1)(h), 25B, 28 and paragraphs 2(1)(a), 24, 70, 71, 72 and 80 of the Eighth Schedule: Provided that—

- (c) no deduction shall be allowed in respect of any—
  - (ii) exchange difference determined in terms of section 24I in respect of any exchange item to which that company and any other controlled foreign company are parties;

- (iii) exchange difference in respect of any forward exchange contract or foreign currency option contract entered into to hedge the exchange item referred to in subparagraph (ii); or

### **Section 9D(6)**

(6) The net income of a controlled foreign company in respect of a foreign tax year shall be determined in the functional currency of that controlled foreign company and shall, for purposes of determining the amount to be included in the income of any resident during any year of assessment under the provisions of this section, be translated to the currency of the Republic by applying the average exchange rate for that foreign tax year: Provided that any exchange item denominated in any currency other than the functional currency of that controlled foreign company shall be deemed not to be attributable to any permanent establishment of the controlled foreign company if the functional currency is the currency of a country which has an official rate of inflation of 100 per cent or more for that foreign tax year.

### **Section 9D(9)(fA)(ii) and (iii)**

(9) Subject to subsection (9A), in determining the net income of a controlled foreign company in terms of subsection (2A), there must not be taken into account any amount which—

- (fA) is attributable to—
  - (ii) any exchange difference determined in terms of section 24I in respect of any exchange item to which that company and any other controlled foreign company are parties;
  - (iii) any exchange difference in respect of any forward exchange contract or foreign currency option contract entered into to hedge the exchange item referred to in subparagraph (ii); or

### **Section 9D(9A)(a)(iii)**

(9A)(a) Any amount which is attributable to a foreign business establishment of a controlled foreign company as contemplated in subsection (9)(b) must, notwithstanding that subsection, be taken into account in determining the net income of that controlled foreign company if that amount—

- (iii) arises in respect of a financial instrument—
  - (aa) unless that financial instrument is attributable to the principal trading activities of the foreign business establishment and those principal trading activities—
    - (A) constitute the activities of a bank, financial service provider or insurer; and
    - (B) do not constitute the activities of a treasury operation or captive insurer;
  - (bb) unless—
    - (A) that amount is attributable to any exchange difference determined in terms of section 24I in respect of that financial instrument;
    - (B) the exchange difference contemplated in subitem (A) arises in the ordinary course of business of the principal trading activities of that foreign business establishment; and
    - (C) the principal trading activities contemplated in subitem (B) do not constitute the activities of a treasury operation or captive insurer; or

- (cc) to the extent that the total of—
- (A) those amounts arising in respect of financial instruments attributable to activities of that foreign business establishment; and
  - (B) amounts arising from exchange gains determined in terms of section 24I attributable to activities of that foreign business establishment,
- other than amounts in respect of which paragraphs (c) to (fB) of subsection (9) apply or amounts derived from the activities of a treasury operation or a captive insurer, exceeds five per cent of the total of all amounts received by or accrued to the controlled foreign company that are attributable to that foreign business establishment, other than amounts in respect of which paragraphs (c) to (fB) of subsection (9) apply or amounts derived from the activities of a treasury operation or a captive insurer;

### Sections 11(a), (i) and (j)

**11. General deductions allowed in determination of taxable income.**—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

- (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;
  - (i) the amount of any debt due to the taxpayer which has during the year of assessment become bad, provided such amount is included in the current year of assessment or was included in previous years of assessment in the taxpayer's income;
  - (j) an allowance as may be made each year by the Commissioner in respect of so much of any debt due to the taxpayer as the Commissioner considers to be doubtful, if that debt would have been allowed as a deduction under any other provisions of this Part had that debt become bad: Provided that such allowance shall be included in the income of the taxpayer in the following year of assessment;<sup>143</sup>

### Section 19(1) – (6)<sup>144</sup>

**19. Reduction of debt.**—(1) For the purposes of this section—

“**allowance asset**” means a capital asset in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;

“**capital asset**” means an asset as defined in paragraph 1 of the Eighth Schedule that is not trading stock;

“**debt**” does not include a tax debt as defined in section 1 of the Tax Administration Act;

<sup>143</sup> Section 11(j) is to be substituted by section 18(1)(i) of the Taxation Laws Amendment Act 25 of 2015 with effect from a date determined by the Minister of Finance in the Gazette – date as yet not determined.

<sup>144</sup> As it read in respect of years of assessment commencing before 1 January 2018. Section 19(7) and (8) are not quoted in this Annexure, since these provisions are considered irrelevant for purposes of this Note. Section 19 was amended by the Taxation Laws Amendment Act 17 of 2017. The amendment, which is effective for years of assessment commencing on or after 1 January 2018, includes substantive changes and changes in the terminology used.

**“reduction amount”**, in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.

(2) Subject to subsection (8), this section applies where a debt that is owed by a person is reduced by any amount and—

- (a) the amount of that debt was used, directly or indirectly, to fund any expenditure in respect of which a deduction or allowance was granted in terms of this Act; and
- (b) the amount of that reduction exceeds any amount applied by that person as consideration for the reduction.

(3) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt,

the reduction amount in respect of that debt must, to the extent that an amount is taken into account by that person in respect of that trading stock in terms of section 11(a) or 22(1) or (2) for the year of assessment in which the debt is so reduced, be applied to reduce the amount so taken into account in respect of that trading stock.

(4) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2);
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund expenditure incurred in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt; and
- (c) subsection (3) has been applied to reduce an amount taken into account by that person in respect of trading stock as contemplated in that subsection to the full extent of that amount so taken into account,

the reduction amount in respect of that debt must, to the extent that a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt is reduced less any amount of that reduction amount that has been applied to reduce an amount as contemplated in subsection (3).

(5) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund any expenditure other than expenditure incurred—
  - (i) in respect of trading stock that is held and not disposed of by that person at the time of the reduction of the debt; or
  - (ii) in respect of an allowance asset,

the reduction amount in respect of that debt must, to the extent that a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure, be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt is reduced.

(6) Where—

- (a) a debt owed by a person is reduced as contemplated in subsection (2); and
- (b) the amount of that debt was used as contemplated in paragraph (a) of that subsection to fund expenditure incurred in respect of an allowance asset,

the reduction amount in respect of that debt must, to the extent that—

- (i) a deduction or allowance was granted in terms of this Act to that person in respect of that expenditure; and
- (ii) paragraph 12A of the Eighth Schedule has not been applied to reduce the amount of expenditure as contemplated in paragraph 20 of that Schedule in respect of that allowance asset to the full extent of that expenditure,

be deemed, for the purposes of section 8(4)(a), to be an amount that has been recovered or recouped by that person for the year of assessment in which the debt is reduced.

### Section 20(2)

(2) For the purposes of this section “assessed loss” means any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible.

### Section 22(3)(a)(i)

(3)(a) For the purposes of this section the cost price at any date of any trading stock in relation to any person shall—

- (i) subject to subparagraphs (iA) and (ii), be the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus any further costs incurred by such person, in terms of IFRS (in the case of a company), up to and including the said date in getting such trading stock into its then existing condition and location, but excluding any exchange difference as defined in section 24I(1) relating to the acquisition of such trading stock;

### Section 24I

**24I. Gains or losses on foreign exchange transactions.**—(1) For the purposes of this section—

“**acquisition rate**” means the exchange rate in respect of an exchange item obtained by dividing the amount of the expenditure incurred for the acquisition of such exchange item by the foreign currency amount in respect of such exchange item;

“**affected contract**” means any foreign currency option contract or forward exchange contract to the extent that the foreign currency option contract or forward exchange contract has been entered into by any person during any year of assessment to serve as a hedge in respect of a debt, where—

- (a) that debt—
  - (i) is to be utilised by that person for the purposes of acquiring any asset or for financing any expenditure; or
  - (ii) will arise from the sale of any asset or supply of any services, in terms of an agreement entered into by that person in the ordinary course of the person’s trade prior to the end of the current year of assessment; and
- (b) that debt has not yet been incurred by such person or the amount payable in respect of such debt has not yet accrued during that current year of assessment;

“**disposal rate**” means the exchange rate in respect of an exchange item obtained by dividing the amount received or accrued in respect of the disposal of such exchange item by the foreign currency amount in respect of such exchange item;

**“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;
- (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;

**“foreign currency option contract”** means any agreement in terms of which any person acquires or grants the right to buy from or to sell to any other person a certain amount of a nominated foreign currency on or before a future expiry date at a specified exchange rate;

**“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”;

**“intrinsic value”**, in relation to a foreign currency option contract, means the value for the holder or writer thereof, as the case may be, determined by applying the difference between—

- (a) the spot rate on translation date or the date on which the foreign currency option contract is realised, as the case may be; and
- (b) the option strike rate,

to the amount of foreign currency as specified in such foreign currency option contract: Provided that such foreign currency option contract shall have a nil value for the holder or writer thereof if such holder thereof would have sustained a loss had he exercised his right in terms of such foreign currency option contract on such translation date or date realised due to the unfavourable difference between the option strike rate and the spot rate on such translation date or date realised;



**“local currency”** means in relation to—

- (a) any person in respect of an exchange item which is attributable to any permanent establishment outside the Republic, the functional currency of that permanent establishment: Provided that for purposes of this paragraph any exchange item shall be deemed not to be attributable to any such permanent establishment if the functional currency of that permanent establishment is the currency of a country which has an official rate of inflation of 100 per cent or more throughout the relevant year of assessment;
- (b) any resident other than a headquarter company in respect of an exchange item which is not attributable to a permanent establishment outside the Republic, the currency of the Republic;
- (c) any person that is not a resident in respect of any exchange item which is attributable to a permanent establishment in the Republic, the currency of the Republic;
- (d) any headquarter company in respect of an exchange item which is not attributable to a permanent establishment outside the Republic, the functional currency of that headquarter company;
- (e) any domestic treasury management company in respect of an exchange item which is not attributable to a permanent establishment outside the Republic, the functional currency of that domestic treasury management company;
- (f) any international shipping company defined in section 12Q, in respect of an amount which is not attributable to a permanent establishment outside the Republic, the functional currency of that international shipping company;

**“market value”**, in relation to a foreign currency option contract, means—

- (a) in the case of a person who for accounting purposes uses a market-related valuation method in terms of a practice consistently applied by him to determine the value of all his foreign currency option contracts, the market-related value so determined; or
- (b) in the case of any other person, the intrinsic value of such foreign currency option contract;

**“option strike rate”** means the specified exchange rate as referred to in the definition of “foreign currency option 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;
- (b) a forward exchange contract, when payment is received or made in respect of such forward exchange contract;
- (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;
  - (ii) the date it is translated, the spot rate on such date; or
  - (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;

- (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;
  - (iv) . . . . .
- (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 the purposes of financial reporting pursuant to IFRS;

**“spot rate”** . . . . .

**“transaction date”** means, in relation to—

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

- (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;

**“transitional exchange difference” . . . . .**

**“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.

(2) The provisions of this section shall apply in respect of any—

- (a) company;
- (b) trust carrying on any trade;
- (c) natural person who holds any amount contemplated in paragraph (a) or (b) of the definition of “exchange item” as trading stock; and
- (d) natural person or trust in respect of any amount contemplated in paragraph (c) or (d) of the definition of “exchange item”:

Provided that this section does not apply in respect of any exchange item of a person who is not a resident (other than a controlled foreign company), unless that exchange item is attributable to a permanent establishment of that person in the Republic.

(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 subsection (10A); and
- (b)
  - (i) any premium or like consideration received by, or paid by, such person in terms of a foreign currency option contract entered into by such person; or
  - (ii) any consideration paid by such person in respect of a foreign currency option contract acquired by such person.
- (c) . . . . .

(4) Subject to section 11, in determining the taxable income of any person contemplated in subsection (2) in respect of a debt owing to that person as referred to in paragraph (b) of the definition of exchange item, to the extent that it has become bad—

- (a) the amount of any foreign exchange gain, relating to that debt, that is or was included in the income of that person in the current or any previous year of assessment must be deducted from the income of that person; and
- (b) the amount of any foreign exchange loss, relating to that debt, that is or was deducted from the income of that person in the current or any previous year of assessment must be included in the income of that person.

(5) . . . . .

(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.

(7) Notwithstanding the provisions of subsection (3), but subject to the provisions of section 36—

- (a) any exchange difference arising from a debt having been utilised by a person in respect of—
  - (i) the acquisition, installation, erection or construction of any machinery, plant, implement, utensil, building or improvements to any building, as the case may be; or
  - (ii) the devising, developing, creation, production, acquisition or restoration of any invention, patent, design, trade mark, copyright or other similar property or knowledge contemplated in section 11(gA) or (gC), as the case may be;
- (b) any exchange difference arising from a forward exchange contract or a foreign currency option contract which has been entered into by a person contemplated in paragraph (a), to the extent to which such forward exchange contract or foreign currency option contract is entered into to serve as a hedge in respect of a debt incurred or to be incurred for the utilisation thereof as contemplated in paragraph (a); and
- (c) any premium or other consideration paid or payable in respect of or in terms of a foreign currency option contract entered into or acquired by a person contemplated in paragraph (a), to the extent to which such foreign currency option contract is entered into or obtained in order to serve as a hedge in respect of a debt incurred or to be incurred for the utilisation thereof as contemplated in paragraph (a),

shall, where such exchange difference arose or such premium or other consideration was paid or became payable in a year of assessment prior to the year of assessment during which such machinery, plant, implement, utensil, building, improvements to any building, invention, patent, design, trade mark, copyright or other similar property or knowledge was or is brought into use for the purposes of such person's trade, be carried forward and be taken into account in the determination of the taxable income of such person in the year of assessment during which such machinery, plant, implement, utensil, building, improvements to any building, invention, patent, design, trade mark, copyright or other similar property or knowledge was or is so brought into use for the purposes of such person's trade: Provided that where during any year of assessment subsequent to the year of assessment during which such exchange difference arose or such premium or other consideration was paid or became payable—

- (a) the debt to be incurred as contemplated in paragraph (b) or (c) of this subsection will no longer be so incurred;
- (b) such debt has not been utilised as contemplated in paragraph (a); or
- (c) any such asset, property or knowledge will no longer be brought into use for the purpose of such person's trade,

such exchange difference or premium or other consideration shall no longer be carried forward, but shall be taken into account in the determination of such person's taxable income in such subsequent year of assessment.

(7A) . . . . .

(8) Any foreign exchange loss sustained in respect of a transaction entered into by a person, or any premium or other consideration paid in respect of or in terms of a foreign currency option contract entered into or acquired by a person, shall not be allowed as a deduction from such person's income under subsection (3), if such transaction was entered into or such foreign currency option contract was entered into or acquired solely or mainly to enjoy a reduction in tax by way of a deduction from income.

(9) . . . . .

(10) . . . . .

(10A)(a) Subject to paragraph (b), no exchange difference arising during any year of assessment in respect of an exchange item contemplated in paragraph (b) of the definition of “exchange item” shall be included in or deducted from the income of a person in terms of this section—

- (i) if, at the end of that year of assessment—
  - (aa) that person and the other party to the contractual provisions of that exchange item—
    - (A) form part of the same group of companies; or
    - (B) are connected persons in relation to each other; and
  - (bb) no forward exchange contract and no foreign currency option contract has been entered into by that person to serve as a hedge in respect of that exchange item; and
- (ii) that exchange item—
  - (aa) or any portion thereof does not represent for that person a current asset or a current liability for the purposes of financial reporting pursuant to IFRS; and
  - (bb) is not directly or indirectly funded by any debt owed to any person that—
    - (A) does not form part of the same group of companies as; or
    - (B) is not a connected person in relation to,
 that person or the other party to the contractual provisions of that exchange item.

(b) Where paragraph (a) was applied during any year of assessment to any exchange difference in respect of an exchange item and—

- (i) that exchange difference was not included in nor deducted from the income of a person in that year of assessment; and
- (ii) during any year of assessment—
  - (aa) subsequent to that year of assessment, paragraph (a) no longer applies to that exchange difference; or
  - (bb) that exchange item is realised,

an amount in respect of that exchange item must be included in or deducted from the income of that person in that subsequent year of assessment or in the year of assessment during which the exchange item is realised which amount shall be determined by multiplying that exchange item by the difference between the ruling exchange rate on the last day of the year of assessment immediately preceding that subsequent year of assessment and the ruling exchange rate on transaction date, less any amount of the exchange differences included in or deducted from the income of that person in terms of this section in respect of that exchange item for all years of assessment preceding that subsequent year of assessment during which the person was a party to the contractual provisions of the exchange item.

(11) . . . . .

(11A) . . . . .

(12) Where a person holds any exchange item and the provisions of this section at any time during a year of assessment—

- (a) become applicable to that person, that exchange item shall be deemed to have been acquired at that time for the purposes of this section; or
- (b) cease to apply to that person, that exchange item shall be deemed to have been realised at that time for the purposes of this section.

**Section 24J(2), (3) and (5A)**

(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to—

- (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
- (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument,

which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.

(3) Where any person is the holder in relation to an income instrument during any year of assessment, there shall for the purposes of this Act be deemed to have accrued to that person and must be included in the gross income of that person during that year of assessment (whether or not that amount constitutes a receipt or accrual of a capital nature), an amount of interest which is equal to—

- (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in part or in whole, within such year of assessment in respect of such income instrument; or
- (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such income instrument.

(5A) Any amount which has been deemed to have been incurred by or accrued to a person, as the case may be, in respect of an instrument in terms of the provisions of this section, shall for the purposes of this Act not be deducted from or included in, as the case may be, the income of such person more than once by reason of the application of this section.

**Section 25D**

**25D. Determination of taxable income in foreign currency.**—(1) Subject to subsections (2), (3) and (4), any amount received by or accrued to, or expenditure or loss incurred by, a person during any year of assessment in any currency other than the currency of the Republic must be translated to the currency of the Republic by applying the spot rate on the date on which that amount was so received or accrued or expenditure or loss was so incurred.

(2) Any amounts received by or accrued to, or expenditure incurred by, a person in any currency other than the currency of the Republic which are attributable to a permanent establishment of that person outside the Republic must be determined in the functional currency of that permanent establishment (other than the currency of any country in the common monetary area) and be translated to the currency of the Republic by applying the average exchange rate for the relevant year of assessment.

(2A) Subsection (2) shall not apply to the extent that—

- (a) the other currency contemplated in that subsection is not the functional currency of that permanent establishment; and
- (b) the functional currency is the currency of a country which has an official rate of inflation of 100 per cent or more throughout the relevant year of assessment.

(3) Notwithstanding subsection (1), a natural person or a trust (other than a trust which carries on any trade) may elect that all amounts received by or accrued to, or expenditure or losses incurred by that person or trust in any currency other than the currency of the Republic, be translated to the currency of the Republic by applying the average exchange rate for the relevant year of assessment.

(4) Where, during any year of assessment—

- (a) any amount—
  - (i) is received by or accrued to; or

(ii) of expenditure is incurred by,

a headquarter company in any currency other than the functional currency of the headquarter company; and

(b) the functional currency of that headquarter company is a currency other than the currency of the Republic,

that amount must be determined in the functional currency of the headquarter company and must be translated to the currency of the Republic by applying the average exchange rate for that year of assessment.

(5) Where, during any year of assessment—

(a) any amount—

(i) is received by or accrues to; or

(ii) of expenditure is incurred by,

a domestic treasury management company in any currency other than the functional currency of the domestic treasury management company; and

(b) the functional currency of that domestic treasury management company is a currency other than the currency of the Republic,

that amount must be determined in the functional currency of the domestic treasury management company and must be translated to the currency of the Republic by applying the average exchange rate for that year of assessment.

(6) Where, during any year of assessment—

(a) any amount—

(i) is received by or accrues to; or

(ii) of expenditure is incurred by,

an international shipping company in any currency other than the functional currency of the international shipping company; and

(b) the functional currency of that international shipping company is a currency other than the currency of the Republic,

that amount must be determined in the functional currency of the international shipping company and must be translated to the currency of the Republic by applying the average exchange rate for that year of assessment.

(7) Any amounts received by or accrued to, or expenditure incurred by—

(a) a headquarter company contemplated in subsection (4);

(b) a domestic treasury management company contemplated in subsection (5); or

(c) an international shipping company contemplated in subsection (6),

during any year of assessment in a functional currency that is a currency other than the currency of the Republic must be translated to the currency of the Republic by applying the average exchange rate for the relevant year of assessment.

## The Eighth Schedule – Paragraph 12A<sup>145</sup>

**12A. Reduction of debt.—(1)** For the purposes of this paragraph—

“**allowance asset**” means a capital asset in respect of which a deduction or allowance is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;

“**capital asset**” means an asset that is not trading stock;

“**debt**” does not include a tax debt as defined in section 1 of the Tax Administration Act;

“**reduction amount**”, in relation to a debt owed by a person, means any amount by which that debt is reduced less any amount applied by that person as consideration for that reduction.

(2) Subject to subparagraph (6), this paragraph applies where a debt that is owed by a person is reduced by any amount and—

- (a) the amount of that debt was used, directly or indirectly, to fund any expenditure—
  - (i) other than expenditure in respect of which a deduction or allowance was granted in terms of this Act; or
  - (ii) incurred in respect of an allowance asset; and
- (b) the amount of that reduction exceeds any amount applied by that person as consideration for that reduction.

(3) Where—

- c(a) a debt owed by a person is reduced as contemplated in subparagraph (2); and
- (b) the amount of that debt was used as contemplated in item (a) of that subparagraph to fund expenditure incurred in respect of an asset that is held by that person at the time of the reduction of the debt,

the amount of expenditure so incurred in respect of that asset must, for the purposes of paragraph 20, be reduced by the reduction amount in respect of that debt.

(4) Where—

- (a) a debt owed by a person is reduced as contemplated in subparagraph (2); and
- (b) the amount of that debt was used as contemplated in item (a) of that subparagraph to fund expenditure incurred in respect of an asset (other than an allowance asset) that is—
  - (i) held by that person at the time of the reduction of the debt, and subparagraph (3) has been applied to reduce any expenditure in respect of that asset to the full extent of that expenditure; or
  - (ii) no longer held by that person at the time of the reduction of that debt,

the reduction amount in respect of that debt, less any amount that has been applied to reduce any amount of expenditure as contemplated in subparagraph (3), must be applied to reduce any assessed capital loss of that person for the year of assessment in which the reduction takes place.

<sup>145</sup> As it read in respect of years of assessment commencing before 1 January 2018. Paragraph 12A(5) – (7) is not quoted in this Annexure, since these provisions are considered not relevant for purposes of this Note. Paragraph 12A was amended by the Taxation Laws Amendment Act 17 of 2017. The amendment, which is effective for years of assessment commencing on or after 1 January 2018, includes substantive changes and changes in the terminology used.



**The Eighth Schedule – Paragraph 35(3)(a)**

(3) The proceeds from the disposal, during a year of assessment, of an asset by a person, as contemplated in subparagraph (1) must be reduced by—

- (a) any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain;

**The Eighth Schedule – Paragraph 43**

**43. Assets disposed of or acquired in foreign currency.**—(1) Where, during any year of assessment, a person that is a natural person or a trust that is not carrying on a trade disposes of an asset for proceeds in a foreign currency after having incurred expenditure in respect of that asset in the same currency, that person must determine the capital gain or capital loss on the disposal in that currency and that capital gain or capital loss must be translated to the local currency by applying the average exchange rate for the year of assessment in which that asset was disposed of or by applying the spot rate on the date of disposal of that asset.

(1A) Where, during any year of assessment, a person disposes of an asset (other than a disposal contemplated in subparagraph (1)) for proceeds in a foreign currency or after having incurred expenditure in respect of that asset in a foreign currency, that person must, for the purposes of determining the capital gain or capital loss on the disposal of that asset, translate—

- (a) the proceeds into the local currency at the average exchange rate for the year of assessment in which that asset was disposed of or at the spot rate on the date of disposal of that asset; and
- (b) the expenditure incurred in respect of that asset into the local currency at the average exchange rate for the year of assessment during which that expenditure was incurred or at the spot rate on the date on which that expenditure was incurred.

(2) . . . . .

(3) . . . . .

(4) . . . . .

(5) Where a person is treated as having derived an amount of proceeds from the disposal of any asset and the expenditure incurred to acquire that asset is determined in any foreign currency—

- (a) the amount of those proceeds must be treated as being denominated in the currency of the expenditure incurred to acquire that asset; and
- (b) the expenditure incurred by a person acquiring that asset must for purposes of section 9HA and paragraphs 12, 38 and 40 be treated as being denominated in that currency.

(5A) . . . . .

(6) Where a person has adopted the market value as the valuation date value of any asset contemplated in this paragraph, that market value must be determined in the currency of the expenditure incurred to acquire that asset and for purposes of the application of subparagraph (1A) be translated to the local currency by applying the spot rate on valuation date.

(6A) Subparagraph (1A) must not apply in respect of the disposal by a person of—

- (a) . . . . .
- (b) any amount of a debt owed to that person denominated in a foreign currency; or
- (c) any right of that person arising from any contractual agreement or arrangement to which that person and another party are parties where—
  - (i) that contractual agreement or arrangement gives rise to that right and to a corresponding obligation of the other party; and

- (ii) the value of that right and the amount of that obligation are determined directly or indirectly with reference to an amount contemplated in item (b).

(7) For the purposes of this paragraph—

**“foreign currency”** means currency other than local currency; and

**“local currency”** means—

- (a) in relation to a permanent establishment of a person, the functional currency of that permanent establishment (other than the currency of any country in the common monetary area);
- (b) in relation to a headquarter company, in respect of amounts which are not attributable to a permanent establishment outside the Republic, the functional currency of that headquarter company;
- (c) in relation to a domestic treasury management company, in respect of amounts which are not attributable to a permanent establishment outside the Republic, the functional currency of that domestic treasury management company;
- (d) in relation to an international shipping company defined in section 12Q, in respect of amounts which are not attributable to a permanent establishment outside the Republic, the functional currency of that international shipping company; or
- (e) in any other case, the currency of the Republic.

#### **The Tenth Schedule – Paragraph 4(1)**

4(1) Currency gains or losses of an oil and gas company during any year of assessment (regardless of whether those gains or losses are realised or unrealised) must be determined solely with reference to—

- (a) the functional currency of that company; and
- (b) the translation method used by that company for purposes of financial reporting.

**Annexure B – Index of common terms used in this Note and where to find an explanation or definition**

| <b>Term</b>                              | <b>Paragraph in this Note</b> |
|--|-------------------------------|
| Acquisition rate                         | <b>4.5.2(d)</b>               |
| Affected contract                        | <b>4.5.3(e)</b>               |
| Average exchange rate                    | <b>4.4.10</b>                 |
| CFC                                      | <b>4.11.1</b>                 |
| Disposal rate                            | <b>4.5.2(d)</b>               |
| Exchange difference                      | <b>4.4.1</b>                  |
| Exchange item                            | <b>4.4.2</b>                  |
| FCOC or foreign currency option contract | <b>4.5.4(a)</b>               |
| FEC or forward exchange contract         | <b>4.5.3(a)</b>               |
| Foreign currency                         | <b>4.4.3</b>                  |
| Forward rate                             | <b>4.5.3(a)</b>               |
| Functional currency                      | <b>4.4.4</b>                  |
| Intrinsic value                          | <b>4.5.4(f)</b>               |
| Local currency                           | <b>4.4.3</b>                  |
| Market value                             | <b>4.5.4(e)</b>               |
| MRFR or market-related forward rate      | <b>4.5.3(d)</b>               |
| Option strike rate                       | <b>4.5.4(g)</b>               |
| Realised                                 | <b>4.4.7</b>                  |
| Ruling exchange rate                     | <b>4.4.8</b>                  |
| Spot rate                                | <b>4.4.9</b>                  |
| Transaction date                         | <b>4.4.5</b>                  |
| Translate                                | <b>4.4.6</b>                  |