INTRODUCTION OF MARK-TO-MARKET (FAIR VALUE) TAXATION IN SOUTH AFRICA

by

NF RADEBE (38946580)

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SUPERVISOR: Prof J.S. Wilcocks

CO-SUPERVISOR: Mr. H.A. Combrink

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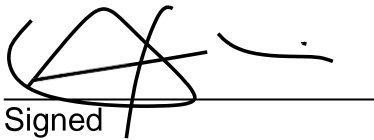
DECLARATION

Student nr: 38946580....................................

I, N.F. RADEBE, declare that:

(Introduction of mark to market (fair value) taxation in South Africa)

is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.



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ABSTRACT

This study examines the annual fair value taxation of financial instruments in respect of banks and brokers (defined as “covered person” in section 24JB of the Act) in accordance with the South African Income Tax Act (“the Act”). A “covered person” is taxed in accordance with accounting principles of International Financial Reporting Standards (“IFRS”) 9. This study investigated whether the adoption of accounting principles in section 24JB of the Act could give rise to divergent interpretations and inappropriate treatments.

The study also examined how other countries tax financial instruments and how those tax rules are aligned to accounting principles. This, to identify similarities and differences, to highlight possible improvements to section 24JB of the Act.

It was concluded in this study that, without proper guidance, the adoption of accounting principles in section 24JB of the South African tax legislation could give rise to divergent interpretations and inappropriate applications.

BEKENDSTELLING VAN BELASTING OP MARKWAARDE (BILLIKE WAARDE) IN SUID-AFRIKA

OPSOMMING

In hierdie studie is ondersoek ingestel na die jaarlikse billikewaarde-belasting van finansiële instrumente ten opsigte van banke en makelaars (omskryf as "gedekte persoon" in artikel 24JB van die Wet) ingevolge die Suid-Afrikaanse Inkomstebelastingwet ("die Wet"). 'n "Gedekte persoon" word belas ooreenkomstig die rekeningkundige beginsels van Internasionale Finansiële Verslagdoeningstandaarde ("IFVS") 9. Hierdie studie het ondersoek of die ingebruikneming van rekeningkundige beginsels in artikel 24JB van die Wet kan aanleiding gee tot uiteenlopende interpretasies en onvanpaste toepassings.

In die studie is daar ook gekyk hoe ander lande finansiële instrumente belas en hoe daardie belastingreëls in ooreenstemming gebring word met rekeningkundige beginsels. Dit is gedoen om ooreenkomste en verskille te identifiseer, om moontlike verbeteringe aan artikel 24JB van die Wet uit te wys.

Die gevolgtrekking van hierdie studie was dat, sonder behoorlike leiding, die toepassing van rekeningkundige beginsels in artikel 24JB van Suid-Afrikaanse belastingwetgewing kan lei tot uiteenlopende interpretasies en onvanpaste toepassings.

UKWETHULWA KWENTELA ESUKELA EKUMAKWENI UKUYA EKUMAKHETHENI (INANI ELIFANELEKILE) ENINGIZIMU AFRIKA

ISIFINQO

Lolu cwaningo luhlole intela yenani elifanelekile lonyaka lamathuluzi ezezimali maqondana namabhange nabadayisi (okuchazwa "njengomuntu okhaviwe" esigabeni 24JB soMthetho) ngokuvumelana noMthetho Wentela yaseNingizimu Afrika ("uMthetho"). "Umuntu okhaviwe" ukhokhiswa intela ngokuhambisana nezimiso zokubala Amazinga Okubika Ngezezimali Wamazwe Ngamazwe ("IFRS") 9. Lolu cwaningo luphenye ukuthi ukwamukelwa kwezimiso zokubalwa kwezimali esigabeni 24JB soMthetho kungase kubangele ukuhunyushwa okuhlukene kanye nokuphathwa ngendlela engafanele.

Ucwaningo luphinde lwahlola ukuthi amathuluzi amanye amazwe ezezimali anentela kanjani nokuthi leyo mithetho yentela ihambisana kanjani nezimiso zokubala. Lokhu, ukuhlonza ukufana nokwehluka, ukugqamisa ukuthuthukiswa okungenzeka kwesigaba 24JB soMthetho.

Kulolu cwaningo kwaphethwa ngokuthi, ngaphandle kwesiqondiso esifanele, ukwamukelwa kwezimiso zokubalwa kwezimali esigabeni 24JB somthetho wentela waseNingizimu Afrika kungase kubangele ukuhunyushwa okuhlukene kanye nezicelo ezingafanele.

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ABBREVIATIONS USED

Abbreviation	Meaning
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
SARB	South African Reserve Bank
SARS	South African Revenue Service
The Act	Income Tax Act of South Africa 58 of 1962 (as amended)

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CHAPTER 1: INTRODUCTION

1.1 THE RELATIONSHIP BETWEEN ACCOUNTING AND TAXATION

Walter B. Wriston said "All the Congress, all the accountants and tax lawyers, all the judges, and a convention of wizards all cannot tell for sure what the income tax law says" (Yablon, 2013:1621). Currently, income tax law is already complicated and attempting to merge accounting principles and tax principles may inevitably lead to different opinions on how to apply the income tax law.

The adoption of accounting standards by certain taxation laws, requiring amounts determined using accounting principles to be used for tax, may or may not be an appropriate base. According to Alley and James (2005:2) in a Working Papers Series prepared for the University of Waikato, the purposes and requirements of commercial accounting principles and taxation are not always the same. Accounting entails the preparation of data for the purposes of control and decision-making and includes the interpretation and documenting of factual information.

In general, the purpose of taxation is to raise revenue for the *fiscus.* In addition, it is used as an instrument of government economic and social policy. Alley and James (2005:2) further argue that a move towards greater reliance on accounting principles for taxation may lead to the preparation of the financial statements being influenced by the taxation implications. This statement may mean that in certain cases, accounting may lead to the 'cherry-picking' of losses, whereby losses are realised in the current year but gains are postponed and taxed later. However, in cases where there is an active market of trading, fair value basis (measuring the value of assets and liabilities based on actual or fair market prices) could lessen this problem, and the problem could be one of timing rather than recognition.

Sometimes, the same variables that are used for tax and accounting may yield different amounts for tax and accounting purposes but although different, each are appropriate for

their specific purpose. This stems from the fact that accounting and taxation exist for different reasons (Alley & James 2005:3).

The use of different amounts for the same variables can be inferred from the article by Mills, Newberry and Trautman (2002:3) where it was stated that financial accounting standards and taxation legislation provide specific and often different rules for how to report income for accounting and tax purposes even though both income reports are based on the same underlying transactions.

Furthermore, Alley and James (2005:3) state that the financial reporting rules and practices might not be appropriate for determining the tax liability due to the difference in the purpose of accounting and taxation. Other reasons stated are challenges in defining the concept of income, the continuous revision of accounting standards and taxation legislation and the strive for administrative efficiency.

However, in a study by Hanlon, Hoopes and Shroff (2014:10) examining the association between tax enforcement and financial reporting quality, it was mentioned that there are three avenues through which increased tax enforcement can lead to an improvement in financial reporting quality. The first avenue is to align the calculation between the accounting and taxable income (this avenue will be further investigated in this study). Secondly, stricter tax enforcement by tax authorities may reduce transactions and corporate structures aimed at diverting profits towards shareholders. Stated differently, Hanlon et al (2014:10) argue that many tax avoidance mechanisms require complexity and obfuscation to circumvent tax rules but an increase in tax enforcement by tax authorities may reduce this practice. However, for the purposes of this study, if there are no differences in interpretations or inappropriate applications between accounting and tax, the audit conducted by the tax authorities will minimise the ‘back and forth communication’ between the taxpayer and the tax authorities over a matter that relates to tax and accounting treatments. The conclusion of this study highlights the difference in interpretations or inappropriate treatment that need to be addressed to reduce the ‘back and forth communication’ between the taxpayer and the tax authorities. Therefore, this

second avenue, namely stricter tax enforcement by tax authorities will be excluded from this study. The third avenue, to increase reporting quality with increased tax enforcement, is excluded from the scope of this study.

Hanlon et al (2014:31) concluded that:

i. tax authority enforcement is associated with financial reporting quality;
ii. tax enforcement has a more prominent effect on financial reporting quality when other monitoring mechanisms are weaker; and
iii. lastly, that tax enforcement serves as a corporate governance mechanism.

It is further evident that a greater alignment between tax and accounting is necessary to reduce audit fees. According to Kuo and Lee (2016:1), the increased book-tax conformity (alignment of accounting and tax) can reduce audit fees by simplifying tax accruals and increasing tax authorities' monitoring, which reduce audit risk. Furthermore, Kuo and Lee (2016:1293) argue that book-tax conformity eliminates the gaps in the calculation of accounting income and taxable income.

In the article by Norberg (2007:3), it is stated that the basic rules in tax legislation do not exhaustively explain the association between financial accounting and tax accounting. The relationship must be analysed taking into account the following factors:

i. To what degree are fundamental accounting principles covered by specific tax rules, when is the basic rule still used and is this basic rule connected to financial accounting, or not?
ii. To what degree do specific tax rules mentioned above deviate from financial accounting?
iii. To what degree is tax legislation interpreted taking International Financial Reporting Standards (IFRS) principles into account?
iv. Are gaps in tax legislation addressed taking IFRS principles into account or is there some guidance or interpretation note to address the gaps?

The closer alignment between tax and accounting could be beneficial for both taxpayers and revenue services if the amounts that are reported for accounting purposes are the same (or close) to the amounts that are reported for tax purposes. This benefit (which may be a simpler tax calculation by the taxpayer) could result in a reduction of the audit fees for taxpayers. And to a greater extent a "sense of comfort" for the revenue services that the amounts that have been reported to shareholders via financial statements are the same as the amounts submitted to the revenue service via the income tax return. However, as stated by Norberg (2007:3), a detailed analysis must be conducted to assess this relationship between accounting and tax.

The Income Tax Act, Act 58 of 1962 (hereafter "the Act") now specifically references the specific accounting standards to use as basis for taxation. In general, the focus of this study is to investigate the divergence between accounting treatment of gains and losses from financial assets and financial liabilities (financial instruments) and the taxation of these gains and losses from financial assets and financial liabilities in light of the provisions introduced in the Act by section 24JB. Section 24JB of the Act prescribes the tax treatment of gains and losses from financial assets and financial liabilities that are measured on a fair value basis using accounting principles. The accounting principles referred to consist mainly of the concepts relating to fair value accounting.

The following section introduces fair value accounting. Prior to the application of the tax principles on fair value, the pertinent question that needed to be answered was how the financial assets or financial liabilities were measured at fair value and how the fair value adjustments were treated in accordance with accounting principles. The importance of this question is due to accounting principles requiring certain financial assets and financial liabilities of the taxpayer to be measured at fair value at year end and the difference between the beginning of the year and year end amount be treated as a "gain" or "loss" by that taxpayer. It is this amount that is regarded as an accounting "gain" or "loss" that the taxation principles seek to either "include" in income for tax purposes or allow as a "deduction".

1.1.1 INTRODUCTION TO FAIR VALUE ACCOUNTING

According to the IFRS Conceptual Framework for Financial Reporting (2018), fair value accounting is an alternative measurement base compared to the traditional form of accounting, namely the historical cost accounting. Under historical cost accounting, the initial price paid by the entity during the purchase of an asset or incurrence of a liability is the amount that is recorded. The price reflected on the statement of financial position is the purchase price reduced by either obsolescence or depreciation. Stated differently, assets or liabilities are shown on the statement of financial position of entities at the original price paid for the asset, taking depreciation into account (the carrying amount) or the asset is derecognized if it is obsolete. Fair value accounting is an update or alternative to the traditional concepts.

PWC (2008:1) states that fair value accounting refers to the method of updating the valuation of assets or liabilities on a regular basis ideally with reference to current prices for similar assets. In essence fair value accounting reveals how financial assets and financial liabilities are affected by current market conditions which are reflected in the amounts disclosed in the statement of financial position.

An introduction to fair value accounting was provided in this section, the following section investigates how fair value is measured.

1.1.2 WHAT IS FAIR VALUE MEASUREMENT?

According to Procházka (2011:82), fair value measurement provides an entity's with a useful forecast of its price movements. If one uses an example of a share, which is either a financial asset, financial liability or equity depending on the circumstances, historical cost accounting will not be an appropriate measure to reflect the price movement. Procházka referred to the 2008 financial crises where there were both entities that made losses and entities that made gains. Those who made gains had anticipated the

magnitude of the crisis, took corrective measures and changed their asset portfolios, which resulted in gains. Furthermore, he describes fair value measurement as a tool useful to a broad group of users in their decision-making. Fair value measurements constitute relevant sources of information for evaluating the financial position and performance of the underlying asset or liability.

De Jager (2014:69) explains that fair value is the exchange value in an idealised market and can be determined in three ways (which is a summary of how fair value measurement is determined for a financial asset or financial liability as stated in paragraph B5.1.1 and B5.1.2A(a) of IFRS 9 (Financial Instruments), in order of preference:

a. Mark-to-market accounting (level 1): the significant inputs are quoted prices on an idealised market for similar instruments.
b. Mix of mark-to-market accounting and modelling (level 2): the significant inputs are directly observable market inputs other than Level 1 inputs; for example, adjusted market values - that is, statement values are derived from valuation models using observable inputs, such as the discount rate on similar assets.
c. Mark-to-model (level 3): the significant inputs are not based on observable market data; instead, an estimate is made of what the value of the instrument would be if it was to be traded.

The International Accounting Standards Board (hereafter IASB) issued a fair value standard, IFRS 13 (Fair Value Measurement), in 2013 that also provides guidance on fair value measurement and hierarchy of inputs for arriving at fair value. IFRS 13 defines fair value, sets out in a single standard a framework for measuring fair value and requires disclosures for fair value measurements. The guidance in IFRS 13 is not addressed in this study as IFRS 9 (which replaced IAS 39 for periods beginning on or after 1 January 2018) comprehensively deals with the fair value recognition and measurement of financial assets and liabilities.

De Jager (2014:69) states that under fair value accounting an asset is carried on the

statement of financial position at the price at which that asset could be recovered, and a liability at the amount required to settle that liability, in the current market. Changes in the fair value (unrealised gains or losses) are recognised in current earnings, compared to historical cost accounting, which usually only recognises changes in value when realised.

Sundgren (2013:250) asked this question, "So how fair are fair values?" She deduced that:

> "I think it is difficult to get an unanimous answer to the question from the literature but my personal view is that fair values are fair enough. However, it is important that fair value measurements are supplemented with high quality disclosures about the methods used and assumptions applied in the fair value calculations."

This study will not reflect on the pros and cons of fair value measurement, but it is crucial to understand the meaning of fair value and the calculation methods of a fair value amount.

Apart from the measurement of the financial asset or financial liability, each item also has a tax consequence, which will be discussed in the following section. The following section introduces the taxation of financial assets and financial liabilities under section 24JB of the Act. The definitions of financial asset and financial liability are newly introduced concepts in the Act and will be discussed in the following section. Furthermore, the following section seeks to illustrate the general approach of section 24JB of the Act to "tax" economic gains and losses from a financial asset or financial liability as determined using accounting principles. These gains and losses would have been determined for accounting purposes by calculating the differences in fair values at the beginning of the year and at year end using the methods of fair value measurements mentioned above. Given that section 24JB is complex, other countries' regime will also be investigated in Chapter 4 to draw a comparison and make some conclusions regarding the suitability of South Africa's regime.

1.1.3 INTRODUCTION TO SECTION 24JB OF THE ACT

1.1.3.1 Reasons for introducing section 24JB of the Act

According to Theron (2014), in South Africa, income tax is usually payable on actual receipts and accruals, but for every rule, there are always exceptions. One exception to this rule applies to companies that deal in instruments, interest rate agreements, or option contracts. The Act previously provided (in section 24J(9) thereof) a specific rule that allowed taxpayers to utilise annual mark-to-market fair value methodology. The rule was an elective regime, subject to various requirements, that allowed companies that deal in instruments, interest rate agreements or option contracts to pay tax on a valuation basis. This meant, irrespective of actual receipts and accruals, that the interest and amounts payable or receivable on option contracts and interest rate agreements were considered for tax purposes, according to changes in the fair value of the underlying instruments over that assessment period (Theron, 2014:1). The fair value valuation in relation to all instruments, interest rate agreements or option contracts was determined in accordance with commercially accepted practice, which was applied by such company consistently in respect of all such instruments, interest rate agreements or option contracts for financial reporting purposes to its shareholders (section 24J(9) of the Act).

This exception rule mentioned above was deleted in 2012 when section 24JB (taxation in respect of financial assets and liabilities of certain persons) was introduced by the Taxation Laws Amendment Act, No. 31 of 2013. Section 24JB of the Act differs from section 24J(9) of the Act in that it is a mandatory section (i.e. not elective) and applies only to a “covered person” as defined in section 24JB(1) of the Act.

The Explanatory Memorandum on the Taxation Laws Amendment Act, 2013 dated 24 October 2013 provided reasons in support of the deletion of section 24J(9) of the Act. Firstly, the rules pertaining to financial instruments in respect of income tax and financial accounting have completely diverged. This divergence has proven to be a challenge for

both taxpayers and the SARS (South African Revenue Service) alike. The volume of financial transactions for large financial institutions requires expensive systems that require continuous modification. Tax deviations are frequently accounted for manually as a result of these continuous modifications, increasing the risk of errors. From a SARS perspective, the divergence between tax and accounting has increased to such an extent that accounting is no longer considered a useful benchmark for assessing risk *vis-à-vis* the accuracy of taxable income (National Treasury, 2013:53).

Secondly, as previously noted, section 24J(9) of the Act contained a specific rule that allowed taxpayers to utilise annual mark-to-market fair value methodology. However, this methodology was limited insofar as it only catered for specific instruments, thereby excluding equity and other instruments that had to be catered for using the normal rules. Moreover, this election focused solely on financial assets without regard to financial liabilities, thereby resulting in serious mismatches. Lastly, the elective and pre-approval nature (under section 24J(9) of the Act) of the mark-to-market system gave rise to uncertainty and confusion (National Treasury, 2013:53).

According to the Explanatory Memorandum on the Taxation Laws Amendment Act, the tax implications of financial assets and financial liabilities (herein collectively called financial instruments) in section 24JB of the Act follow the accounting treatment of those instruments (National Treasury, 2013:53). For accounting purposes, certain financial instruments are recorded at fair value to provide users of financial statements with information regarding the accounting values and the prevailing market values as at the end of that entity's financial year-end.

1.1.3.2 Persons that should apply section 24JB of the Act and general application

The persons that should apply section 24JB of the Act (in this section these companies are referred as "covered person" as defined in s 24JB(1)) are:

i. "*any authorised user as defined in section 1 of the Financial Markets Act that is a*

company other than any company of which the principal trading activities constitute the activities of a treasury operation;

ii. the South African Reserve Bank;

iii. any bank, branch, branch of bank or controlling company as defined in section 1 of the Banks Act; and

iv. any company or trust that forms part of a banking group excluding a company that is a long-term insurer as defined in section 1 of the Long-term Insurance Act, a company that is a short-term insurer as defined in section 1 of the Short-term Insurance Act, a company of which more than 50 per cent of the shares are directly or indirectly held by a company that is a long-term or short-term insurer and any subsidiary as defined in section 1 of the Companies Act of a long-term or short-term insurer."

Section 24JB of the Act therefore requires every "covered person" for tax purposes to include in, or deduct from, their income all amounts in respect of a financial asset and a financial liability that are recognised for accounting purposes at the end of the financial year in profit or loss in the statement of profit or loss and other comprehensive income. The following section seeks to quantify entities that will qualify as a "covered person" under section 24JB.

With respect to banks who form part of the "covered person" definition, the scope of section 24JB potentially includes both a subsidiary of a foreign bank that conducts its banking activities in South Africa and the branch of a South African bank conducting banking activities outside of South Africa. According to The Banking Association of South Africa, the banking industry is made up of 36 banks licensed by the South African Reserve Bank (SARB) and is broken down as follows: 16 locally and foreign controlled banks, 15 local branches of foreign banks, 3 mutual banks and 2 cooperatives banks (The Banking Association of South Africa, 2017). In addition, any company that is a "broker", defined as an authorised user in section 1 of the Financial Markets Act, will also be included in the definition of a "covered person". According to the draft Financial Inclusion Policy Paper, the largest four banks account for 80 per cent of the banking sector assets (National

Treasury, 2018:15).

The introduction of the principles of fair value taxation, on which section 24JB of the Act is based, required the introduction of new terminology into the Act. This was because all references to financial instruments and how these financial instruments are measured at fair value for accounting purposes, as well as the disclosure of these instruments, could only be implemented by applying accounting standards. In order to determine this gain or loss by a "covered person", that 'covered person' should utilise the accounting standard dealing with the accounting treatment of a financial asset and a financial liability, that is IFRS 9 (Section 24JB(2) of the Act).

1.1.3.3 Accounting standards relevant to the application of section 24JB

To provide the relevant context for the analysis of the provisions of section 24JB of the Act, it is therefore important that this study also deals with the accounting standards that are applicable to financial assets and financial liabilities in relation to a "covered person" to gain an understanding as to whether the current taxation legislation is in line with accounting standards or if these specific tax rules deviate from financial accounting. These accounting standards are IAS 32 (Financial Instruments: Presentation), IAS 39 (Financial Instruments: Recognition and Measurement), IFRS 7 (Financial Instruments: Disclosures) and IFRS 9 (the replacement standard of IAS 39 which are effective for financial years beginning on or after 1 January 2018 with earlier adoption permitted). These accounting standards will be discussed in more detail in Chapter 2.

1.1.3.4 Analysis of the definitions of "financial asset" and "financial liability"

To understand the application and objective of section 24JB of the Act, it is important to understand the definitions of 'financial asset' and 'financial liability' as envisaged in section 24JB of the Act.

A financial asset is defined in section 24JB(1) of the Act to mean:

"(a) a financial asset defined in and within the scope of International Accounting Standard 32 of IFRS or any other International Accounting Standard that replaces International Accounting Standard 32; and
(b) a commodity taken into account in terms of IFRS at fair value less cost to sell in profit or loss in the statement of comprehensive income;"

A financial liability is defined in section 24JB(1) of the Act to mean:

"a financial liability defined in and within the scope of International Accounting Standard 32 of IFRS or any International Accounting Standard that replaces International Accounting Standard 32;"

An extensive analysis of these definitions from an accounting perspective is provided in chapter 2. It is important to note at this stage that section 24JB of the Act marks a significant shift from the normal tax rules, where, for example, tax definitions are usually embodied in the Act. However, in section 24JB of the Act consideration must be given to the definition of a financial asset or financial liability in accounting terms before the principles in section 24JB of the Act can be applied.

This section introduced the fair value accounting and the tax principles of financial assets and financial liabilities of a "covered person". To investigate whether there are deviations between the applicable standards of financial assets and financial liabilities and the application of the tax legislation in section 24JB of the Act, it is necessary to describe a financial asset and financial liability. As section 24JB of the Act also utilises the definitions in the relevant accounting standards, the following section will first define the definitions, then discuss IFRS 9. However, due to IAS 39 being applicable when section 24JB of the Act was introduced, the discussion will include the prescriptions of IAS 39.

This following section provides a summary of the definitions in terms of IFRS and classification of financial assets and financial liabilities (a full discussion is provided in

Chapter 2). It further highlights that there are various accounting standards that are relevant to this study.

1.2 ASPECTS REGARDING THE DEFINITION, CLASSIFICATION AND ACCOUNTING TREATMENT OF A FINANCIAL ASSET AND FINANCIAL LIABILITY BASED ON THE RELEVANT ACCOUNTING STANDARDS

1.2.1 ASPECTS REGARDING THE DEFINITION OF A FINANCIAL ASSET AND FINANCIAL LIABILITY

The IASB issued the revised Conceptual Framework for Financial Reporting (hereafter Conceptual Framework) in March 2018, and it establishes the concepts that underlie the preparation and presentation of financial statements for external users. Furthermore, it thoroughly explains concepts that are commonly used in IFRS (IASB: 2010). For instance, in IFRS 9, the term "financial asset" or "financial liability" (that is referred to in section 24JB of the Act) is defined in IAS 32 with reference to the term "asset" or "liability". An "asset" is not defined in the IFRS 9 standard; however, it is defined in the Conceptual Framework.

Accordingly, to understand the concepts of a financial asset and financial liability as used in IFRS 9, it is important to interpret the terms with reference to their definition in IAS 32.

1.2.2 DEFINITION OF FINANCIAL ASSET AND FINANCIAL LIABILITY

To provide some background, the applicable accounting standards will be listed, followed by the definitions. The accounting standards that affect the accounting and taxation treatment of financial assets and financial liabilities are:

- IAS 32 (Financial Instruments: Presentation), with the objective to establish principles for classification into a financial asset or a financial liability and the classification of the related interest, dividends, gains and losses (IAS 32:2).
- IAS 39 (Financial Instruments: Recognition and Measurement) that sets objectives

for the accounting treatment of a financial asset and a financial liability (IAS 39:1).

- IFRS 9 (Financial Instruments), with the objective to specify the accounting treatment of a financial asset and a financial liability for which a completed version was issued on 24 July 2014 by the IASB (IASB online). The Standard has a mandatory effective date for annual periods beginning on or after 1 January 2018, with earlier application permitted (IFRS 9.7.1.1). IFRS 9 is the replacement standard for IAS 39.
- IFRS 7 (Financial Instruments: Disclosures) deals only with disclosures related to market risk, credit risk, liquidity risk and fair values of a financial asset or a financial liability (IFRS 7. Appendix A and IFRS 7. 36-42).

The definition of a financial asset and a financial liability can be found in IAS 32:11.

A financial asset is:

- *"cash;*
- *an equity instrument of another entity;*
- *a contractual right:*
  - *i. to receive cash or another financial asset from another entity; or*
  - *ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or*
- *a contract that will or may be settled in the entity's own equity instruments and is:*
  - *i. a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or*
  - *ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own instruments."*

A financial liability is any liability that is:

- *"a contractual obligation:*
  - *i. to deliver cash or another financial asset to another entity; or*
  - *ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*
- *a contract that will or may be settled in the entity's own equity instruments and is:*
  - *i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or*
  - *ii. a derivative that will or may be settled other than by the exchange of a fixed amount of a cash or another financial asset for a fixed number of the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments."*

The definition describes a financial asset as contractual agreements that give rise to a right. The opposite should therefore hold in respect of a financial liability that would be the opposing side to the contractual agreement and would encompass a contractual obligation.

The following examples illustrate the concept of a financial asset and financial liability respectively:

Example 1:

When an invoice is issued on the sale of goods on credit, the entity that has sold the goods recognises a financial asset – the receivable – while the buyer recognises a financial liability – the payable.

Example 2:

When an entity raises finance by issuing bonds (debentures) the entity that subscribes to the bonds – i.e., lends the money, – has a financial asset (an investment); while the issuer of the bonds – i.e., the borrower who has raised the finance – must account for the bonds

as a financial liability.

Example 1 and 2: Illustration of financial asset and financial liability

Source: Examples adapted from "Accaglobal". by T. Clendon 4 December 2015

In summary, when the accounting treatment of a financial asset and a financial liability is discussed, it includes how contractual investments in shares, investments in bonds and receivables (financial assets), trade payables and long-term loans (financial liabilities) and equity share capital (equity instruments) are accounted for.

In considering the principles on how to account for financial assets and financial liabilities, various issues around classification, initial measurement and subsequent measurement must be considered. Below is a brief treatment discussion on financial assets and financial liabilities within the scope of IFRS 9. A full discussion is provided, together with a summary of the differences between IAS 39 and IFRS 9 in the context of financial assets and financial liabilities that are measured at fair value through profit or loss in chapter 2.

1.2.3 CLASSIFICATION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES IN IFRS 9

IFRS 9 has three defined categories of financial assets namely:

- Financial assets classified and measured at amortised cost;
- Financial assets classified and measured at fair value through other comprehensive income; and
- Financial assets classified and measured at fair value through profit or loss.

In the above list, a financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with IFRS 9.4.1.2 or at fair value through other comprehensive income in accordance with IFRS 9.4.1.2A. However, an entity may make an irrevocable election at initial recognition for particular investments in

equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income.

A financial asset can be classified as at fair value through profit or loss if it meets the following conditions:

- upon initial recognition, it is designated by the entity as at fair value through profit or loss; or
- it is classified as held-for-trading.

These two concepts are defined in detail in Chapter 2.

In the summary by Meyers Norris Penny (2016:9) of IFRS 9, it is stated that the IFRS 9 requirements for the classification and measurement of financial liabilities are substantially the same as those contained in IAS 39 (see section 1.2.4), except for the following:

- removal of the cost exception for derivative financial liabilities; and
- the recognition of changes in fair value because of an entity's own credit risk in Other Comprehensive Income.

Furthermore, financial liabilities are measured at amortised cost except for:

- Financial liabilities measured at fair value through profit or loss (i.e., those held for trading, designated at fair value through profit or loss or contingent consideration recognized by an acquirer in a business combination); and
- Loan commitments and financial guarantee contracts for which specific measurement guidance exists (IFRS 9.4.2).

This study is based on financial assets and financial liabilities that are measured at fair value through profit or loss only because this category is measured at fair value and the gain or loss on these assets is "taxed" in accordance with the provisions of section 24JB of the Act, which is the focus of this study.

This study reviews the impact and possible changes brought by IFRS 9, one being the fact that changes to the fair value of a financial liability designated at fair value through profit or loss attributable to changes in own credit risk is presented in other comprehensive income and not the statement of profit or loss and other comprehensive income (IFRS 9:5.7.7). This treatment was not available under IAS 39, (see section 1.2.4 below) – there were two categories of financial liabilities and all gains or losses on a financial liability designated at fair value through profit or loss were presented in the statement of profit or loss and other comprehensive income.

In addition, this study also investigates the introduction of a new impairment model by IFRS 9 based on expected losses, (rather than incurred loss as per IAS 39) which has a wider scope of application than IAS 39. The 2017 Taxation Laws Amendment Act, section 19 caters for impairment losses under the new section 11(*j*A) of the Act (2017:30). An impairment loss results from one or more events that occurred after the financial asset's value has declined from the beginning of year versus year end. According to IFRS 9:9.5.2.1(c), the changes in fair value for 'at fair value through profit or loss' assets are recorded in the 'profit or loss' section of the statement of profit or loss and other comprehensive income.

The changes in 'fair value` for financial assets measured at fair value through other comprehensive income are recorded in the "other comprehensive income" section of the statement of profit or loss and other comprehensive income. However, it should be noted that if there is objective evidence that an available-for-sale financial asset is impaired – the loss in the "other comprehensive income" report is reclassified and recognised in the 'profit or loss' report (IAS 39:67). Strangely, section 24JB of the Act was silent on the treatment of impairment prior to the amendment made in the 2017 Taxation Laws Amendment Act.

Lastly, this study reviews other anomalies that are caused by either interpretation differences of accounting standards or that are caused due to matters that are not

specifically clarified in section 24JB of the Act.

The following section will briefly summarise IAS 39. It is important to discuss IAS 39 as it was utilised to account for financial instruments when section 24JB of the Act was introduced.

1.2.4 CLASSIFICATION OF A FINANCIAL ASSET AND FINANCIAL LIABILITY UNDER IAS 39 (FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT)

IAS 39 had four defined categories of financial assets namely:

- Financial assets 'at fair value through profit or loss;
- Held to maturity investments;
- Loans and receivables; and
- Available-for-sale financial assets.

The main reason for the different categories was due to certain financial assets that are held-for-trading while others were held long-term as an investment. This reasoning was deduced from Whittington (2005:138) who stated that the classification of financial assets was because of a technical change that was made to IAS 39 in December 2003 after an enormous growth in the volume of financial derivatives and the markets in which they were traded. This change resulted in the traditional historical cost basis being inadequate. Whittington was therefore of the opinion that historical cost could not cope with current values of some financial instruments that were held for a short period hence the reforms were made to IAS 39.

In the above list, financial assets 'at fair value through profit or loss' and available-for-sale financial assets are measured at fair value while the remaining two, that is held to maturity investments and loans and receivables, are measured at amortised cost (IAS 39 paragraph 9).

A financial asset can be classified as at fair value through profit or loss if it meets the following conditions:

- upon initial recognition, it was designated by the entity as at fair value through profit or loss; or
- it was classified as held-for-trading.

These two concepts are defined in detail in Chapter 2.

This study is based on financial instruments that are measured at fair value through profit or loss only. The gain or loss on these assets is “taxed” in accordance with the provisions of section 24JB of the Act, which is the focus of this study.

The following subsection will look at the classification of a financial liability under IAS 39.

1.2.5 CLASSIFICATION OF A FINANCIAL LIABILITY UNDER IAS 39 (FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT)

There are two categories of financial liabilities, namely:

- At fair value through profit or loss; and
- At subsequently measured at amortised cost (IAS 39:47).

The study will investigate the financial liabilities that are recognised at fair value through profit or loss. These are financial liabilities that the entity either holds for trading purposes or, upon initial recognition, it irrevocably designates these financial liabilities as at fair value through profit or loss. The conditions to be met to designate a financial liability at fair value through profit or loss are the same as those for financial assets (IAS 39: AG4B).

The following section discusses the next step that needs to be taken after the financial instruments have been classified and identified, specifically those financial instruments that are recognised at fair value through profit or loss, since these assets will be taxed in

accordance with section 24JB. The next step will therefore be to investigate the 'charging section' applied by SARS when taxing amounts resulting from gains or losses made on financial instruments.

The following subsection will deal with taxing amounts resulting from gains or losses made on financial instruments.

1.2.6 INCOME FROM A FINANCIAL INSTRUMENT

In general, section 24JB(2) of the Act allows amounts to be included in, or deducted from income if these amounts are recognised in profit or loss in the statement of profit or loss and other comprehensive income.

The amounts should be in respect of financial instruments of the "covered person" that are:

i. measured at fair value in profit or loss in terms of IFRS 9; or

ii. In the case of commodities, at fair value less cost to sell in profit or loss in terms of IFRS.

A notable anomaly that will briefly be investigated in this study, is the treatment of dividends from financial assets and financial liabilities. In summary, section 24JB of the Act excludes the taxation of dividends from a financial asset or liability, however, according to IAS 32:35, interest, dividends, losses and gains are recognised in profit or loss. However, distributions, which includes dividends, are recognised directly in equity. The question is, therefore, what is the rationale for excluding dividends from section 24JB as this amount is recognised in profit or loss in the statement of comprehensive income and relate to the financial asset or liability?

The following section presents the conclusion on aspects identified that relate to the definition of a financial asset and financial liability.

1.2.7 CONCLUSION

To interpret section 24JB of the Act, a detailed knowledge of the relevant accounting principles is also required. This link between accounting and tax and the resultant interpretation of section 24JB of the Act can cause confusion. This study will address the perception by some tax practitioners and auditors that section 24JB is difficult to understand. The main reason for not understanding this section lies with the fact that there is no guidance provided for the application of section 24JB, specifically since it is based on the specialized accounting treatment of these financial assets and liabilities.

When there is an alignment between accounting and tax, tax practitioners need to have both accounting and tax knowledge as stated in a report by Oats and Tuck (2008:ix). The report stated, *"the increased use of accountancy expertise by the United Kingdom Revenue Service has potential to reduce antagonisms resulting from Revenue officers pursuing inappropriate issues during enquiries as a consequence of not fully understanding the accounting which underpins the tax computations. At the same time, there is reduced scope for taxpayers and their advisers to 'pull the wool over the eyes' of Revenue officers, and so there is to some extent a diminution of a 'knowledge superiority' previously possessed by the taxpayer."*

This study will address the concerns of merging the accounting standards and tax principles and to investigate and clarify the concepts that are not fully addressed by section 24JB of the Act.

The following section will address the research question.

1.3 RESEARCH QUESTION

Acknowledging that the purpose and reporting requirements of accounting standards and their governing principles versus tax legislation with its attendant policy considerations do

not always work in conjunction with each other due to their differing objectives, the introduction of accounting principles into the South African tax legislation by section 24JB of the Act, where the principles on which the section is based rely on accounting, results in a new landscape for taxpayers and SARS alike and without proper guidance, this could lead to divergent interpretations and inappropriate applications.

In short, Divergent from Oxford Learner's online dictionary means developing or moving in different directions; becoming less similar (Oxford Learner's Dictionaries, online).
While, interpretations is defined in Oxford Learner's online dictionary to mean the particular way in which something is understood or explained (Oxford Learner's Dictionaries, online). Therefore, divergent interpretations means moving in different directions the way from what is understood or explained. The definitions of inappropriate and treatment are defined as not suitable or appropriate in a particular situation and the act of making a rule, etc. operate or become effective respectively. Therefore, the combined definition of divergent interpretations and inappropriate applications mean moving in different directions (becoming less similar) from what is understood and not suitable in the act of making a rule.
Divergent interpretations and inappropriate treatments include interpretations that may arise when interpreting a term and trying to reach a so called halfway house between the accounting and tax concepts. The term 'halfway house' was coined in *Pyott v CIR* 13 SATC (A) case where it was stated that amounts that are not of a capital nature will be regarded as income, as no halfway house exists. This study will investigate whether the principles applied in section 24JB relates to a mark-to-market model in line with fair value, or if it relates to a hybrid model combining accounting and tax law principles. Is it possible that interpretations may lead to a divergent interpretations given that section 24JB of the Act is based on accounting? If it is a hybrid model, it will be evident from the inclusion of tax law principles in section 24JB. From the policy point of view, was this an intention to go this far with accounting principles? An example is that per IFRS 9, financial assets could be classified as amortised cost or fair valued based on their contractual cash flow and business model (see Chapter 2). For these assets, it could be argued that where the assets remain part of a business model where the objective is to hold the assets for the

long term and collect the contractual cash flows, the gains are of a capital nature and taxed differently. However, the question of whether financial instruments are capital or revenue in nature depend on the facts and circumstances of each case.

The main research question of this study is therefore:

Could the adoption of accounting principles in section 24JB of the Income Tax Act give rise to divergent interpretations and inappropriate treatments?

Part of the importance of the study is to ensure that any discrepancies in section 24JB of the Act that are identified and brought to the attention of the legislators to either be remedied or justified by submitting this thesis when National Treasury invites taxpayers, tax practitioners and members of the public to submit tax proposals of a technical nature (and not of a policy nature) to be considered for possible inclusion in Annexure C of the Budget Review.

The address the research question, the main purpose of the study is to review the introduction of annual fair value taxation of financial instruments in respect of banks and brokers (defined as "covered person" in section 24JB of the Act) that will be taxed in accordance with accounting principles. In addition, it will examine the accounting principles in the context of the tax provisions dealing with financial assets and financial liabilities of a "covered person" envisaged in section 24JB of the Act. The relevant accounting principles for this study are encompassed in *IAS 32, IAS 39, IFRS 7* and *IFRS 9* and are analysed in detail.

Sub-section 1.4 sets out the purpose of the research.

1.4 PURPOSE OF THE RESEARCH

The purpose of the research is firstly to compare the accounting definitions and principles to the application thereof in section 24JB of the Act to establish if there are divergent

practices relating to interpretations and inappropriate applications between accounting and taxation of financial instruments. This will be achieved by embarking on an analysis of the accounting definitions and principles and the accounting treatment of financial instruments and then comparing it to the definitions referred to in section 24JB of the Act to establish if these definitions are the same as those used for accounting. In addition, this study determines whether there are any differences or similarities in the accounting treatment of financial assets and financial liabilities and the Act because the Act (section 24JB) in theory should be following accounting treatment of financial assets and financial liabilities. Secondly, this study also identifies and investigates those items that are excluded from the application of section 24JB of the Act. An example of this is the exclusion from the application of section 24JB of amounts representing a dividend or foreign dividend as stated in section 1.2.5 above.

Sub-section 1.5 defines the most important concepts in this study.

1.5 DEFINITIONS OF TERMS AND CONCEPTS

The most important definitions used in this study is that of a *"covered person", financial asset* and *financial liability* and can be defined as:

"Covered person" in general means a registered bank and brokerage firm – see full definition in chapter 3.

The definition of *financial asset* means a financial claim on an asset that is subject to a contractual agreement. *Financial liability* means a contractual agreement to transfer an asset to another at a specified date. These definitions are discussed briefly in section 1.2.2.

Sub-section 1.6 sets out the research method used to answer the research question.

1.6 THE RESEARCH METHOD

This study addresses the research question through a comprehensive literature review. Myllärniemi (2015:4) explains a literature review to say it "identifies, analyses and synthesises available relevant research to a particular research question or topic". According to Saptono and Khozen (2021:632) a qualitative method with a descriptive approach is applicable to tax research that focuses on accounting standard development and its interaction with the related tax system.

The primary data that is analysed is section 24JB of the Act and the relevant accounting standards dealing with financial assets and financial liabilities to establish if there are divergent interpretations and inappropriate applications between the accounting and taxation treatment of financial instruments. The literature review includes an analysis of the appropriate sections of the Income Tax Act, the reported decisions of the Tax Court, the High Court and Supreme Court that relates to the study, IFRS standards, relevant reference books including journal articles pertaining to the subject matter being researched and other relevant documents, such as Explanatory Memorandums to the Income Tax Act. In addition, this study collects, analyses and interprets relevant published information that pertains to financial assets and financial liabilities designated at fair value through profit or loss. The information will be acquired from books and articles as well as electronic sources from the worldwide web.

In this study, the paragraphs of the main accounting standards are the primary source for establishing the treatment of financial instruments according to IFRS. In any other case, the Application Guidance to IFRS 9 (Financial Instruments) and IAS 39 (Financial Instruments: Recognition and Measurement) are used as basis for interpretation. According to paragraph 11 of IAS 1, interpretations approved by the IASB are part of IFRS and have the same authority as accounting standards (IAS 1:11).

This study analyses and interprets accounting standard IFRS 9 together with the standard that it replaced, namely IAS 39, to identify possible amendments that may be made to

section 24JB of the Act after the implementation of IFRS 9 effective for financial years beginning on or after 1 January 2018. These amendments were made in the 2017 Taxation Laws Amendment Act and included exclusions that were allowed by section 24JB of the Act prior to 2017 amendment. Furthermore, this study discusses the detail application of section 24JB of the Act and thereafter concludes on the combined implications of the accounting and tax principles on the application of section 24JB of the Act.

Section 11(*j*A) of the Act is part of this discussion to add completeness that impairment requirements under IFRS 9 do not apply to financial assets measured at fair value through profit or loss. As stated above, only financial measured at fair value through profit or loss are subject to section 24JB of the Act. In addition, section 11(*j*A) of the Act was added because some of the financial instruments held by a "covered person" might not all be subject to section 24JB of the Act and the inclusion of the impairment discussion is to illustrate how changes to those financial instruments would be treated for tax.

The other financial assets that are not measured at fair value through profit or loss are to be assessed for impairment under IFRS 9 using the expected credit loss model. For financial assets subject to section24JB of the Act, any expected credit loss would be reflected in the fair value changes and recognised in profit or loss and allowed for deduction accordingly and no separate loss allowance or impairment loss would be made.

This concept known as impairment under IFRS 9, requires entities to calculate provisions based on expected losses, covering all credit exposures. In short, as soon as a credit is originated companies are required to recognise provisions based on 12-month expected losses, that is, Stage 1 loans. Once a loan has experienced a "significant increase in credit risk" since initial credit recognition it should be moved to Stage 2 and Stage 3, respectively, with provisions being recognised based on lifetime expected losses. At issue is, does this introduction of accounting principles introduce new law and should this concept of "significant increase in credit risk" be defined to ensure consistency across all companies? Should this statistically estimated loan loss provision be considered as

incurred in terms of tax law?

The study also investigates section 24I of the Act as the tac treatment in terms of this section also follows accounting. In addition, given that a 'commodity' is not specifically defined in section 24JB of the Act and is recorded for accounting purposes using the accounting standard, IAS 2 (Inventories) that prescribes the accounting treatment of inventories, it was deemed necessary to investigate the reasons for the inclusion of commodities in section 24JB that only deals with financial instruments.

This study then compares the South African mark-to-market taxation regime with the mark-to-market regimes in Australia, Canada and the United Kingdom. These countries were selected based on the following principles, namely:

- the income tax legislation "taxes" gains and losses on financial instruments based on the amounts determined in accordance with IFRS 9; and
- the legislation in these countries specifically cover the financial asset or financial liability category where gains or losses will be reflected in the profit or loss section in the statement of profit or loss and other comprehensive Income.

The treatment of financial instruments is therefore similar or comparable to the treatment of financial assets and financial liabilities under section 24JB of the Act.

The comparative analysis specifically investigates the similarities or differences with the three identified countries that have introduced mark-to-market taxation on financial instruments. In all of the countries selected there are, however, slight differences. In the first country that is reviewed, Australia, the fair value taxation is elective (Income Tax Assessment Act, 1997:230). The United Kingdom, for example, is taxing the derivative income (derivatives will not be addressed in this study (see section 1.7) although it is covered by section 24JB of the Act). Furthermore, it has rules under the "loan relationships" section that defines "fair value accounting" as the basis of accounting under which assets and liabilities are measured and changes in fair value recognised in profit or loss (HM Treasury Corporation Tax, 2009:313). The third country, Canada, has to a

large extent similar rules to South Africa since the companies that utilise this method are banks and insurance companies. In terms of section 142.5 of Canada's Income Tax Act, a taxpayer that is a financial institution shall include annually in computing income the increase or decrease in the value of securities that are regarded as mark-to-market property. The financial institution is defined to include a bank and insurance company (Canada's Income Tax Act, 1985:142).

In the research for the Tax Law Review Committee of the Institute for Fiscal Studies, Macdonald (2002:46) argued that since tax law and accounting principles did not, and should not always conform, the divergence should be explicit and properly planned. Macdonald has called for legislation to set out accounting principles as they apply to taxation rather than leaving this to be reviewed by the courts' unspecified principles. It is in this spirit that the study will assess whether the tax legislation (section 24JB) is clear enough and can be read without any ambiguity.

Sub-section 1.7 sets out the limitations of this study given the various classifications for financial assets and financial liabilities.

1.7 LIMITATIONS OF THE STUDY

Financial instruments also include embedded derivative instruments. In general, an embedded derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition (IFRS 9.B4.3.3). However, in the absence of implied or stated terms, the entity makes its own judgement of the terms (IFRS 9.IG.C.1). These instruments fall outside the scope of the study, as there are certain instances where the financial assets or financial liabilities component does not fall within the scope of IFRS 9.

IFRS 9 places financial instruments into various categories (see section 1.2). For the purposes of this study specific emphasis will be placed on financial instruments that are

designated at fair value through profit or loss, as section 24JB of the Act is not applicable to the other classifications.

Given that the accounting of financial instruments is complex, the scope of this study will focus mainly on the annual accounting (in accordance with IFRS 9) of financial assets and financial liabilities designated at fair value through profit or loss. The tax is levied on this accounting fair value amount in terms of section 24JB of the Act at the end of the year of assessment of a “covered person”. Furthermore, the study investigates the definitions that are used in section 24JB of the Act but defined in IAS 32.

The replacement standard to IAS 39, IFRS 9 is effective for annual periods beginning on or after 1 January 2018. This study will analyse IFRS 9 in detail, however it will also investigate the significant changes from IAS 39 to IFRS 9 as this has an impact on the application of section 24JB of the Act with respect to financial instruments that were held at fair value through profit or loss. In addition, this study only briefly discusses the treatment of impairments under IFRS 9 as a separate section in Chapter 2 (see Chapter2.5). This is due to the 2017 Taxation Laws Amendment Act that introduced a separate section (section 11(*j*A)) into the Act that is applicable to a “covered person”, that is only a bank, that is effective for years of assessment commencing on or after 1 January 2018.

This study will analyse all tax amendments effective until 30 November 2021.

Chapter 4 focusses on the tax treatment of financial assets and financial liabilities in different jurisdictions. However, this discussion will be limited to the applicable tax legislation of four countries, namely South Africa, Australia, the United Kingdom and Canada.

Sub-section 1.8 highlights the significance of the study.

1.8 SIGNIFICANCE OF THE STUDY

It was stated in section 1.1 that the adoption of accounting standards by certain taxation laws to require the amounts that was determined using accounting principles to be used for tax may or may not be an appropriate base. In the main, is the fact that requirements of commercial accounting principles and taxation are not always aligned. This study assists in identifying divergent interpretations and inappropriate applications between the accounting and taxation of financial assets and financial liabilities. At the time of identifying and conducting this research, this is the first study that this researcher could identify that evaluates in detail the interaction between accounting principles and section 24JB of the Act.

This study, therefore, assists South African tax practitioners and auditors when section 24JB of the Act is applicable to their clients. In addition, this study can assist the SARS to carry out their functions in auditing a "covered person" or in issuing an interpretation note for section 24JB of the Act, given the complexities of the accounting standards dealing with financial instruments.

As a general matter, given that the objectives of taxation and accounting differs. Despite the efforts of introducing section 24JB of the Act, it is important that in practice, there is a thorough overview of this section to gauge if there are no divergent interpretations that may arise. The divergent interpretations and inappropriate applications that are identified in this study can help various stakeholders. The auditor appointed by the company in terms of section 90 of the Companies Act 71, of 2008, the individual determined by that firm, in terms of section 44(1) of the Auditing Profession Act to be responsible for performing the functions of auditor when it comes to the tax issues in section 24JB of the Act, and the accountant responsible for recording and disclosing financial instruments will be able to use this study to reconcile the accounting and taxation treatment of financial instruments. In addition, this study can assist South African tax practitioners and auditors and SARS officials to carry out their functions in auditing "covered person". This study will also assist SARS in issuing interpretation notes on section 24JB of the Act and National

Treasury in making amendments to the legislation. In addition, this study is significant as it reviews the interaction of accounting standards and tax legislation.

The following section provides a brief overview of the contents of chapter 1 to chapter 6.

1.9 CHAPTER OUTLINE

The study can schematically be presented as follows:

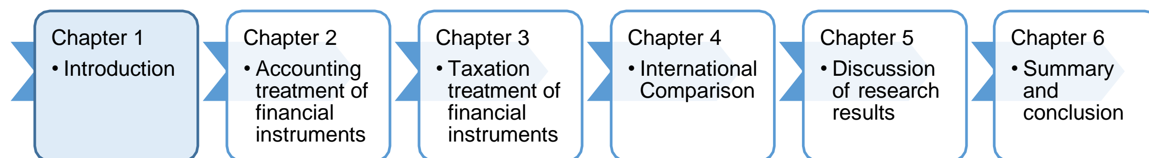


Figure 1.1: Study Outline

Source: Author's own

This study has been structured into the following chapters to achieve the purpose of the study:

Chapter 1:

Chapter 1 comprises of the analysis of the relationship between accounting and taxation, and it is stated that when there is a closer alignment, both the taxpayers and the revenue service will benefit. In addition, chapter 1 sets out the introductions to fair value accounting, section 24JB of the Act and aspects regarding the definition, classification and accounting treatment of a financial asset and a financial liability. Chapter 1 also sets out the research question and purpose of the study and defines the limitations and the significance of the study.

Chapter 2

This chapter investigates the accounting treatment of a financial asset and financial liability to reflect the gains and losses arising from changes in fair value and how those gains and losses are included in the statement of profit or loss and other comprehensive income in the period in which they occur. This chapter includes basic examples that will demonstrate the impact of the accounting standards on the application of section 24JB of the Act.

The examples that illustrate the accounting treatment of financial instruments in Chapter 2, together with certain diagrams, is utilised to demonstrate in Chapter 3 how section 24JB of the Act is applied.

Chapter 3

This chapter investigates the taxation treatment of financial instruments. Existing literature that is relevant to the research objectives are examined. In particular, this chapter summarises section 24JB of the Act. Furthermore, it also examines other sources that may relate to the core tax principles that may have deviated due to the "tax following accounting" approach in section 24JB of the Act.

Chapter 4

This chapter provides a comparative analysis relating to the taxation of financial instruments in the selected countries, namely, Australia, Canada and the United Kingdom and how it relates to section 24JB of the Act. This comparison identifies similarities and differences to highlight possible improvements to section 24JB of the Act.

Chapter 5

This chapter analyses the implications of the literature review, as well as the findings gathered from the international comparison.

Chapter 6

In summary, this chapter offers the conclusion and recommendations. At the main, it provides the extent to which the tax principles embodied in section 24JB conform with IFRS 9 and the previous accounting standard, IAS 39. In addition, it also indicates to what extent section 24JB of the Act deviates from the accounting standard and what areas still needs clarification or amendments. Areas for possible future research are also discussed.

1.10 CHAPTER SUMMARY

This chapter is the first step in analysing whether accounting principles in section 24JB of the South African tax legislation give rise to divergent interpretations and inappropriate applications. This chapter provided an overview of the taxation of financial instruments under section 24JB of the Act, including an introduction to the relevant accounting standards and their application to financial instruments. It highlighted the studies that indicated that it is possible for a greater alignment between tax and accounting, but that there are still grey areas that need to be investigated further to see whether these grey areas are addressed by the tax legislation. In addition, chapter 1 (see section 1.3) highlighted the reasons for the introduction of section 24JB of the Act.

Chapter 1 also stated the research question, research objectives and the importance of the study. The limitations of the study were also provided. It continued to give an overview of the proposed research methodology, as well as the proposed structure of the thesis.

Chapter 2 elaborates on the accounting standards and the treatment of financial assets and financial liabilities. In addition, accounting examples of how the gain or loss will be recognised in the statement of profit or loss and other comprehensive income are provided. This chapter includes a discussion on the differences in the change from IAS 39

to IFRS 9 as well as the applicable accounting treatment of financial instruments measured at fair value through profit or loss.

CHAPTER 2: ACCOUNTING TREATMENT OF FINANCIAL INSTRUMENTS

2.1 INTRODUCTION

Section 24JB of the Act was inserted by section 56 of Act 22 of 2012, and then substituted by section 71 of Act 31 of 2013. Section 24JB of the Act requires the amounts used for tax purposes to be calculated using accounting principles. The focus of this study is to compare the accounting definitions and principles to the application thereof in section 24JB of the Act to establish if there are divergent interpretations and inappropriate applications between accounting and taxation of financial instruments. Specifically, since the Act (section 24JB) in theory should be following the accounting treatment of financial instruments.

To achieve the objective of this study, the relationship between the accounting principles and the tax provisions dealing with financial instruments of a "covered person", envisaged in section 24JB of the Act, are investigated. This investigation is performed by comparing the taxation with the relevant accounting principles as encompassed in IAS 32 (Financial Instruments: Presentation), IAS 39 (Financial Instruments: Recognition and Measurement), IFRS 7 (Financial Instruments: Disclosures) and IFRS 9 (Financial Instruments) (which has a mandatory effective date for annual periods beginning on or after 1 January 2018). IAS 32 (Financial Instruments: Presentation) prescribes the presentation of financial instruments in the financial statements, whereas IFRS 9 (Financial Instruments) (that replaced IAS 39) prescribes the recognition and measurement of financial instruments. IFRS 7 (Financial Instruments: Disclosures) relates to the disclosure of financial instruments.

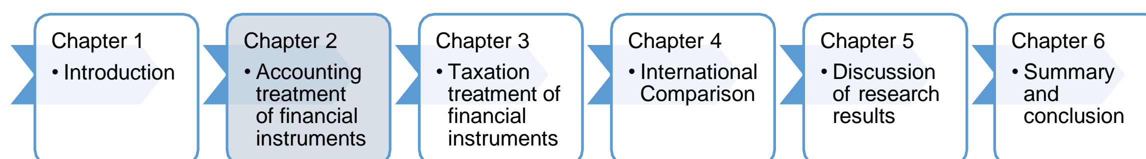
The aim of the comparison between the taxation and the accounting treatment of financial instruments is to identify possible divergent interpretations and inappropriate applications between accounting and in the application of the provisions of section 24JB of the Act.

This chapter commences with an analysis of the relevant accounting terminology and principles, where after the accounting treatment of financial instruments are discussed. It further investigates the profits or losses on financial instruments that are recorded in the statement of profit or loss and other comprehensive income for accounting purposes due to fair value changes of these financial instruments at year end. It has been established in Chapter 1, (see section 1.1.2) that fair value is measured as the difference between the beginning of the year value and the year-end value of the financial instrument. The main reason for this analysis is that section 24JB of the Act is applicable only to fair value amounts from financial instruments that are recognised for accounting purposes at the end of the financial year in profit or loss in the statement of profit or loss and other comprehensive income.

The following sections are investigated in this chapter: the basis for using IFRS by a "covered person" (see section 2.2), the qualitative characteristics of financial statements (see section 2.3), overview of the underlying accounting standards relevant to this study (see section 2.4), the main accounting standard applicable to this study, namely IFRS 9 (see section 2.5) and the chapter summary (see section 2.6).

The following diagram provides an overview of the structure of the dissertation and specifically where the discussion in this chapter fits into the study:

Figure 2.1: Study Outline



Source: Author's own

The objective of this study is to investigate the relationship between the accounting principles and the tax provisions dealing with financial instruments of a "covered person"

envisaged in section 24JB of the Act. The concept of a "covered person" is fully explained in Chapter 3 (see section 3.2.4.2). However, to facilitate the discussion in this chapter the concept is briefly explained and the discussion in the following section on using IFRS as the financial reporting framework is limited to the "covered person" definition.

In general, the definition of a "covered person" in the Act is intended to include banks and stockbrokers and their subsidiaries. In relation to a bank, the concept of "covered person"" includes, amongst others, any company or trust that forms part of a banking group as defined in section 1 of the Banks Act (Income Tax Act, section 24JB(1)). In relation to stockbrokers, a "covered person" means a company defined in section 1 of the Financial Markets Act (Income Tax Act, section 24JB(1)).

The following section will explain the basis for a "covered person" to utilise IFRS as their reporting framework.

2.2 BASIS FOR USING IFRS FOR FINANCIAL REPORTING PURPOSES

It is mandatory for all listed companies to prepare their financial statements in accordance with the IFRS, therefore a "covered person" must use IFRS as its financial accounting framework if that "covered person" is listed on the Johannesburg Stock Exchange (JSE) (JSE Listing Requirement 8.6.2(b)) and section 29(4) of the Companies Act 2008, 71 of 2008). This statement can be ascertained by the discussion below.

According to Shev (2012.35), the Companies Act No. 71 of 2008, as amended, that came into effect on 1 May 2011, requires every company and close corporation to calculate its public interest score (PIS) at the end of each financial year. Amongst other things, the PIS is used to determine the financial reporting standards applicable for the preparation of an entity's financial statements, whether those financial statements will be subject to an audit or an independent review, and who can perform the audit or independent review engagement.

Regulation 26(2) of the Companies Regulations, 2011 (hereafter 'Companies Regulations') state the criteria required to calculate the PIS score:

- average number of employees of the company during the financial year;
- third party liability of the company, at the financial year end;
- turnover during the financial year; and
- number of individuals who have a direct or indirect shareholding in the company.

Regulation 27 of the Companies Regulations then continues to prescribe the financial reporting standards for the preparation of financial statements, based on the PIS, for annual periods beginning on or after 1 May 2011. Most of the "covered person" as defined in section 24JB of the Act are listed on the JSE, perform securities services (largely in in the instance of stockbrokers) and have a high PIS score (due to being listed) and therefore the prescribed financial reporting standard to be used by these entities will be IFRS.

Even though section 24JB does not refer to the full IFRS but merely the relevant standards mentioned in sections 2.4 and 2.5 below, according to accounting rules, any entity claiming that a set of financial statements is in compliance with IFRS, must comply with all IFRS standards and related interpretations (IAS 1:16).

However, as an alternative, a private entity without public accountability, or a PIS score below the threshold, may consider applying IFRS for Small and Medium–sized Entities (IFRS for SMEs). The IFRS for SMEs is applicable for entities that publish general purpose financial statements for external users and that do not have public accountability. An entity will have public accountability if it files (or is in the process of filing) financial statements with the securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market or it holds assets in a fiduciary capacity for a broad group of outsiders (KPMG 2013:11). Therefore, it can be deduced that a "covered person" cannot be eligible to use IFRS for SMEs as it will fail the "without public accountability" test mentioned above.

In addition, to ensure the validity of these financial statements, a "covered person's" annual financial statements are required to be audited as determined by section 30 of the Companies Act No.71 of 2008 read with Regulations 28 and 29 of the Companies Regulation. As the financial statements are audited, an unqualified report assists the SARS to rely on amounts provided in the tax return (tax filings) submitted.

The following section explains the characteristics that will help a stakeholder (including SARS) to identify the information that is useful in financial reporting. SARS is of specific importance as a stakeholder in this instance since they will have to administer the application of section 24JB of the Act. The section discusses the qualitative characteristics applicable to general purpose financial statements; that is, financial statements intended to meet the information needs common to a range of users who are unable to command the preparation of reports tailored to satisfy their own needs.

2.3 QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

Christian and Ludenbach (2013:2) confirms that the objective of general purpose financial reporting is a very broad concept namely that "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity" (Conceptual Framework OB2:2018). It may be on this basis that Mackenzie (2013:28) states that the accounting standards assist national standard-setters, preparers, auditors, users and others interested in IFRS in completing their tasks.

Van Beest, Braam and Boelens (2009:3) state that the IASB highlights the importance of high-quality financial reports; however, one of the key problems found in prior literature is how to operationalise and measure this quality. Because this high quality is context-specific and since different user groups will have dissimilar preferences, perceived quality will deviate among constituents. However, Barth, Landsman, Lang and Williams (2012:70) found higher quality and increased comparability when comparing financial

statements between companies and across countries due to the adoption of IFRS by these companies and countries.

According to Mackenzie (2013:28) it was envisaged that the objective and qualitative characteristics in the conceptual framework allow users to make appropriate decisions.

These qualities represent the criteria by which a user can, *inter alia*, judge accounting information. SARS places reliance on the correctness of the financial statements due to procedures carried out by independent persons on the financial statements in assessing risk visà-vis the accuracy of taxable income (National Treasury. 2012:57). This is necessary since the income tax calculation in the tax return starts with the accounting information in the annual financial statements, which is then subsequently adjusted in the tax return due to divergence between the treatment of certain items/ transactions for accounting and tax purposes.

The qualitative characteristics are divided into fundamental qualitative characteristics and enhancing qualitative characteristics (Conceptual Framework QC 5 and QC 9: 2018) According to Van Beest et al (2009:9), the fundamental qualitative characteristics (i.e., relevance and faithful representation) are the most important and determine the content of financial reporting information. The enhancing qualitative characteristics (i.e., understandability, comparability, verifiability and timeliness) can improve decision usefulness when the fundamental qualitative characteristics are established. However, the enhancing qualitative characteristics cannot determine financial reporting quality on its own. To understand the qualitative characteristics of financial information, the fundamental characteristics are discussed in more detail below.

According to the summarised Conceptual Framework (Conceptual Framework QC 6- QC 9) relevant and faithful representation is explained as follows:

> Relevant financial information "*is capable of making a difference in the decisions. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both. The predictive value and confirmatory*

value of financial information are interrelated." Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes (adapted from Conceptual Framework:QC6). Financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations (adapted from Conceptual Framework: QC9).

- Faithful representation is explained as "*general purpose financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only be relevant, it must also represent faithfully the phenomena it purports to represent. Faithful representation means representation of the substance of an economic phenomenon instead of representation of its legal form only. A faithful representation seeks to maximise the underlying characteristics of completeness, neutrality and freedom from error. A neutral depiction is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty*." This means that the financial information represents the substance of an economic phenomena rather than merely representing its legal form (Conceptual Framework: BC3.26). It includes three characteristics that is: complete, neutral and free from error. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. A neutral depiction is without bias in the selection or presentation of financial information. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process (adapted from Conceptual Framework QC 12-14).

In summary, it can be concluded that the predictive value and the confirmatory value of financial information contributes to the relevance of financial reporting information. Therefore, if a "covered person" (in terms of section 24JB(1) of the Act) submits information to SARS the relevance characteristics provide feedback to SARS about previous transactions or events, with respect to financial instruments. For example, shares in a certain company may be regarded as a financial asset by a "covered person"

and SARS will be able to confirm for example a deduction claimed by a “covered person” based on confirmatory value of that share because confirmatory value provides feedback about previous evaluations by using qualitative characteristics because tax returns are submitted after the year end.

The following sections (see section 2.4 and 2.5) will analyse the accounting standards applicable to financial instruments.

2.4 INTRODUCTION TO IAS 32, IAS 39 AND IFRS 7

It was outlined in Chapter 1 how IAS 32 (Financial Instruments: Presentation), IAS 39 (Financial Instruments: Recognition and Measurement) and IFRS 7 (Financial Instruments: Disclosures) form the basis for the taxation of financial instruments under section 24JB of the Act (see section 2.1). IAS 39 is analysed in this section, even though IFRS 9 (discussed under section 2.5) is now the applicable accounting standard because when section 24JB of the Act was introduced, IAS 39 was applicable. The objective of these standards can be summarised as follows:

- with respect to IAS 32, the objective is to establish principles for the classification (presentation) as a financial asset or financial liability and the classification of the related interest, dividends, gains and losses (IAS 32:2).
- the objective of IAS 39 was to set out the principles relating to the accounting treatment of a financial instrument (IAS 39:1). It has been superseded by IFRS 9 for periods beginning on or after 1 January 2018.
- the objective of IFRS 7 is to clarify the disclosures related to market risk, credit risk, liquidity risk and fair values of financial instruments (IFRS 7:32).

The following order will be followed to analyse IAS 32, IAS 39 and IFRS 7:

- IAS 32 will be discussed first because this standard contains the definitions of a financial asset and financial liability and these definitions form an integral part of this study and the discussions to follow.
- Thereafter, IAS 39 is analysed as it was the accounting standard applicable when

section 24JB of the Act was issued.

- Finally, the application of IFRS 7 is discussed. It relates to the disclosure of a financial instrument that is measured at fair value through profit or loss.

2.4.1 ANALYSIS OF IAS 32

2.4.1.1 History and objectives of IAS 32

IAS 32 was issued in 1995 and represented a commitment to a strict 'substance over form" approach. The substance of a financial instrument rather than its legal form governs its classification on the statement of financial position (Mackenzie: 2013: 628). This study focusses on the current revised format of IAS 32. The objective of IAS 32 is to provide amongst others, principles for presenting financial instruments as assets, liabilities or equity, classifying financial instruments into financial assets, financial liabilities, equity and the classification of the related interest, dividends, losses and gains (IAS 32:2).

IAS 32 defines a financial instrument as any contract that gives rise to a financial asset of one entity and financial liability or equity instrument of another entity. In addition, this standard split financial instruments into financial assets and financial liabilities. Financial assets include cash, equity instruments, contractual rights to receive financial assets or a contract that will or could be regulated in an entity's equity instruments. A financial liability is any liability in the form of a contractual obligation or a contract that will or may be settled in the entity's own equity instruments (IAS 32:11).

2.4.1.2 Definition of financial asset and financial liability

The Preface to IFRS was approved in 2002 and generally sets out the objectives of the IASB. The Preface states that an objective of IASB is to develop accounting standards in order:

"…to help participants in the various capital markets of the world and other users of the information to make economic decisions." (IASB, 2003).

Therefore, using the Preface to IFRS as a means of interpretation, it appears that the information provided by IFRS primarily serves the needs of investors rather than the needs of creditors (Hilling, 2007: 9).

The Conceptual Framework that was first issued by IASB in September 2010 and reissued in March 2018, generally establishes the concepts that underlie international accounting standards. Furthermore, it thoroughly explains concepts that are commonly used in IFRS. For instance, in IAS 32 and IAS 39, the term "financial asset" or "financial liability" (that is referred to in section 24JB of the Act) is defined with reference to the term "asset" or "liability". An "asset" is not defined in the IAS 32 or IAS 39 standard, however in the Conceptual Framework (2018: paragraphs 4.8 and 4.15), an asset is defined as a resource controlled by a company as a result of a past event, and from which future economic benefits are expected. Similarly, a liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

According to IAS 32 paragraph 11, a *financial asset* and a *financial liability* are defined as follows:

A *financial asset* is any asset that is:

- *"cash (e.g. a deposit at a bank)* – this asset is not covered by section 24JB of the Act*;*
- *a contractual right to receive cash (e.g. a receivable (debtor) or another financial asset from another entity* – this asset is covered by section 24JB of the Act;
- *a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable (e.g. a forward exchange contract taken out to hedge a foreign creditor and while the Rand deteriorates)* – this asset is covered by section 24JB of the Act;
- *any equity instrument of another entity (e.g. investment in shares of another entity)* – this asset is covered by section 24JB of the Act although some investment may

be excluded from section 24JB of the Act if this financial asset does not constitute trading stock (see chapter 3); *or*

- *a contract that will or may be settled in the entity's own equity instruments and is*
    - *a non-derivative for which the entity is or may be obliged to receive a variable number depending on market value of shares, of the entity's own equity instruments; or*
    - *a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments* – this asset is covered by section 24JB of the Act".

A financial liability is a contractual obligation to:

- *"deliver cash (e.g. creditors and loans payable) or another financial asset (e.g. loan repayable in government bond) to another entity* – delivery of cash is not covered by section 24JB of the Act however, delivery of financial asset is covered by section 24JB of the Act*;*
- *exchange financial instruments with another entity under conditions that are potentially unfavourable (e.g. a forward exchange contract taken out to hedge a foreign creditor when the Rand improves)* – this asset is covered by section 24JB of the Act *or*
- *a contract that will or may be settled in the entity's own equity instruments and is:*
    - *a non-derivative for which the entity is or may be obliged to deliver a variable number of its own equity instruments; or*
    - *a derivative that will or may be settled other than by the exchange of fixed amounts of cash or another financial asset for a fixed number of the entity's own equity instruments* - this asset is covered by section 24JB of the Act.

To summarise what constitutes a financial asset and a financial liability, the definition of an asset and liability in the Conceptual Framework is important to distinguish if the company will be expecting future economic benefits or is expected to pay another party, thus an outflow of economic resources (no benefit). Therefore, to the extent that the company will receive benefits, it is a financial asset and a financial liability if the company

is obligated to pay the other party. To practically illustrate the types of financial assets and liabilities within the scope of section 24JB of the Act, the following examples of each is provided:

Example 2.1: Illustration of financial asset

Facts: Entity A holds 10 000 shares in entity B valued at R 2. These shares were acquired at fair value on 1 January 2020 for purposes of receiving dividends. Therefore, this investment in equity shares of entity B would be classified as a financial asset in the accounting records of entity A at R 20 000. At 31 December 2020, the value of the share in entity B is R 3.

Results: The aim of investing is to receive dividends; therefore, this is a financial asset as the company will be receiving economic benefits.

Source: Adapted from "Descriptive Accounting, IFRS Focus. by Q Vorster* et al *2007

Example 2.2: Illustration of financial liability

Facts: Company A issues 1 million redeemable preference shares of R 0.50 cents each, on 1 January 2020 and each preference shareholder is entitled to a fixed dividend of 5 per cent annually, subject to distributable profits. The preference shares are redeemable for cash at the option of the holder. Company A has a contractual obligation to the preference shareholders, both in respect of dividends and to return the cash when the holder redeems. The value of a preference share on 31 December 2020 is R 0.80 cents.

Results: Given that company A must pay the dividends and must repay the money whenever the holder demands repayment, it can be concluded that the preference shares are financial liabilities of Company A.

Source: Author's own

This section explained what a financial asset and financial liability is. The following section

will analyse IAS 39 with respect to the recognition and measurement of financial instruments. Although IFRS 9 will be applicable for years of assessment beginning on or after 1 January 2018, it is still important to understand the application of IAS 39 since it was the applicable accounting standard when section 24JB of the Act was introduced.

2.4.2 ANALYSIS OF IAS 39 WITH RESPECT TO FINANCIAL INSTRUMENTS

2.4.2.1 History and objectives of IAS 39

According to Vorster, Koen, Koornhof and Oberholster (2007:634), IAS 39 (2004 revision) shall be applied for annual periods beginning on or after 1 January 2005. Vorster et al (2007:634), continues by stating that IAS 39 sets requirements for the accounting treatment of a wide range of instruments, including all derivatives, an entity's investments in debt and equity securities, financial assets and financial liabilities at fair value through profit or loss.

IAS 39 was applicable to all financial instruments (including a financial asset and financial liability), except for:

i. interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IAS 27 (Separate Financial Statements), IAS 28 (Investments in Associates and Joint Ventures) and IAS 31 (Interest In Joint Ventures) respectively;
ii. rights and obligations under leases to which IAS 17 (Leases) applies;
iii. employers' rights and obligations under employee benefit plans, to which IAS 19 (Employee Benefits) applies;
iv. financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32;
v. rights and obligations arising under (i) an insurance contract as defined in IFRS 4 Insurance Contracts, other than an issuer's rights and obligations

arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) a contract that is within the scope of IFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of IFRS 4 if the derivative is not itself a contract within the scope of IFRS 4;

vi. contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date;

vii. loan commitments other than those loan commitments described in paragraph 4;

viii. financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 Share-based Payment applies, except for contracts within the scope of paragraphs 5–7 of this Standard, to which this Standard applies;

ix. rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognises as a provision in accordance with IAS 37, or for which, in an earlier period, it recognised a provision in accordance with IAS 37 (IAS 39:2).

According to Vatsadze (2017:19), IAS 39 was an accounting standard that set out the principles for the recognition and measurement of financial instruments and some contracts for buying or selling of non-financial items. Usually, financial instruments are initially recognised when an entity becomes a party to the contractual provisions of the instrument, and are classified into various categories, which depending on the type of instrument, then determines the subsequent measurement of the instrument.

2.4.2.2 Classification and Measurement of Financial Instruments

At initial recognition an entity shall measure a financial instrument at its fair value plus (in the case of financial instruments not at fair value through profit or loss) transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (IAS 39:43).

Thereafter, financial assets are classified into the following four categories that are defined in paragraph 9 of IAS 39 (IAS 39:45):

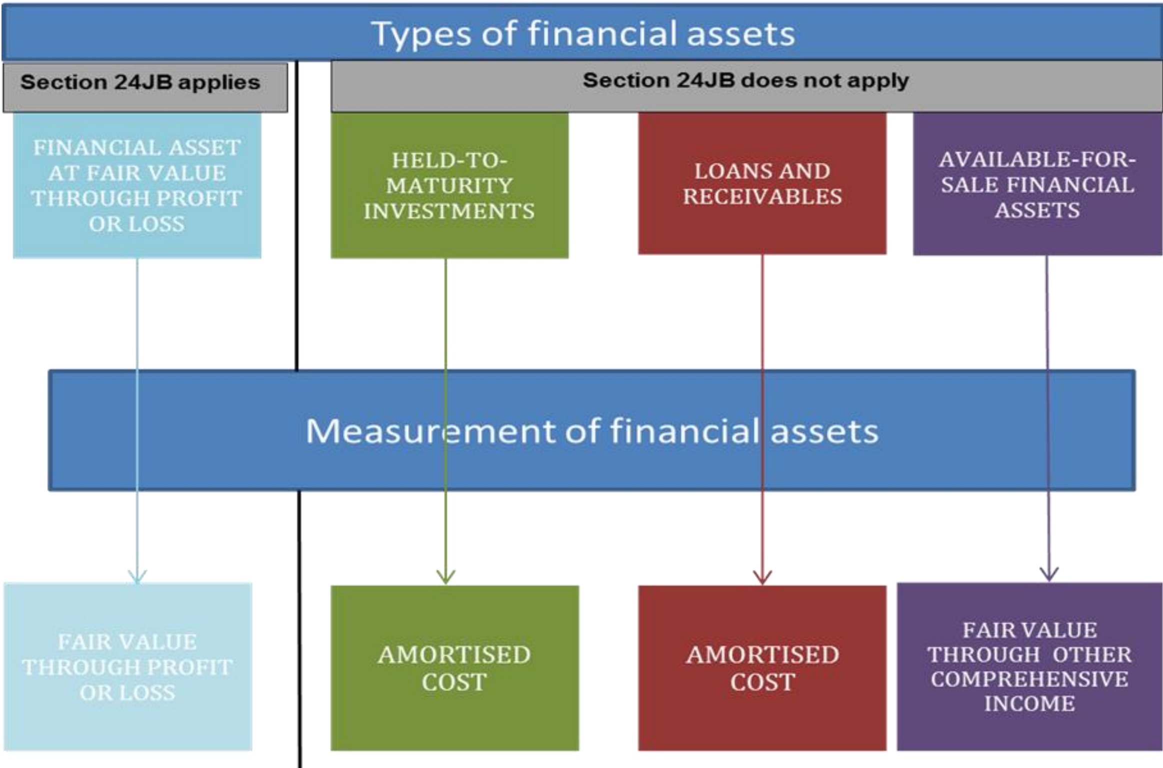
- Financial assets at fair value through profit or loss, this category will be discussed in detail below.
- Held to maturity investments, these instruments are non-derivative assets with fixed payments and a fixed term to maturity where the company intends to hold the asset until maturity (IAS 39:9). These instruments are measured at amortised cost using the effective interest method.
- Loans and receivables, these instruments are non-derivatives and have fixed payments (IAS 39:9). These instruments are subsequently measured at amortised cost using the effective interest method (IAS 39:46). Gains or losses are recognised in profit or loss through the amortisation process and when the financial asset is derecognised or impaired (IAS39:56).
- Available-for-sale financial assets, these are non-derivative assets that are designated as available-for-sale or that cannot be classified into any of the other three categories mentioned above (IAS 39:9). Gains or losses arising from changes in the fair value of available-for-sale financial assets are recognised in equity in other comprehensive income, except for impairment losses and certain foreign exchange gains and losses (IAS 39:46).

Therefore, according to IAS 39, after initial recognition, financial assets shall be classified into four categories. Unlike a financial asset, a financial liability has two categories, which are financial liabilities measured at amortised cost or financial liabilities measured at fair value through profit or loss. Section 24JB(2) of the Act allows amounts to be included in, or deducted from income if these amounts are recognised in profit or loss in the statement of comprehensive income. Note that accounting refers to statement of profit or loss and other comprehensive income while under the Act, reference is made to profit or loss in the statement of comprehensive income. For purposes of this study, the accounting term of statement of profit or loss and other comprehensive income is used. It is not clear why there was a difference in the wording, however, based on the intention by the legislator

these two terms should have the same meaning. The amounts should be in respect of financial instruments of the “covered person” that are measured at fair value in profit or loss in terms of IAS 39 (now in terms of IFRS 9). Therefore, for the purpose of this study, only the financial instruments measured at fair value through profit or loss are discussed.

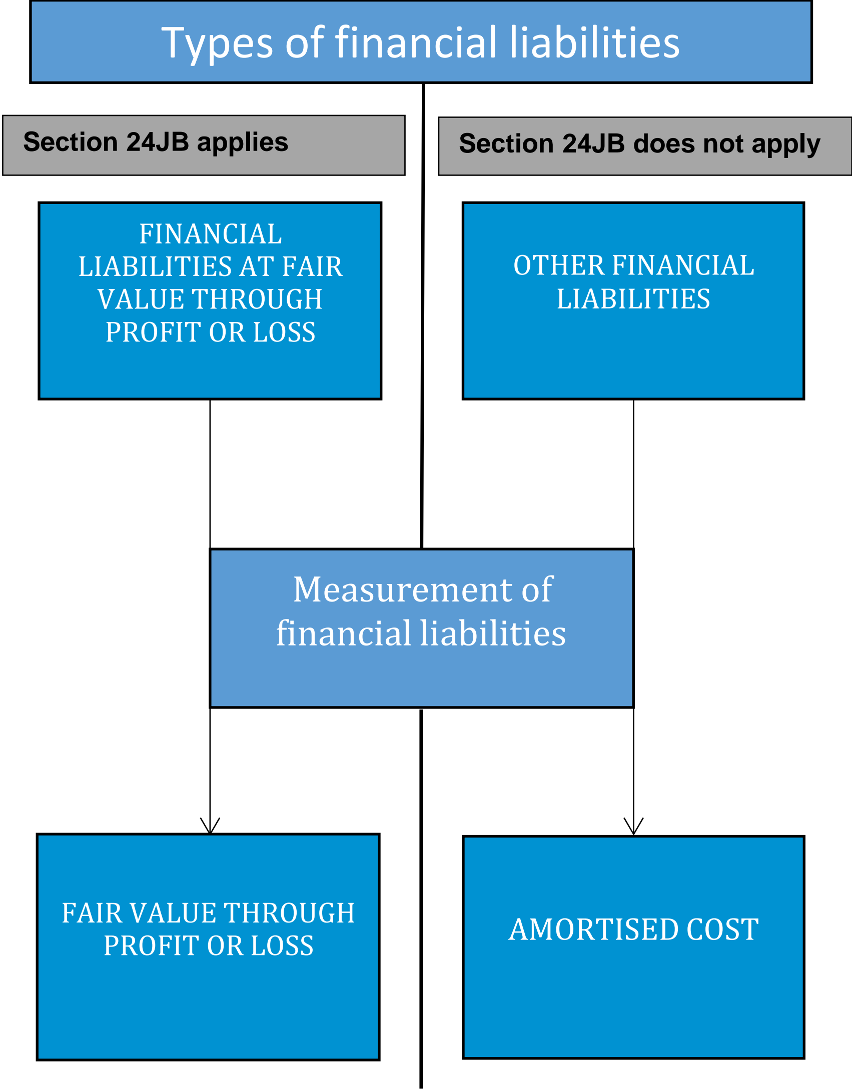
The figures below illustrate the classification of financial assets and financial liabilities in accordance with IAS 39. There are four types of financial assets and only the financial asset at fair value through profit or loss is recognised at fair value through profit or loss and subject to section 24JB of the Act. However, there are two types of financial liabilities and similarly only the financial liability at fair value through profit or loss is subject to section 24JB of the Act.

Figure 2.2: Types of financial assets per IAS 39, indicating where section 24JB was applicable and not applicable



Source: Author’s own

Figure 2.3: Types of financial liabilities per IAS 39, indicating where section 24JB was applicable and not applicable.



Source: Author's own

The section below will discuss the financial instruments at fair value through profit or loss category. The financial instruments at fair value through profit or loss category have two sub-categories ('held-for-trading' and 'designation'). This section will explain in detail the two key concepts ('held-for-trading' and 'designation') used to describe this category.

2.4.2.3 Financial instruments classified at fair value through profit or loss

According to the definition of a financial asset or financial liability at fair value through profit or loss, that financial instrument should meet either of the following conditions (IAS 39:9):

"(a) It must be classified as held for trading. A financial asset or financial liability is classified as held for trading if:

(i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

(ii) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

(iii) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument), or

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A of IAS 39, or when doing so results in more relevant information, because either

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 Related Party Disclosures (as revised in 2003)), for example the entity's board of directors and chief executive officer."

These conditions are discussed in more detail below.

(a) Held-for-trading

According to Mackenzie (2013:617), the financial instruments reported at fair value through profit or loss are those financial instruments that are either acquired or incurred for trading. It is explained that trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in the price or dealer's margin (IAS39:AG14). The term "portfolio" was not defined in IAS 39 but when read it seems to suggest a collection of financial assets and financial liabilities.

These financial instruments are therefore principally held for:

a. the purpose of generating a profit from short-term fluctuations in price or dealer's margin; or
b. which are held as part of identified commonly managed financial instruments and for which there is a pattern of short-term profit-taking by the entity; or
c. which is a derivative unless designated for, and effective as, a hedging instrument or upon initial recognition is designated for carrying at fair value through profit or loss.

It should further be noted that a financial liability used to fund trading activities does not in itself make that financial liability one that is held for trading (IAS 39:AG15). The question arises whether this accounting financial liability that was used to fund trading activities, but does not qualify to be a financial liability is still regarded as a financial liability for purposes of section 24JB of the Act? A discussion on possible divergent interpretations and inappropriate applications between tax and accounting will follow in Chapter 3.

(b) (i) Designation of a financial asset or a financial liability at fair value through profit or loss

The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it was not required to be applied consistently to all similar transactions). This means, an entity chose freely when the relevant criteria were met and then which of its financial assets and financial liabilities were to be designated (IAS39:AG4C). Mackenzie (2013:617) further explains that where an entity has designated the financial assets or financial liabilities at fair value through profit or loss, that category was irrevocable. This means that the classification cannot be changed at a later stage.

(b) (ii) Designation eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch)

According to the 'Basis for Conclusions' on IAS 39, a mixed measurement under which some financial instruments are measured at fair value and others at amortised cost results in some gains and losses that are recognised in profit or loss and others in other comprehensive income. This combination of measurement and recognition requirements can result in inconsistencies (sometime referred to as an accounting mismatch) between the accounting for an asset and a liability. An accounting mismatch occurs when assets and liabilities that are economically related are treated inconsistently (IAS 39:BC75). This is evidenced when a financial asset that is classified as available for sale with most changes in fair value recognised directly in other comprehensive income while the related financial liability is measured at amortised cost (where changes in the fair value are not recognised). In this case, a company may decide that its financial statements would provide more relevant information if both the financial asset and the financial liability were classified as at fair value through profit or loss (IAS 39:AG 4D).

The second situation in which the fair value option may be used was where a group of

financial assets, financial liabilities or both was managed and its performance was evaluated on a fair value basis, in accordance with a documented risk management or investment strategy. According to the Application Guidance ("AG") to IAS 39, the focus in this case was on the way the entity manages and evaluates performance rather than on the nature of the financial instrument (IAS 39:AG4H). The following example was given in AG 4I: the entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (interest or dividends and changes in fair value) and evaluates its performance on that basis. The portfolio may be held to back specific liabilities. If the portfolio is held to back specific liabilities, the condition may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis.

The following examples (examples 2.3 and 2.4) reflect the amounts that will be recognised as a gain or loss in the statement of profit or loss and other comprehensive income for the year ended after the financial instrument has been measured at fair value.

Example 2.3: Illustration of amounts that will be recognised in the statement of profit or loss and other comprehensive income

Facts: Entity A holds 10 000 shares in entity B valued at R 2. These shares were acquired at fair value on 1 January 2021. Therefore, this investment in equity shares of entity B would be classified as a financial asset in the books of entity A at R20 000. On 31 December 2021, the value of the share in entity B is R3. Entity A classified the investment in equity shares of entity B as at fair value through profit or loss.

Solution: On 31 December 2021, entity A will reflect a gain of R 10 000 in profit or loss in the statement of profit or loss and other comprehensive income section (as per section 2.4.2.2 above) being the difference of share price (R 3 to R 2) multiplied by 10 000 shares.

Source: Adapted from "Descriptive Accounting, IFRS Focus. by Q Vorster et al 2007

Example 2.4: Illustration of the calculation of financial liability at year end reflecting a "loss"

Facts: Company A issues 1 million redeemable preference shares for R 0.50 each, on 1 January 2021 and each preference shareholder is entitled to a fixed dividend of 5 per

cent annually, subject to distributable profits. The preference shares are redeemable for cash at the option of the holder. Company A has a contractual obligation to the preference shareholders, both in respect of dividends and to return the cash when the holder redeems. The value of preference shares on 31 December 2021 is R0.80 cents each. Company A classified the preference shares as fair value through profit or loss.

<u>Solution:</u> *On 31 December 2021, company A will reflect a loss R 300 000 in profit or loss in the statement of profit or loss and other comprehensive income (as per section 2.4.2.2 above) being the difference of share price (R 0.80 and R 0.50) multiplied by 1 million preference shares.*

Source: Author's own

Based on example 2.3 and example 2.4 above, section 24JB(2) of the Act would allow an amount of R10 000 to be included in, and allow an amount of R 300 000 to be deducted from income, respectively, because these amounts would have been recognised in the statement of profit or loss and other comprehensive income. These amounts are included as it is in respect of financial assets and financial liabilities of the "covered person" that are measured at fair value in profit or loss in terms of IFRS 9 (and previously under the provisions of IAS 39).

The following section deals with the impairment of financial assets that are not measured at fair value through profit or loss category. Although in these categories, the fair value gains or losses in respect of financial assets are recognised in other comprehensive income, in the event that there is an impairment in the financial assets held in these categories, that loss is reflected in profit or loss in the statement of profit or loss and other comprehensive income. It is for this reason that brief discussions on the impairment loss of financial assets in these categories are required since it will result in a tax implication.

2.4.2.4 Impairment of financial assets that are not recognised at fair value through profit or loss statement as per IAS 39

IAS 39 requires that a financial asset or group of financial assets (except for financial assets measured at fair value through profit or loss) need to be assessed at the end of each reporting period whether there is any objective evidence that the assets are impaired (IAS 39:58). The exclusion from the annual assessment of financial assets measured at fair value through profit or loss is due to the fact that its fair value adjustments are already recognised in profit or loss. According to Mackenzie (2013:656), this assessment is a result of one or more events that occurred after the initial recognition of the asset (a loss event) and that loss event impacts the estimated future cash flows of the financial asset that can be reliably estimated. Mackenzie further states that loss events include any significant financial difficulties of the issuer, a contractual breach (default or delinquency) by the issuer, the probability of a bankruptcy or financial reorganisation, or the disappearance of an active market for the issuer's instruments.

IAS 39 requires that the impairment loss be recognised for financial assets carried at amortised cost (that is financial assets in the loans and receivables category, held-to-maturity investments category and available-for-sale category) if there is objective evidence that an impairment has been incurred (IAS 39:63).

2.4.2.4.1 Impairment of financial assets at amortised cost

If there is objective evidence that an impairment loss has been incurred on an asset carried at amortised cost (i.e., loans and receivables or held-to-maturity investments), the amount of the loss is measured as the difference between –

a) the asset's carrying amount; and

b) the present value of estimated future cash flows (excluding future losses that have not been incurred) discounted at the asset's original effective interest rate.

The carrying amount shall be reduced either directly against the financial asset or with the use of an allowance account, with the amount of the loss recognised in profit or loss (IAS 39:63).

2.4.2.4.2 Impairment of available for sale financial assets

The fair value of an equity security that is classified as available-for-sale may decrease below its carrying amount but that is not necessarily evidence of impairment. When an entity reports fair value changes on available-for-sale financial assets in other comprehensive income and equity in accordance with IAS 39 it continues to do so until there is objective evidence of impairment. If objective evidence of impairment exists, any cumulative impairment loss that has been recognised in other comprehensive income should be reclassified from equity to profit or loss for the period (IAS 39:67).

The amount of cumulative impairment loss that is reclassified from equity to profit or loss is the difference between the acquisition cost and the current fair value, less any impairment loss previously recognised in other comprehensive income and not yet recognised in profit or loss (IAS 39:68).

For available-for-sale equity investments, past impairment losses recognised in profit or loss should not be reversed through profit or loss when fair value increases (IAS 39:69). Since no reversals of the impairment loss is allowed for equity instruments, if subsequent to impairment recognition there is an increase in the fair value of the available-for-sale investment, that increase is recognised in other comprehensive income and not profit or loss.

Reversals of impairment losses recognised in profit or loss for an investment in debt instruments should be reversed with an amount of the reversal recognised in profit or loss if the increase in the fair value is objectively linked to an event occurring after the impairment loss was recognised (IAS 39:70).

What can be deduced above is that an impairment loss should always be recognised in profit or loss. However, section 24JB of the Act did not exclude impairment loss from financial instruments recognised in profit or loss in the statement of profit or loss and other comprehensive income. Given that there was no clarity on the tax treatment of these impairment losses, for a taxpayer this creates uncertainty. The fact that there was no clarity on the tax treatment of these impairment losses links to the Norberg (2007:3) analysis about the association between financial accounting and tax accounting in Chapter 1 (see section 1.1). Norberg (2007:3) indicated that certain questions can be raised where the basic rule is covered by specific tax rules however, if a specific situation is not covered by a specific tax rule but is left to the basic rule, one needs to consider whether it should be interpreted using accounting principles or not? In this instance, regardless of the fact that these financial assets mentioned above are not fair valued therefore any gains or losses do not affect the statement of profit or loss and other comprehensive income, impairment may be measured based on an instrument's fair value using an observable market price (IAS 39:AG84).

Based on above, can it be concluded that a "covered person" was eligible for a deduction of impairment based on the fact that the deduction of a loss (impairment loss) was in relation to: (1) a financial asset, (2) the amount was measured at "fair value" and (3) this amount was recorded in the statement of profit or loss and other comprehensive income in terms of IAS 39? If the "covered person" was not eligible for a deduction, was it because section 24JB's intention was to cover only financial instruments that are recognised at fair value through profit or loss? This raises another question for SARS, namely, how far should SARS go when auditing these amounts? Is it expected that SARS should confirm the method of measurement used to determine the value of these financial instruments that are not recognised at fair value through profit or loss? Further analysis of impairment losses will be addressed in Chapter 3.

The following section discusses reasons that led to the IASB to embark on a project to replace IAS 39 with IFRS 9 due to the complexities of IAS 39 and what is contained in the IFRS 9 standard.

2.5 IFRS 9 – REPLACEMENT STANDARD TO IAS 39

2.5.1 HISTORY AND REASONS FOR THE INTRODUCTION OF IFRS 9

In a response to the financial crisis in 2008, the IASB commenced its work on IFRS 9 in November 2008 and issued the complete version of IFRS 9 in July 2014 (Picker, Clark, Dunn, Kolitz, Livne, Loftus & van der Tas 2016:156). IFRS 9 introduced a new classification and measurement approach for financial assets and financial liabilities, a forward-looking expected credit loss model, an improved hedge accounting model and a better approach to deal with the so-called "own credit" issue. These changes were made to address the concerns that the Group of Twenty (G-20, an international forum for the governments and central bank governors from 20 major economies), the Financial Crisis Advisory Group and others had raised (Picker et al 2016:156).

An extract of the Report of the Financial Crisis Advisory Group, 28 July 2009 state the following:

"While the post-mortems are still being written, it seems clear that accounting standards were not taken as a root cause of the financial crisis. At the same time, it is clear that the crisis has exposed weakness in accounting standards and their application. The weaknesses primarily involved (1) the difficulty of applying fair value ('mark-to-market' accounting in illiquid markets; (2) the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies and other financial institutions and (3) the extraordinary complexity of accounting standards for financial instruments, including multiple approaches to recognising asset impairment.

Proponents of fair value accounting do not deny that indeed mark-to-market accounting shows the fluctuations of the market, but they maintain that these cycles are a fact of life and that the accounting standards provided 'early warning' signals by revealing the market's discomfort with inflated asset values. In their view, this contributed to a timelier

recognition of problems and mitigation of the crisis.

However, improvements in standards that enhance transparency and reduce complexity can help restore the confidence of financial market participants and thereby serve as a catalyst for increased financial stability and sound economic growth".

The extract of the report above, summarises the issues and complexities that were identified in the accounting of financial instruments and the need to enhance the related standard, that is IAS 39 and replace it with IFRS 9.

On 24 July 2014, the IASB issued IFRS 9 Financial Instruments as the final version of the project to replace IAS 39 Financial Instruments: Recognition and Measurement. IAS 39 sets out the requirements for classifying and measurement of financial instruments. However, IAS 39 is a complicated standard and many users (possibly this statement was made to include an extract of the report mentioned above) of financial statements and other interested parties asked the IASB to develop a new standard for financial reporting of financial instruments (IFRS 9.4). The IASB developed IFRS 9 with the objective of improving usefulness for users of financial statements by simplifying the requirements for the financial reporting of financial instruments (IFRS 9.IN2).

The measurement rules in IFRS 9 address the following issues:

- initial measurement
- subsequent measurement
- reclassifications
- gains and losses
- impairment of financial assets

2.5.2 FINANCIAL ASSETS UNDER IFRS 9

As stated above, IFRS 9's objective is to set principles for financial reporting of financial instruments that is relevant and useful to users in assessing the amounts and timing of

an entity's future cash flows. This study will only address the initial and subsequent measurements of financial instruments that are relevant to the study.

2.5.2.1 Initial measurement of financial asset

The requirements for the initial measurement of financial instruments under IFRS 9 are the same as under IAS 39, (see section 2.4.2.2). A change in IFRS 9 is that an entity shall measure trade receivables at their transaction price (as defined in IFRS 15 Revenue from Contracts with Customers) if they do not contain a significant financing component, or if the entity applies the 'practical expedient' in accordance with IFRS 15 (IFRS 9.5.1.3) (IFRS 15 includes contract assets).

2.5.2.2 Subsequent measurement of financial asset

According to Picker et al (2016:168), during the credit crisis commentators argued that IAS 39 contained too many categories of financial assets (see four categories mentioned in section 2.4.2.1 figure 2) that did not cater specifically for various business models, in particular for those used by the banks, and it was not flexible enough to allow preparers to reclassify the category of the financial assets when their business model changed. Grant Thornton (2015:2) concurred with this view when the firm stated that the IASB, when publishing the original 2009 version of IFRS 9, made a conscious effort to reduce the complexity in accounting for financial assets by identifying just two categories of financial assets (fair value and amortised cost). Further discussions stated that having just two categories would create too sharp a divide between financial instruments that are measured at fair value through profit or loss and the ones measured at amortised cost. In addition, the two categories failed to reflect the way many businesses manage their financial assets. This resulted in an additional category being added in July 2014 when the final version of IFRS 9 (2014) was published.

Picker et al (2016:168) summarised the amendments as a result to the feedback provided, by saying that the IASB issued a proposal with three categories of financial

assets, no options and rigid criteria to classify financial assets that included the business model test.

IFRS 9 requires that financial assets are classified subsequently into categories of "amortised cost" or "fair value through other comprehensive income" (FVOCI) or "fair value through profit or loss" on the basis of both:

A. the entity's business model for managing the financial assets; and

B. the contractual cash flow characteristics of the financial asset (IFRS 9.4.1.1).

In addition, IFRS 9 also provides the following option that allows an entity, on initial recognition only, to irrevocably designate:

- financial assets that would otherwise be measured at amortised cost or fair value through other comprehensive income under IFRS 9's general principles at fair value through profit or loss if this designation would reduce or eliminate so-called 'accounting mismatches" (IFRS 9.4.1.5).

According to Christian and Ludenbach (2013:464), there is a subjective condition and an objective condition for classifying financial instruments. The subjective condition is whether the objective of the business model for the group of assets to which the asset under review belongs, is to hold assets to collect contractual cash flows. The objective condition is whether the contractual terms of the financial asset give rise on specified dates to cash flows which are solely payments of interest and principal on the principal amount outstanding. According to Zaiceanu (2016:42-43), although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity, for example an entity's assessment that it holds investments to collect its contractual cash flows will remain valid even if the entity disposes of the investments to fund capital expenditure.

Given that in determining the business model within which the financial asset is held is necessary to determine the appropriate classification category under IFRS 9, the following section will discuss the business model requirements. Picker et al (2016:169)

states that the business models for managing financial assets are observable through particular activities that the entity undertakes to achieve its stated objectives. They further state that a business model is not an instrument-by-instrument assessment, but it takes place at a higher level of aggregation, which is the level at which the key decision makers manage groups or portfolios of financial assets to achieve the business objective.

A. Business model test

Although IFRS 9 defines two business models, in reality there are three business models (as stated in IFRS 9. B4.1.2C, B4.1.4A and B4.1.6) summarised as follows:

- 'Hold to collect' business model. Management's objective is to collect the instruments contractual cash flows. A typical example of such a business model is a liquidity buffer portfolio where an entity only sells assets in rare 'stress case' scenarios (example from Picker et al 2016:169). This model is discussed for completeness and in case an entity uses the fair value option (see figure 4)
- 'Hold to collect and sell' business model. The entity's key management personnel have made a decision that both collecting contractual cash flows and selling are fundamental to achieving the objective of the business model. An example will be, the objective of the business model may be to manage everyday liquidity needs, to achieve a particular interest yield profile or to match the duration of financial assets to the duration of the liabilities that those assets are funding. To achieve these objectives, the entity will both collect contractual cash flows and sell the financial assets (example from Picker et al 2016:169). This model is discussed for completeness and in case an entity uses the fair value option (see figure 4).
- Other business models. Financial assets are held for trading or are managed on a fair value basis. In each case, the entity manages the financial assets with the objective of realising cash flows through the sale of the assets and the entity's objective will typically result in active buying and selling to achieve the business objective. This model is important to the study because these financial assets are measured at fair value through profit or loss.

Despite the models being mentioned above, the objective of the business model relates to the collection of cash flow. The cash flow characteristics that are considered in the business model is discussed below.

B. Cash flow characteristics

According to Picker et al (2016:170), the assessment of the characteristics of the contractual cash flows is done at the individual financial asset level and aims to identify whether the contractual cash flows are solely payments of principal and interest (SPPI) on the principal amount outstanding. They further state that, the SPPI test is designed to screen out financial assets for which the application of the effective interest rate is not viable from a pure mechanical standpoint (e.g., a share where the cash flows simply cannot be reflected by the effective interest rate method) or does not (i.e. effective interest rate) provide useful information about the uncertainty, timing and amount of the financial asset's contractual cash flows (e.g., a debt instrument that is linked to a commodity price where the variability of cash flows is largely caused by the change in the commodity price) (Picker et al 2016:170). This model is discussed for completeness and in case an entity uses the fair value option (see figure 4).

To summarise, the following are financial assets under IFRS 9 that are measured at fair value through profit or loss:

(1) debt instruments that are neither measured at amortised cost nor fair value through other comprehensive income are measured at fair value through profit or loss (see figure 4 for more clarification);
(2) certain debt instruments that eliminates or significantly reduces a measurement or recognition inconsistency ("accounting mismatch"); and
(3) financial assets and financial liabilities that are held for trading.

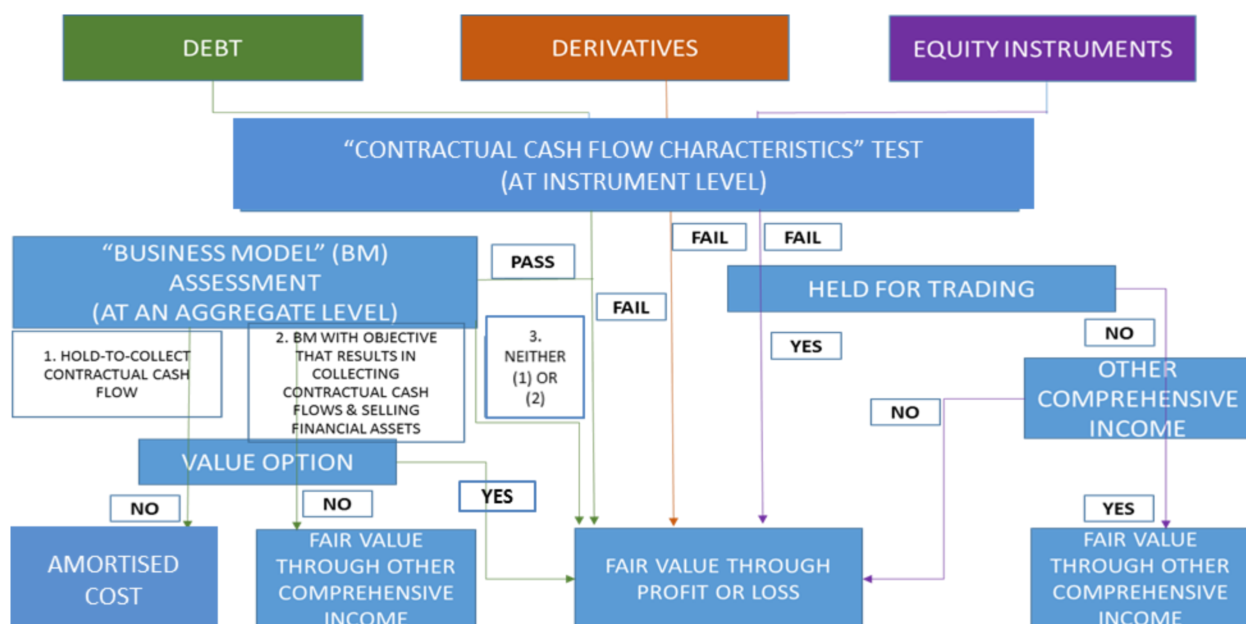
In terms of similarities between financial assets under IAS 39 (see section 2.4.2.3), the same concepts discussed in section 2.4.2.3 under IAS 39 subsection (i) and (iii) in respect of the meaning of "held for trading" and the meaning of "accounting mismatches" will apply

to IFRS 9. In addition, the term 'portfolio' is still not defined and its meaning when read in context is still the same as in IAS 39.

In terms of differences between the classification of financial assets under IAS 39 (see section 2.4.2.3) and IFRS 9, (1) only the fair value through profit or loss category remained and (2) the business model assessment and contractual cash flow assessment are the steps to classify financial assets as opposed to the four categories in terms of IAS 39 (see section 2.4.2.2). The business model test is performed under IFRS 9 based on scenarios that the entity expects to occur (IFRS 9. B4.1.2A) and under IAS 39 there was no business model assessment.

The schematic presentation of financial assets per IFRS 9 is provided in figure 2.4.

Figure 2.4: Presentation of financial assets per IFRS 9



Source: Adapted from Applying IFRS Standards, by Picker et al 2016

2.5.3 FINANCIAL LIABILITIES UNDER IFRS 9

The classification of financial liabilities remained generally the same as in IAS 39. Financial liabilities are measured either at fair value through profit or loss or at amortised

cost. In order for the financial liabilities to be measured at fair value through profit or loss, those financial liabilities must meet the following requirements:

- financial liabilities should meet the definition of held for trading;
- financial liabilities should be designated at fair value through profit or loss because it reduces or eliminates a measurement or recognition inconsistency (IAS 39:9).

Under IFRS 9, for financial liabilities that do not meet the definition of held for trading but are designated as at fair value through profit or loss, the element of gains or losses attributable to changes in the entity's own credit risk is recognised in other comprehensive income (IFRS 9:5.7.7).

According to Elliott and Elliot (2017:338) this was done to address the concerns about the way the gains and losses on liabilities measured at fair value through profit or loss were presented. They state that the fair value of a liability changes primarily due to changes in interest rates and changes in the credit position of the company issuing the liability. They argue that if the company's credit risk increases, its credit rating gets reduced; therefore, the fair value of the liabilities would fall. They then argue that the company would be perceived as less able to pay debts therefore the debts would have a lower market value. For a company that was measuring financial liabilities at fair value through profit or loss this would result in a gain being recognised in income, which was potentially misleading.

The analysis of Picker et al (2016:171) clearly support the statement above, as it was stated that this was done to avoid the counterintuitive effect of a deterioration of an entity's credit standing resulting in a gain recognised in profit and loss. Furthermore, if this creates or enlarges an accounting mismatch in profit or loss, gains and losses must be entirely presented in profit or loss (Picker et al 2016:171).

Below is an illustration of the impact of changes in fair value due to changes in credit risk.

Example 2.5: Illustration of the calculation of the amount due to changes in credit risk of a financial liability

Facts: Blue Bank has designated financial liabilities to be measured at fair value through profit or loss. These liabilities are worth R100 million at the beginning of the year and are worth R120 million at the end of the year. Over this period the credit position of Blue Bank has improved and resulted in the financial liabilities increasing in value by R5 million.

Solution: Blue Bank would recognise the following journal to reflect the change in fair value of the financial liabilities:

Debit: Other comprehensive income	*R5 million*	
Debit: Profit or loss	*R15 million*	
Credit: Financial liabilities		*R20 million*

Source: Adapted from "Financial Accounting and Reporting" by Elliot & Elliot, 2017

Based on example 2.5 above, an amount of R5 million that should not have been subject to section 24JB of the Act because it was recognised in other comprehensive income, will now be specifically included, and will be taxed under section 24JB(2A) of the Act for years of assessment commencing on or after 1 January 2018 (see Chapter 3.3.3).

In summary, the IASB decided to keep the requirements of IAS 39 for classifying and measuring financial liabilities in IFRS 9. An exception to this is changes in financial liabilities due to changes in a company's own credit risk. These changes to the fair value of a financial liability designated at fair value through profit or loss attributable to changes in own credit risk is presented in other comprehensive income and not the statement of profit or loss and other comprehensive income.

The 2017 Taxation Laws Amendment Act introduced section 11(*j*A) into the Act that is based on IFRS 9's 'three-stage' model for impairment provisioning for financial assets of a "covered person" (that is a bank) for years of assessment commencing on or after 1 January 2018. The brief discussion below is intended to increase awareness regarding

further alignment between taxation and accounting principles. The following section will discuss only the three categories of impairment under IFRS 9 that are covered by section 11(*j*A).

2.5.4 IMPAIRMENT AND UNCOLLECTABILITY OF FINANCIAL ASSETS UNDER IFRS 9

As previously stated, part of the reason for introducing IFRS 9 was to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information. The IASB sought to address the concerns about delayed recognition of credit losses by introducing in IFRS 9 a forward-looking expected credit loss model (Picker et al 2016:176). According to Picker et al (2016:176), the expected credit loss model applies to:

- financial debt assets measured at amortised cost or fair value through other comprehensive income under IFRS 9 (which include debt instruments such as loans, debt securities and trade receivables) (IFRS 9.4.1.2);
- loan commitments and financial guarantee contracts that are not accounted for at fair value through profit or loss under IFRS 9 (IFRS 9.2.1(g));
- contracts assets under the revenue standard IFRS 15 (IFRS 9 Appendix A); and
- lease receivables under IAS 17, the standard that prescribes lessee and lessor accounting policies for finance lease and operating lease, as well as disclosures.

2.5.4.1 How impairment is recognised under IFRS 9

Under a general approach, entities must recognise expected credit losses in three stages. Firstly, for credit exposures where there has not been a significant increase in the credit risk since initial recognition i.e., stage 1/ bucket 1. In this stage entities are required to provide for credit losses that result from default events 'that are possible' within the next 12 months (IFRS 9.5.5.3).

Secondly, for those exposures where there has been a significant increase in credit risk

since initial recognition (stage 2/bucket 2), a loss allowance is required for credit losses expected over the remaining life of the exposure irrespective of the timing of the default. An entity should determine whether the risk of a default occurring over the expected life of the financial instruments has increased significantly between the date of initial recognition and the reporting date (IFRS 9.5.5.4).

The last stage (stage 3/bucket 3) is for financial assets that have become credit-impaired. Interest revenue would be calculated by applying the effective interest rate to the amortised cost (net of loss allowance) rather than to the gross carrying amount (IFRS 9 Appendix A). Financial assets are assessed as credit-impaired using the following criteria in Appendix A of IFRS 9:

a. significant financial difficulty of the borrower;
b. a breach of contract or default in interest payments;
c. a lender granting concessions related to the borrower's financial difficulty that the lender would otherwise consider;
d. it becoming probable that a borrower will enter bankruptcy or other financial reorganisation;
e. the disappearance of an active market for the financial asset because of financial difficulties;
f. the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

IFRS 9 does not define 'default' and according to Picker et al (2016:176) it is clear that the word 'default' is broader than failure to pay and entities would have to apply a definition of 'default' that is consistent with the definition used for internal credit risk management purposes. However, there is a presumption that default does not occur later than when a financial asset is 90 days past due unless an entity can demonstrate that a more lagging default criterion is more appropriate (Picker et al 2016:176).

These three stages of impairment will be discussed in Chapter 3 due to the 2017 Taxation Laws Amendment Act introducing section 11(*j*A) into the Act that is based on IFRS 9's

‘three-stage’ model for impairment provisioning for financial assets of a “covered person” (that is a bank) for years of assessment commencing on or after 1 January 2018.

The following section provides information dealing with the disclosure of financial instruments as envisioned in IFRS 7.

2.6 DISCLOSURE REQUIRED BY IFRS 7

IFRS 7 (Financial Instruments: Presentation and Disclosure) was necessitated by increasingly sophisticated methods that reporting entities were using to measure and manage their exposure to risks arising from financial instruments. The IASB concluded that users of financial statements need information about the reporting entities’ exposure to risk and how these risks are being managed (Mackenzie. 2013:695).

The purpose of the disclosure requirements is to provide information to enhance understanding of the significance of financial instruments for an entity’s financial position, performance and cash flows, and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments (Picker et al 2016:188).

According to Mackenzie (2013:695), under IFRS 7, the extent of disclosure required depends on the extent of the entity’s use of financial assets and financial liabilities and of its exposure to risk. The risks are grouped into three categories, namely, market risk, credit risk and liquidity risk.

In the case of financial assets measured at fair value through profit or loss, IFRS 7 requires that the carrying amount of that financial asset as specified in IFRS 9 shall be disclosed either on the face of the statement of financial position or in the notes. An entity must also show separately, (i) those financial assets designated upon initial recognition or subsequently measured and (ii) those mandatorily measured as at fair value through profit or loss in accordance with IFRS 9 (IFRS 7:8) or in terms of a prior standard (IAS 39:9).

If an entity has designated a financial liability as at fair value through profit or loss in accordance with IFRS 9 and it is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss, the entity shall disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability; and

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation (IFRS 7:10A).

In summary, IFRS 7 prescribes the disclosure requirements for the reporting entity to disclose the fair value gains or losses reported through profit or loss or other comprehensive income, in the current and previous reporting period. The following section provides the chapter summary.

2.7 CHAPTER SUMMARY

It was stated in Chapter 1.2.7 that to interpret section 24JB of the Act, a detailed knowledge of the relevant accounting principles relating to financial instruments are required. This chapter mainly dealt with the accounting treatment of financial instruments under IAS 39 (Financial Instruments: Recognition and Measurement), IFRS 9 (Financial Instruments) and IFRS 7 (Financial Instruments: Disclosures).

The chapter discussed that the basis for a "covered person" for using IFRS for financial reporting is the Companies Act No. 71 of 2008 and the fact that JSE listing requirements compels a "covered person" to use IFRS for financial reporting. In addition, the PIS score compels the majority of "covered person" to use IFRS as discussed in Chapter 2.2. The chapter further highlighted the characteristics that any user can rely on because financial statements are not generally prepared to meet the information needs of any specific users. This chapter then discussed the core accounting principles applicable to financial

assets and financial liabilities that are measured at fair value through profit or loss because section 24JB of the Act is based on these accounting principles. It mentioned possible gaps from an accounting perspective that still need to be addressed, but these gaps will be discussed in detail in Chapter 3 together with section 24JB of the Act and other relevant issues.

The chapter also discussed the impairment of financial assets that are not recognised at fair value through profit or loss, section 2.4.3 questioned if a “covered person” is not eligible for a deduction of impairment under section 24JB of the Act while IAS 39 was still utilised. Possibly, it may be this reason that led to the Minister of Finance announcing in the 2017 *Budget Review* that there will be a review of section 24JB, to ensure that it is aligned with IFRS 9 and that section 24JB will exclude impairment. The question however remains – was a deduction for impairment included previously under IAS 39 (Budget Review, 2017:141)? The chapter discussed the treatment of impairment as a separate section under section 2.5 because the 2017 Taxation Laws Amendment Act introduced it as a separate section (section 11(*j*A)) that will be applied by a “covered person” (that is a bank) effective for years of assessment beginning on or after 1 January 2018.

The next chapter will examine existing literature that is relevant to the research objectives relating to the taxation treatment of financial instruments. It will summarise section 24JB of the Act. In addition, other sources that may relate to the core tax principles from which may be deviated due to the “tax follows accounting” approach in section 24JB of the Act are examined. Lastly, the interplay between tax principles and section 24JB of the Act, approaches that have been adopted by courts on accounting principles and certain deviations due to IFRS 9, are discussed.

CHAPTER 3: TAXATION OF FINANCIAL INSTRUMENTS

3.1 INTRODUCTION

Section 24JB of the Income Tax Act, Act No. 58, of 1962 Act ("the Act") was inserted by section 56 of Act 22 of 2012 and was later substituted by section 71 of Act 31 of 2013. In brief, this section requires that amounts used for calculating the taxation implications of financial instruments should be calculated using accounting principles. The focus of this study is to investigate section 24JB of the Act which relates to the taxation of financial instruments.

The main objective is to examine the relationship between the accounting principles and the tax provisions dealing with financial instruments of a "covered person" envisaged in section 24JB of the Act. The relevant accounting principles for such a study are mainly encompassed in IFRS 9 (Financial Instruments) which is the applicable accounting standard (and is effective for financial years beginning on or after 1 January 2018) together with IAS 32 (Financial Instruments: Presentation), IAS 39 (Financial Instruments: Recognition and Measurement) and International Financial Reporting Standards (IFRS) 7 (Financial Instruments: Disclosures) (see chapter 2 for a detailed discussion).

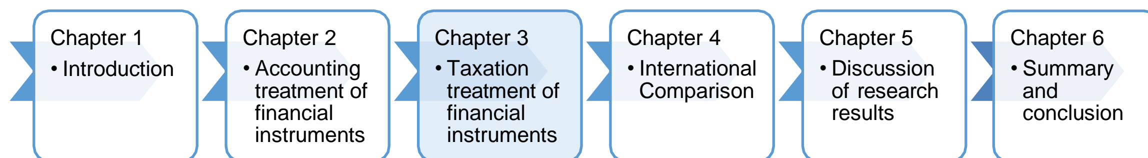
The aim of investigating the relationship between the taxation and the accounting treatment of financial instruments is to identify possible divergence in the interpretation and the application between accounting and the provisions of section 24JB of the Act. This study will serve as a guideline, assisting South African tax practitioners and auditors and the SARS to carry out their various functions of auditing a "covered person" or in issuing an interpretation note for section 24JB of the Act, given the complexities of the accounting standard dealing with financial instruments. Furthermore, this study can assist National Treasury in making amendments to the Act, where necessary, and provide financial statement preparers and auditors with the correct treatment of amounts relating to financial instruments for taxation purposes.

This chapter investigates the taxation treatment of financial instruments by using the existing literature that is relevant to the research objectives, in particular section 24JB of the Act. Areas of concern due to the application of tax rules, based on accounting, for the treatment of financial instruments are also identified.

This chapter commences with an analysis of the approach adopted by the courts in court cases where there were inferences regarding the interpretation of the Act and the application of accounting principles. Given that the concepts in section 24JB of the Act refer to accounting standards, this may have an impact when interpreting the Act. This chapter then addresses the rules of interpretation of statutes as guided by the Constitution of South Africa. It also addresses the reasons for the introduction of section 24JB of the Act, the old version of section of 24JB of the Act when the accounting standard that was utilised was IAS 39, as well as the current version of s 24JB based on accounting standard IFRS 9 (introduced by Act No. 17 of 2017, Taxation Laws Amendment Act, 2017 and effective for years of assessment beginning on or after 1 January 2018). In addition, this chapter discusses some of the amendments made in the 2020 Taxation Laws Amendment Act No. 24 of 2020 that relates to the taxation of financial instruments. This chapter will also provide an overview of some conceptual and practical issues relating to fair value accounting, along with some historical context.

The following diagram provides an overview of the structure of the dissertation and specifically where the discussion in this chapter fits into the study:

Figure 3.1: Study Outline



Source: Author's own

This chapter answers the questions raised by Norberg (2007:3) in chapter 1 of this study, that is:

i. To what degree are fundamental accounting principles covered by specific tax rules, when is the basic rule still used and is this basic rule connected to financial accounting, or not? An example of a basic rule is explained in detail below (see section 3.3) as it relates to section 24JB(9) of the Act since there is no clarification in the Act or explanatory memorandum as to how section 24JB(9) of the Act interacts with other provisions of the Act. However, it was concluded that a clarification is not necessary as the 'basic rules' will apply, which basic rule is not connected to financial accounting.
ii. To what degree do specific tax rules mentioned above deviate from financial accounting? This deviation will be determined by looking at the accounting treatment of financial instruments and comparing it with the ordinary grammatical meaning of the specific tax rules. The example used to explain this principle will be the treatment of dividends by a "covered person" in section 24JB of the Act (see section 3.3).
iii. To what degree is tax legislation interpreted taking International Financial Reporting Standards (IFRS) principles into account? Similarly, the extent will be determined by looking at the accounting treatment of financial instruments versus the ordinary meaning of the tax statute. The example used to explain this will be the reversal of impairment losses (see section 3.3.1).
iv. Are gaps in tax legislation addressed taking IFRS principles into account or is there some guidance or interpretation note to address the gaps? The example used to explain this will be section 24JB(9) and the interaction of this subsection with other provisions of the Act as stated above and in respect of the treatment of dividends.

The following section will discuss the view taken by legal courts and in published research literature on the accounting practice and relevance of accounting practice when it comes to tax.

3.1.1 APPROACH ADOPTED BY THE COURTS REGARDING ACCOUNTING PRACTICE

In an unreported judgment by the Johannesburg Income Tax Special Court, case no 11345 (4 July 2008) it is stated that when analysing a transaction from an accounting perspective, the purpose of accounting is to give a fair reflection of the taxpayer's financial position at the end of the financial year. Furthermore, when analysing a transaction from a tax perspective, the purpose is to establish the basis on which the taxpayer's liability for income tax has to be determined in accordance with the provisions of the Act.

In this case the Judge did not want to follow the accounting principles when deciding on the tax matters. This was highlighted in paragraph 87 of the court case where Professor W, who is a specialist in accounting, gave evidence to the effect that the correct accounting disclosure of the combined loan and hedge transition would result in 'economic substance', a term known in the accounting world. It was argued, on behalf of the appellant, that the opinion of Professor W on the 'economic substance' or 'financial reality' as understood and explained by him is largely irrelevant to the question of the appellant's true intention when concluding agreements. In the search for economic substance the one purpose should be to give a fair reflection of the taxpayer's financial position at the end of the financial year and then the other purpose should be to establish the true agreement based on which the taxpayer's liability for income tax has to be determined in accordance with the provisions of the Act. In paragraph 88, reference was made to *Commissioner for Inland Revenue v Felix Schuh (Pty) Limited 1994 (2) SA 801 (A)* where Corbett CJ commented at 813F:

"…as has frequently been pointed out, the court is concerned with the deductions permitted in terms of the Act and not with debits or other provisions made in a taxpayer's accounts, even though these may be regarded as prudent and proper from an accounting point of view."

In another case, *Stellenbosch Farmers' Winery (Pty) Limited v CSARS* 2012 ZASCA 72, in the main appeal, Stellenbosch Farmers' Winery Limited seeks to argue against the

finding of the court that the receipt by the taxpayer of the sum of R67 million during the 1999 tax year had correctly been included by the Commissioner for the South African Revenue Service in the taxpayer's gross income in the assessment for that tax year and had accordingly correctly been assessed for tax. The taxpayer's contention was that the receipt was of a capital nature and had therefore attracted no tax liability. The judgement of the court then referred to what were stated to be indicators of how the taxpayer, at the time, saw and treated the amount of R67 million it received. The first were entries in the taxpayer's financial statements for the tax year in question where two items were relevant which was "cash flow statement for the year ended 30 June 1999" and secondly, the item in the financial statements that was referred to by the Tax Court as reflecting an entry on dividends. It was held that the nature of a receipt for income tax purposes is not determined by how it is subsequently treated for accounting purposes. Reference was made to the decision in *Secretary for Inland v Eaton Hall (Pty) Ltd 1975 (4) SA 953(A) at 958 B-D]* where it was held that accounting practice cannot override the correct interpretation of the provisions of the Act and their application to the facts of the matter. Based on the above cases, it is clear that the accounting practice was not accepted in the tax matters.

On 19 September 2018 in CSARS v Volkswagen SA (Pty) Ltd (1028/2017) [2018] ZASCA 116 the Supreme Court of Appeal reversed the decision of the tax court and found in favour of SARS in a matter dealing with the valuation of trading stock on hand at the end of a financial year. At the main, was the interpretation and application of International Accounting Standard 2 (IAS 2) whether a taxpayer could take into account the value of its closing trading stock, as determined in accordance with IAS 2 Inventories ('IAS 2') for accounting purposes, when calculating its taxable income to the several categories of trading stock held by Volkswagen SA (Pty) Ltd (VWSA). The main issue in this case was whether the accounting standard accurately reflected the diminution in value of trading stock. The court found in effect that accounting standards do not supersede income tax legislation and principles.

The *CSARS v Volkswagen case* (2018:51) drew a distinction between the net realisable

value concept found in IAS 2 and fair value. Fair value was described to reflect the current value of goods in the market while the net realisable value reflects the amount that will be realised in the market at some future date. At issue was that there was a passage quoted from Volkswagen's notice of objection that sought to confuse the net realisable value and fair value. This Appeal judgement clarifies that fair value reflects the current value of the goods in the market and net realisable value reflects the amount it is thought Volkswagen will realise in the market at some future date.

To summarise, the part that relates mostly to this study using the *CSARS v Volkswagen case*, is that this study agrees with the description of fair value mentioned in this case. This is based on the discussion in Chapter 1.1.2 where De Jager (2014:69) states that under fair value accounting an asset is carried on the statement of financial position at the price at which that asset could be recovered, and a liability at the amount required to settle that liability, in the current market.

In an older case, Centlivres JA in *Sub-Nigel Limited v Commissioner for Inland Revenue* (1948:389), the issue was that the company sought to deduct, in the determination of its taxable profit derived from mining for gold, an amount paid by it as a premium under policies of insurance against loss of standing charges. The insurance in respect of standing charges was designed to enable the company to carry on its essential services without loss, notwithstanding any cessation of mining operations. At the outset, it was stated that the court is not concerned with deductions which may be considered proper from an accountant's point of view or from the view of the prudent trader. It was further stated that the court must merely determine what is permissible according to the language or interpretation of the Act.

The accounting principles regarding the recognition of unrealised gains or losses were embraced in *Plate Glass & Shatterprufe Industries Finance Co (Pty) Limited vs SIR 1979 (3) SA 1124 (T)*. The decision in this case related to the tax status of unrealised foreign exchange gains and losses that arose in a tax year in which the debt to which they relate was neither incurred nor discharged. According to Swart (2003:1) the accounting

principles can be considered when a person's taxable income is determined only if and to the extent to which such principles are recognised by the Act. In summary, in the *Plate Glass & Shatterprufe Industries Finance Co (Pty) Limited vs SIR case* the court accepted the application of accounting principles for tax purposes (Claassen 2013:40) and it seems to suggest that if there are rules in the Act that are stemming from accounting principles, then the Act will follow those rules.

Section 24JB of the Act is using the accounting terms and principles to tax the gains and losses from financial instruments. Based on the above court cases it is evident that our courts will have to correlate with the value of the financial asset or financial liability as recorded in the financial statements of a "covered person" in terms of accounting standards IAS 39 that was previously applied or IFRS 9 if:

- the "covered person" applied the principles of the applicable accounting standard and reflected the amounts as stated in section 24JB of the Act; and
- in cases of dispute such as the *CSARS v Volkswagen case,* the interpretation of the provisions of section 24JB of the Act will follow accounting in terms of establishing whether the gain or loss was reflected in the statement of profit or loss and other comprehensive income.

Section 24JB(3) of the Act appears to take preference over other tax provisions (see section 3.3). Sub-section 3.1.2 discusses the articles that questioned the introduction of accounting concepts to tax law.

3.1.2 DOES AN ACCOUNTING STANDARD INTRODUCE THE QUESTION OF LAW?

In the article written by Freedman (2004:2), titled *"Aligning Taxable Profits and Accounting Profits: Accounting standards, legislators and judges"*, she questioned whether the accounting standard itself introduce questions of law. Freedman mentioned that at times accounting standards refer to legal concepts, or requires analysis of a legal document, in most cases it will be a contract. In this instance an accountant is giving an opinion on a

legal concept or the proper construction of a contract. Furthermore, the article enquires whether, when a legal concept forms part of a standard, it would be interpreted according to legal principles? Therefore, if this scenario exists, it may lead to a complex interaction of accounting principles and legal principles.

The sentiments of Freedman were relayed in an article by Visser (2013:1) where in summary the changes brought by section 24JB of the Act had caused uncertainty for some tax practitioners who felt that the IFRS concepts should not be introduced into the Income Tax Act because this may lead to a complex interaction of accounting principles with the Act. For purposes of section 24JB of the Act it can be concluded that accounting introduces the question of law since section 24JB of the Act identifies the accounting principles that should be applied, when and where in the accounting records this gain or loss should appear and what accounting label should be attached to it before it will be covered by the principles of section 24JB of the Act.

The following section will discuss the rules of interpretation of statutes, which will include the accounting principles that are referred to in section 24JB of the Act. In the main, the following section will give guidance as to how the words should be interpreted irrespective of where they originate as long as they are in the statute.

3.1.3 RULES OF INTERPRETATION OF STATUTES

The starting point in interpreting any legislation is the Constitution of South Africa, as the Constitution is the supreme law in our country; as was stated in paragraph 72 of the *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs 2004 4 SA 490 (CC)* case. Thereafter, the following courts are used, Supreme Court of Appeal, various Provincial Divisions of the High Court and various Provincial Tax Courts for hearing tax appeals (UNISA. 2017:7). In addition, the following means are used, case law, definitions of the words as they are used in other Acts and the ordinary meaning of the words (UNISA. 2017:6).

The following rules of interpretation of statutes were laid down in the case of *Natal Joint Municipal Pension Fund v Endumeni Municipality (920/2010) [2012] ZASCA 13:*

a. The words used in the Act are to be given their ordinary grammatical meaning unless they are illogical.
b. Interpretation is the process of attributing meaning to the words used in legislation after having regard to the context provided by reading the section or sub-sections in the light of that section as a whole and the reasons for having that section.
c. Consideration must be given to the language used in the light of the ordinary rules of grammar and syntax.
d. Where more than one meaning is possible each possibility must be weighed in the light of all these factors.
e. An expression such as "the intention of the legislature" is to be avoided because it is a misnomer as it requires an enquiry into the mind of the legislature.

When analysing the meaning of financial asset and financial liability together with the provisions of section 24JB of the Act, the above judgement from the court forms the basis for the discussion.

The following section will investigate the reasons for the introduction of section 24JB of the Act and a brief discussion on section 24J(9) of the Act which was applicable prior to the introduction of section 24JB of the Act. In addition, the following section will discuss who should apply section 24JB of the Act and the instruments that are allowed.

3.2 SECTION 24JB

3.2.1 BEFORE SECTION 24JB – SECTION 24J(9)

The Act introduced section 24J which marked a shift from the realisation system to the mark-to-market system in 1995. According to Theron (2014:1), income tax in South Africa

is usually payable on actual receipts and accruals, but for every rule, there are always exceptions. That exception to this rule applied to companies that deal in instruments, interest rate agreements, or option contracts. The Act previously provided (in section 24J(9)) for an elective regime, subject to various requirements, that allowed companies that deal in instruments, interest rate agreements or option contracts to pay tax on a valuation basis. Section 24J(9) of the Act provided that any company whose business comprised the dealing in instruments, interest rate agreements or option contracts (collectively the "instruments") may elect in writing that the gains and losses in respect of these instruments be calculated with reference to its market value during the period of the transaction, subject to the approval of the Commissioner of the methodology to be applied in determining such market value. This type of election was binding on that company in respect of all such instruments during the year of assessment in which it took effect until the date of redemption or transfer of that instrument.

This meant, irrespective of actual receipts and accruals, that the interest and amounts payable or receivable on option contracts and interest rate agreements were considered for tax purposes based on changes in the market value of the underlying instruments over that assessment period (Theron, 2014:1). The market valuation in relation to all instruments, interest rate agreements or option contracts was determined in accordance with commercially accepted practices which was applied by such company consistently in respect of all those instruments, interest rate agreements or option contracts for financial reporting purposes to its shareholders (section 24J(9) of the Act). Section 24J(9) of the Act was deleted in 2012 when section 24JB (taxation in respect of financial assets and liabilities of certain persons) was introduced by the Taxation Laws Amendment Act, No. 31 of 2013.

3.2.2 REASONS FOR THE INTRODUCTION OF SECTION 24JB

The Explanatory Memorandum to the Taxation Laws Amendment Act (National Treasury, 2013:53, 116) provided reasons in support of the deletion of section 24J(9) of the Act. It was stated that the rules relating to financial instruments in respect of income tax and

financial accounting have diverged and this has resulted in a challenge for both taxpayers and SARS.
It was also stated that the change was necessary because tax deviations were now frequently accounted for manually and that was leading to inaccuracies. From a SARS perspective, the divergence between tax and accounting has increased to such an extent that accounting is no longer considered a useful benchmark for assessing risk *vis-à-vis* the accuracy of taxable income. In view of the above concerns, section 24J(9) of the Act was deleted and section 24JB of the Act was introduced to reduce the burden for the financial institutions (brokers and banks) of having two systems of calculations, one for tax and another for accounting.

Secondly, section 24J(9) of the Act contained a specific rule that allowed taxpayers to utilise annual mark-to-market fair value methodology (see below). This methodology was limited insofar as it only catered for specific instruments, excluding equity and other instruments accounted for using the normal rules. In addition, this election did not cater for financial liabilities causing severe mismatches. Lastly, the elective and pre-approval nature of the mark-to-market system under section 24J(9), gave rise to uncertainty and confusion (National Treasury, 2013:53).

Section 24JB of the Act differs from section 24J(9) of the Act in that it is a mandatory section (i.e. not elective) and applies only to a “covered person” as defined in section 24JB(1) of the Act. The fact that section 24JB of the Act is not elective, will simplify the taxation system since section 24J(9) of the Act was elective and some covered taxpayers may not have been able to obtain approval from SARS to use the mark-to-market system. However, the fact that the application of section 24JB of the Act is limited to cover mainly brokers and banks may lead to confusion amongst other taxpayers who were previously able to obtain approval from SARS to apply the provisions of section 24J(9) of the Act and who now no longer qualify under section 24JB of the Act, as well as amongst other taxpayers who wish to utilise section 24JB of the Act because they hold financial instruments held for trading.

The following section will discuss section 24JB of the Act and its application.

3.2.3 SECTION 24JB AND ITS APPLICATION

3.2.3.1 Definition of a financial asset and a financial liability

Weidmann (2015:39) developed approaches that need to be followed by national tax legislators when defining derivatives as they exist in a variety of different forms. Although in this instance Weidmann's was defining derivatives, it should be mentioned that to a great extent, these forms also apply to financial instruments. According to Weidmann (2015:40), legislators can choose one of the following five approaches below to define a derivative, including a financial asset or financial liability in domestic legislation:

a. the enumerative approach;
   The enumerative approach does not define a financial asset or financial liability comprehensively based on established definitional criteria but simply states the various forms of financial asset or financial liabilities that will qualify to be taxed under the specific tax legislation.
b. the abstract or abstract-prescriptive approach;
   The abstract or abstract-prescriptive approach contains a specific list of self-contained requirements or features that must be met for a financial instrument to qualify, if such requirements are not met, the financial instrument will not be taxed under the specific tax legislation.
c. the policy-based or principles-based approach;
   A policy-based or principles-based approach focuses on the intended outcome of the law. This approach aims to produce law expressed in such principles whereas the principle specifies the outcome rather than the mechanism that achieves it.
d. the 'borrowing from other legislation' approach; and
   The 'borrowing from other legislation' approach simply borrows the definition of financial asset and of financial liability from other legislation without considering the requirements or purpose of the definition of a financial asset or financial liability

in tax law.

e. the approach that uses the economic definition.

   The economic definition approach simply uses the economic definition to define these instruments for tax purposes. This approach tends to combine the enumerative approach (a) and the 'borrowing from other legislation' (d).

The definition in section 24JB(1) of the Act of a 'financial asset' and that of a 'financial liability' for tax purposes only refers to the accounting definition in IAS 32 or any replacement standard to IAS 32. It is therefore clear that the tax legislators opted for 'borrowing from other legislation' approach if one follows Weidmann's approaches (2015:40). Therefore, the meanings of a financial asset or a financial liability should be interpreted based on the accounting definitions (and interpretation).

However, the definition of a financial asset in section 24JB(1) includes a commodity taken into account in terms of IFRS at fair value less cost to sell in profit or loss in the statement of profit or loss and other comprehensive income. A 'commodity' is not specifically defined in section 24JB of the Act and is recorded for accounting purposes using the accounting standard, IAS 2 (Inventories) that prescribes the accounting treatment of inventories. The fundamental principle of IAS 2 requires that inventory be measured at cost or net realisable value if this is lower than cost (IAS 2:3). IAS 2 contains an exception for broker-traders who may measure their inventory at fair value less cost to sell. The definition of a financial asset in section 24JB of the Act refers to this exception in IAS 2. The definition of financial asset means a financial asset defined and within the scope of IAS 32 and a commodity considered in terms of IFRS at fair value less cost to sell in the statement of profit or loss and other comprehensive income.

The inclusion of commodities in the taxation of financial instruments is a misnomer because there was no specific explanation for the inclusion of the inventory items into the scope of section 24JB of the Act since the Explanatory Memorandum of 2012 and 2013 on section 24JB of the Act does not mention commodities. The main focus of section 24JB of the Act is liquid financial instruments such as listed shares and over-the counter-

shares and listed and over-the-counter bonds. Lastly, the primary aim of this section is to align the taxation of financial instruments with IFRS 9 (National Treasury, 2012:58 and National Treasury, 2013:55).

Given that there is no clarity on the income tax side regarding the treatment of a 'liability used to fund trading activities', the question can be raised whether this 'liability' is part of section 24JB of the Act? In Chapter 2 (see chapter 2.4.2.3) it was discussed whether guidance should be sought in the income tax act or in the accounting principles with respect to the definition of financial liability because accounting principles clearly state that a liability used to fund trading activities does not in itself make that liability one that is held for trading (IFRS 9. BA. 8). This statement, found in the Application Guidance to IFRS 9, is used as basis for interpretation. However, according to paragraph 11 of IAS 1, interpretations approved by IASB are part of IFRS and have the same authority as accounting standards as stated in Chapter 1 (see chapter 1.6). Therefore, accounting principles should be utilised to effect clarity on treatment of a "liability" used to fund trading activities.

The following section clarifies who will be eligible to apply the provisions of section 24JB of the Act.

3.2.3.2 Definition of a covered person

"Covered person" is defined in section 24JB(1) of the Act to mean:

a. *"any authorised user as defined in section 1 of the Financial Markets Act that is a company, other than any company of which the principal trading activities constitute the activities of a treasury operation;*
b. *the South African Reserve Bank;*
c. *any –*
   (i) bank;
   (ii) branch;
   (iii) branch of the bank; or

(iv) controlling company,

as defined in section 1 of the Banks Act;

d. *any company or trust that forms part of a banking group as defined in section 1 of the Banks Act, excluding –*

(i) a company that is a long-term insurer as defined in section 1 of the Long-Term Insurance Act;

(ii) a company that is a short-term insurer as defined in section 1 of the Short-Term Insurance Act;

(iii) a company of which more than 50 per cent of the shares are directly or indirectly held by a company contemplated in subparagraph (i) or (ii) if that company does not form part of the same group of companies as a bank;

(iv) any subsidiary, as defined in section 1 of the Companies Act, of a company contemplated in subparagraph (i) or (ii);"

The authorised user referred to in (*a*) is defined in section 1 of the Financial Markets Act to mean:

> *"a person authorised by a licenced exchange to perform one or more securities services in terms of the exchange rules, and includes an external authorised user, where appropriate."*

In paragraph (*a*), the definition of a "covered person" refers to any user as defined in section 1 of the Financial Markets Act that is a company. This is aimed at including brokers in the ambit of section 24JB of the Act. The security services conducted by the 'authorised user' include the buying or selling of securities for a person's own account or on behalf of another person as a business, as part of a business or incidental to conducting a business as well as the use of the trading system to buy or sell listed securities (Van der Zwan, 2017:123). These authorised users are members of the JSE and include various commodity brokers and traders. A broker-trader is a person who buys commodities/shares for others or on their own account with the purpose of selling them in the near future and generating a profit from fluctuations in price or broker-traders' margins (Van der Zwan, 2017:125). Therefore, this supports the argument that

section 24JB of the Act is for the financial instruments that are held for short durations. Some of these JSE members include state-owned entities such as Eskom Limited and Telkom Limited to name a few who do not trade the shares but are members because of equity derivatives which does not fall within liquid financial instruments. As a result, the legislators realised that large corporates that are not brokers would also be authorised users as defined in section 1 of the Financial Markets Act and have approval from the Johannesburg Stock Exchange to trade in bonds although they may not trade in other instruments with prior approval of the JSE (Van der Zwan, 2017:124). These large corporates are not in the business of banking or trading in shares. The provisions of section 24JB was not intended for a company with a treasury function and such companies were therefore excluded from the ambit of section 24JB (National Treasury, 2016:58).

In relation to a bank, the concept of a “covered person” includes, amongst others, any company or trust that forms part of a banking group as defined in section 1 of the Banks Act, 1990 (Act No. 94of 1990), excluding a company that is a long-term insurer as defined in section 1 of the Long-term Insurance Act, 1990 (Act No. 52 of 1998). According to Who Own Whom (online), various banks hold shares in long-term insurance companies. Standard Bank holds 53.6 per cent of the equity stake in Liberty Holdings Limited, while Firstrand Group Limited holds 100 per cent of Momentum Group. However, other major banks also hold within their group structure insurance companies such as Nedbank Group insurance company and Absa Group insurance company respectively (online).

The Explanatory Memorandum to the Taxation Laws Amendment Act (National Treasury, 2013:53), gave an example of this exclusion saying in a case where a bank owned 60 per cent of a long-term insurer and that insurer owns all the shares of a company, both that insurer and the company will not be eligible for section 24JB. Initially when section 24JB of the Act was introduced, the Act did not include the subsidiaries of insurance companies. Subsequently, the 2017 Taxation Laws Amendment Act included any subsidiary of a long-term insurer and short-term insurer.

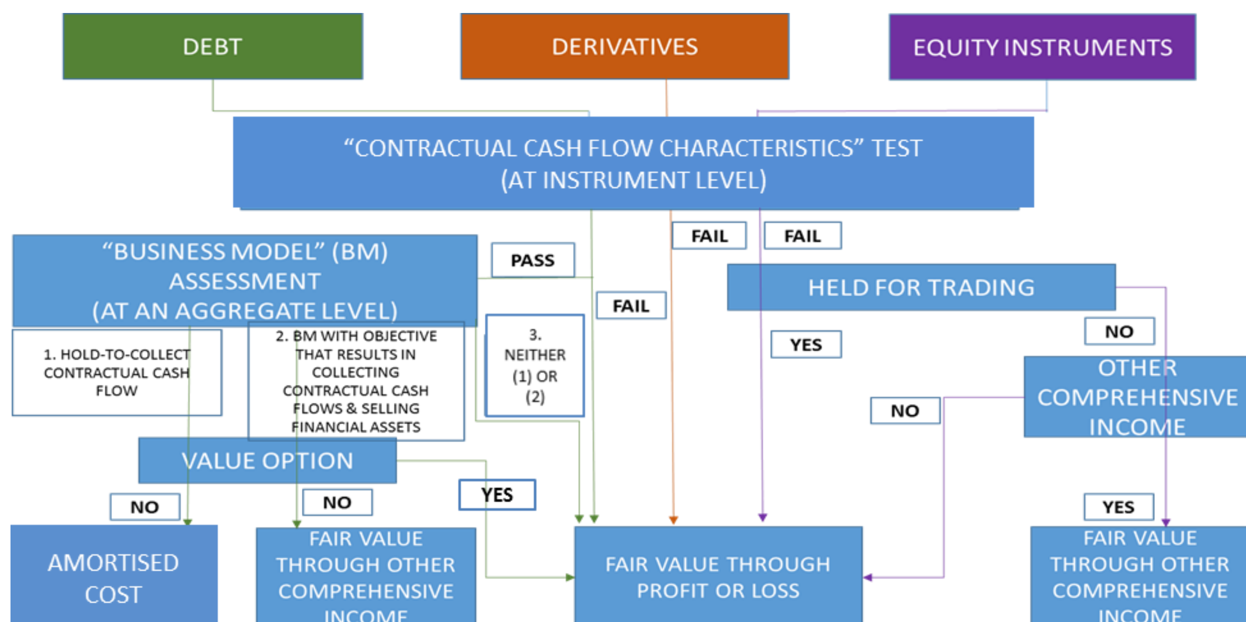
Sub-section 3.3 sets out the contents of section 24JB of the Act until the amendments enacted by section 27(1) of Act No. 23 of 2020 effective 1 January 2021. The sub-section states the conditions that need to be met before the amounts that can be included in income or can be deducted from income and will also address the exclusions allowed under section 24JB of the Act. In addition, sub-section 3.3 illustrates, by way of diagrams, the financial instruments that are recognised for accounting purposes at the end of the financial year in profit or loss in the statement of profit or loss and other comprehensive income.

3.3 IMPACT OF IFRS 9 (AND PREVIOUSLY IAS 39) ON SECTION 24JB OF THE ACT

3.3.1 CLASSIFICATION OF FINANCIAL INSTRUMENTS UNDER IFRS 9

The diagram below illustrates the classification and resultant valuation and treatment for accounting purposes of financial instruments under IFRS 9 (that replaced IAS 39), previously discussed in Chapter 2 (see section 2.5.2).

Figure 3.2: Presentation of financial instruments under IFRS 9



Source: Adapted from Applying IFRS Standards, by Picker et al 2016

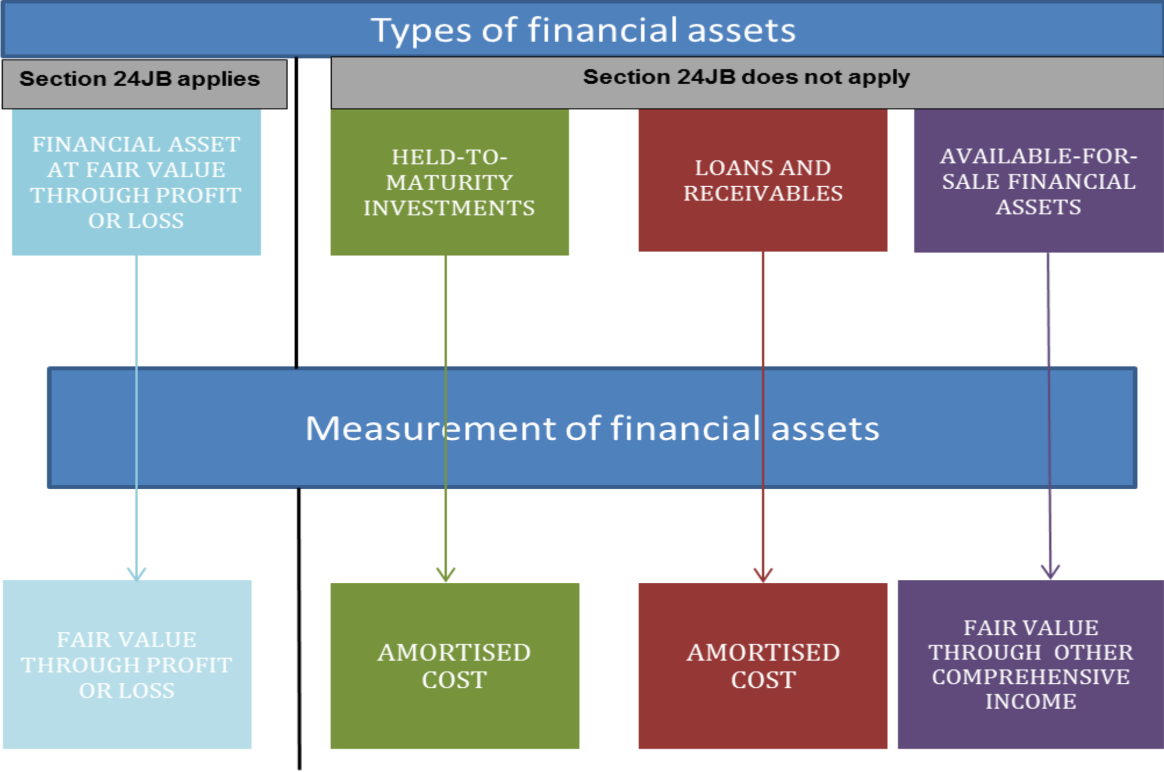
Note that the above diagram is repeated here to provide context for the remainder of the discussion.

The following two diagrams illustrate the classification of financial assets and financial liabilities in accordance with IAS 39, which was previously applicable to financial instruments taxed under section 24JB. These diagrams were included for completeness.

3.3.1.1 Classification of financial assets and financial liabilities under IAS 39

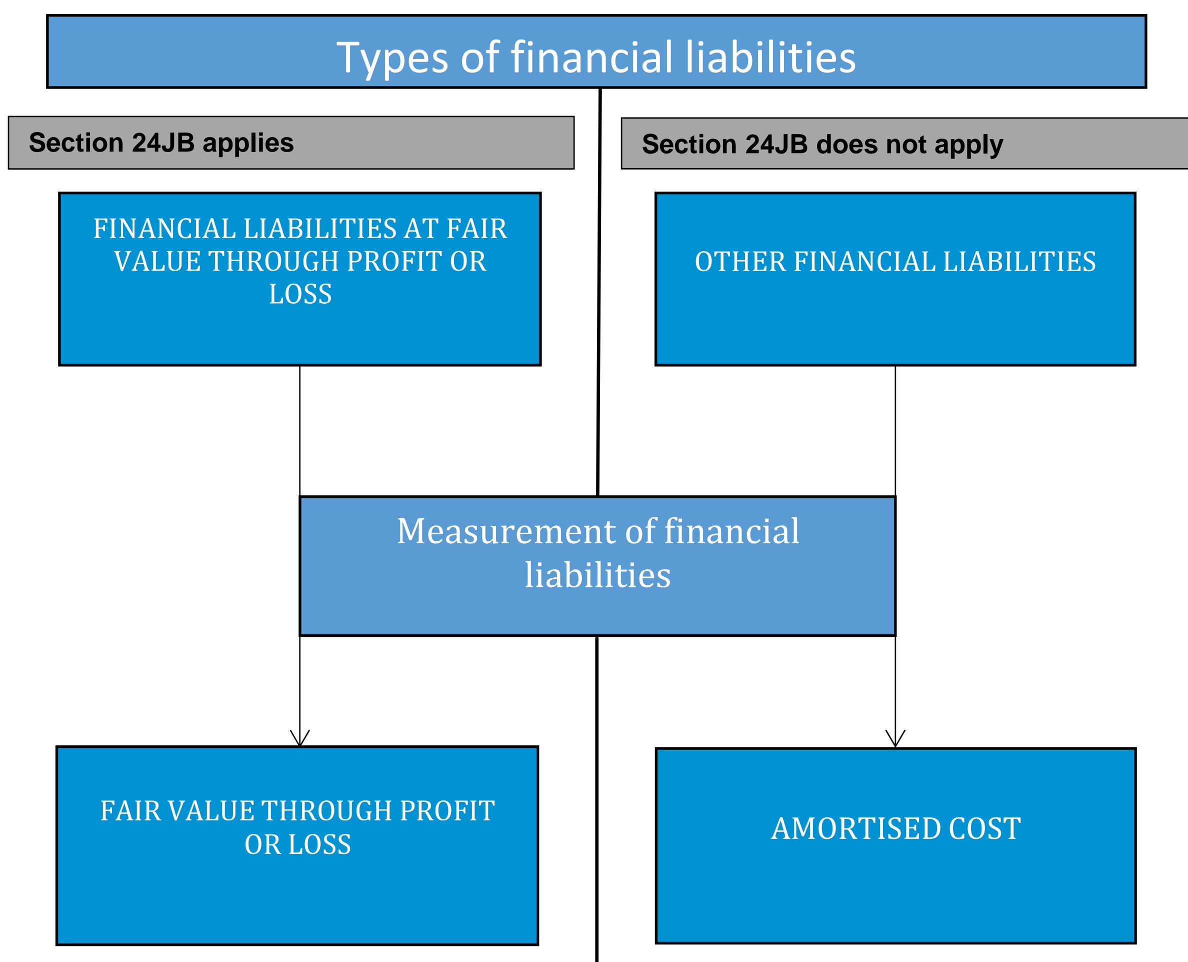
The following two diagrams illustrate the classification of financial assets (see figure 3.3) and financial liabilities (see figure 3.4) according to IAS 39. Financial assets were classified into four categories. Unlike financial assets, the financial liabilities had two categories, which were financial liabilities measured at amortised cost or financial liabilities measured at fair value through profit or loss.

Figure 3.3: Types of financial assets and their treatment when IAS 39 was still applicable to financial instruments taxed under section 24JB



Source: Author's own

Figure 3.4: Types of financial liabilities and their treatment when IAS 39 was still applicable to financial instruments taxed under section 24JB



Source: Author's own

3.3.2 CHARGING PROVISION OF SECTION 24JB (SECTION 24JB(2))

Section 24JB(2) of the Act is the charging provision that is only applicable to the gains or losses on financial instruments that are recorded in the statement of profit or loss and other comprehensive income for accounting purposes due to fair value changes of these financial instruments at year end. Thus, the discussion will be limited to financial instruments that are held at fair value through profit or loss (see figure 3.4).

According to Van der Zwan (2017:126), given that the wording of section 24JB(2) of the

Act refers to 'amounts ***in*** respect of financial assets and financial liabilities' while the exclusions refers to specific instruments designated as at fair value through profit or loss, it would be correct to conclude that the scope of section 24JB is wider than merely those amounts relating to instruments that strictly fall within the fair value ***through*** profit or loss category in IFRS 9 (that replaced IAS 39). Van der Zwan's interpretation (2017:126) is based on interpreting the word 'in' as opposed to 'through' which is based on the interpretation of the plain meaning of the words. However, the words 'at fair value through profit or loss' are well known in accounting standards and to a certain degree are read in full instead of singling out a certain word.

Section 24JB(2) of the Act excludes amounts from certain financial assets from the application of the section. The discussion on the exclusion will be split into two, namely, the wording prior to the 2017 Taxation Laws Amendment Act, Act No 17 of 2017 and the wording of the exclusion after the 2017 Taxation Laws Amendment Act, Act No 17 of 2017.

Prior to the 2017 Taxation Laws Amendment Act, Act No 17 of 2017, section 24JB(2) of the Act excluded any amounts in respect of a financial asset that is:

i. a share;
ii. an endowment policy;
iii. an interest held in a collective investment scheme;
iv. an interest in a trust; or
v. an interest in a partnership (section 24JB(2)(*a*) of the Act).

For this exclusion to apply in section 24JB of the Act, the financial asset should have been, upon initial recognition, designated in terms of IFRS at Fair Value Through Profit or Loss under the fair value option and continued to be measured at fair value with all changes being recognised in profit or loss or because that financial asset is managed and its performance is evaluated on a fair value basis. In addition, these exclusions were allowed because the "covered person" holds these financial assets not for trading purposes but held it for a long period as investments on capital account. This designation

option focuses on how that institution manages and evaluates performance rather than on the nature of use associated with the financial instrument.

The discussion on the designation of financial assets is found in Chapter 2.4.2.3 which occurs when any of the two conditions occur, that is, when a mixed measurement under which some financial assets are measured at fair value and others at amortised cost results in some gains and losses that are recognised in profit or loss and others in other comprehensive income. Secondly, designation occurs where a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

However, for financial years beginning on or after 1 January 2018, banks had to adopt IFRS 9 (which replaced IAS 39) (IFRS 9:7.1.1). This necessitated that amendments be made to section 24JB of the Act to ensure that it is in line with IFRS 9 (National Treasury, 2017:39). In essence, the amendments made in the 2017 Taxation Laws Amendment Act seeks to identify differences between the accounting treatment of the specific financial instruments covered by section 24JB of the Act in IAS 39 and IFRS 9 and to ensure that the outcome of section 24JB of the Act remains the same. Broadly this meant that all references and principles of IAS 39 would now be changed to IFRS 9 for financial assets and financial liabilities that are held for trading whose gains and losses are recognised in profit or loss in the statement of profit or loss and other comprehensive income statement.

The amended wording of the exclusion of financial assets from section 24JB(2) of the Act after the 2017 Taxation Laws Amendment Act, Act No 17 of 2017 will be discussed below. These exclusions are now regarded to the extent that these financial assets are interpreted in the light of tax rules and not according to accounting principles which required the financial asset to be designated upon initial recognition, in terms of IFRS or because that financial asset is managed and its performance is evaluated on a fair value basis as stated above. Therefore, as from 1 January 2018 when applying section 24JB of the Act, the “covered person” must take cognisance of other provisions of the Act, that is, the definition of “trading stock” in section 1(1) of the Act when confirming that the

exclusion applies to a financial asset, that is:

- *i. “a share;*
- *ii. an endowment policy;*
- *iii. an interest held in a collective investment scheme;*
- *iv. an interest in a trust; or*
- v. *an interest in a partnership”* (section 24JB(2)(*a*) of the Act).

The general meaning of “trading stock”, is defined in section 1(1) of the Act to include:
(a) “anything

- i. 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. the proceeds from the disposal of which forms or will form part of the taxpayer’s gross income; and
- iii. any consumable stores and spare parts acquired by the taxpayer to be consumed in the course of the taxpayer’s trade."

The definition excludes a foreign currency option contract or forward exchange contract defined in section 24I (1) of the Act.

Williams (1995:394) states that the question on whether an item of property is trading stock does not depend on the intrinsic nature of the property but on its intended use in the taxpayer’s trade or in a scheme of profit-making.

Section 24JB(2)(*b*) of the Act excludes a dividend or a foreign dividend received by or accrued to a “covered person” from its application. In those instances, the general income tax rules will apply. The basis for the exclusion is not clearly stated because the taxation of financial instruments under section 24JB of the Act follows the accounting treatment of gains and losses from financial instruments as determined using accounting principles. In this case, even though IAS 32 allows for dividends to be recognised in profit or loss in

the statement of profit or loss and comprehensive income, section 24JB of the Act excludes dividends from being “taxed”.

The 2020 Taxation Laws Amendment Act (Act No. 24 of 2020) introduced section 24JB(2)(c) to cater for dividends tax schemes that were identified where any company that forms part of a banking group as defined in paragraph (d) of the definition of a “covered person” is issuing financial instruments to the investors that pays dividends while it receives interest or other income on its financial assets. The special purpose vehicle effectively converts income to dividends for the benefit of investors. To curb these schemes, this section excludes dividends declared by the “covered person”.

To some, there may be confusion stemming from the fact that section 24JB(3) of the Act which is the overriding provision discussed below ., does not override the section 1 definitions (see further discussion on section 24JB(3) below). In short, this provision seeks to ensure that the provisions of section 24JB will take preference over other sections of the Act, or stated differently and specifically applicable for section 24JB, that all basic principles of the Act are not applicable and accounting rules will apply. Therefore, the question remains if the definition of the dividend in section 24JB(2)(*b*) relates to accounting or to the tax definition of a “dividend” or “foreign dividend”? However, Van der Zwan (2017:124) argues that these amounts should remain exempt as taxing dividends would disturb the exemption of dividend income at the shareholder level that is available to other taxpayers. This argument is true if the dividend is paid to another company within the “covered person” group of companies and not a beneficial owner of the dividend.

3.3.2.1 Example of a fair value gain or loss that will be subject to section 24JB(2)

Below are examples of a fair value gain or loss on a financial instrument that will be reflected in the statement of profit or loss and other comprehensive income and subsequently be subject to section 24JB(2) of the Act.

Example 3.1: Illustration of the calculation of a financial asset at year end reflecting a "gain"

Facts:

Entity A holds 10 000 shares in entity B valued at R2. These shares were acquired at fair value on 1 January 2020. Therefore, this investment in equity shares of entity B would be classified as a financial asset in the books of entity A at R20 000. On 31 December 2020, the value of the share in entity B is R3. Entity A classified the investment in equity shares of entity B at fair value through profit or loss.

Solution: gain that will be taxable under section 24JB(2)

For accounting purposes on 31 December 2020, entity A will reflect a gain of R10 000 in profit or loss in the statement of profit or loss and other comprehensive income (as per IFRS 9 paragraph 4.1.4), being the difference in the share price (R3 to R2) multiplied by 10 000 shares.

The R10 000 gain will be classified as income under the provisions of section 24JB(2) of the Act and will therefore be taxable.

Source: Adapted from "Descriptive Accounting, IFRS Focus. by Vorster et al 2007

Example 3.2: Illustration of the calculation of a financial liability at year end reflecting a "loss"

Facts:

Company A issues 1 million redeemable preference shares for 50 cents each on 1 January 2020 and every preference shareholder is entitled to a fixed dividend of 5 per cent annually, subject to distributable profits. The preference shares are redeemable for cash at the option of the holder. Company A has a contractual obligation to the preference shareholders, both in respect of dividends and to return the cash when the holder redeems. The value of every preference share on 31 December 2020 is 80 cents. Company A classified the preference shares as at fair value through profit or loss.

Solution: loss that will be recognised in section 24JB(2)

For accounting purposes on 31 December 2020, company A will reflect a loss of R300 000 in profit or loss in the statement of profit or loss and other comprehensive

income (as per section IFRS 9 paragraph 4.2.2) being the difference in the share price (R0.80 and R0.50) multiplied by 1 million preference shares.
The loss of R300 000 will be deductible for tax purposes under the provisions of section 24JB(2) of the Act.
Source: Author's own

3.3.3 AMENDMENTS IN TAXATION DUE TO THE CHANGE FROM IAS 39 TO IFRS 9 FOR FINANCIAL REPORTING PURPOSES

Another amendment that was made to section 24JB of the Act in the 2017 Taxation Laws Amendment Act that resulted from the differences between IAS 39 and IFRS 9 was the insertion of subsections (2)(A) and (2B). The Explanatory Memorandum to the 2017 Taxation Laws Amendment Act mentioned that under IFRS 9, the amount of the change in the fair value of a financial liability that is attributable to changes in the credit risk of that liability should be disclosed in the "other comprehensive income" statement (National Treasury, 2017:50).

These differences were previously discussed in Chapter 2 (see section 2.5.3). Under IFRS 9, if financial liabilities do not meet the definition of held for trading but are designated at fair value through profit or loss the element of gains or losses attributable to changes in the entity's own credit risk will be recognised in other comprehensive income (IFRS 9:5.7.7; sections 24JB(2A) and (2B)). It can be deduced from the 2017 Taxation Laws Amendment Act that although the gains and losses are recognised in the other comprehensive income section of the statement of profit or loss and other comprehensive income, for purposes of the Act, these gains and losses have now specifically been included and will be taxed under section 24JB(2A) of the Act for years of assessment commencing on or after 1 January 2018. It may look peculiar at first as the charging section of section 24JB (subsection (2)) only focuses on gains and losses recognised in profit or loss in the statement of profit or loss and other comprehensive income. However, as indicated by Picker (2016:171), this was done to avoid the counterintuitive effect of a deterioration of an entity's credit standing resulting in a gain

recognised in profit and loss and should this deterioration of an entity's credit standing create or enlarge an accounting mismatch in profit or loss, gains and losses must be entirely presented in profit or loss. Therefore, from an accounting perspective, this proposed amendment is therefore not entirely unusual in specific circumstances. When liabilities are designated under the fair value option, fair value changes due to changes in an entity's own credit risk should not affect profit or loss, except in exceptional circumstances where the fair value changes of financial assets are directly linked to an issuer's own credit risk. This address concerns relating to the reporting of the effects of changes in own credit risk of liabilities not held-for-trading purposes in profit or loss (EFRAG, 2010:5). However, if tax must follow accounting, this amendment will be normal given that gains and losses are recognised in profit or loss in the statement of profit or loss and other comprehensive income.

In addition, a further amendment was made to section 24JB of the Act with the inclusion of section 24JB(2B) into the Act. This subsection caters for the reversal of any unrealised amount recognised in profit or loss prior to the adoption of IFRS 9 because that unrealised amount as a result of fair value changes in own credit risk was recognised through other comprehensive income (section 24JB(2B)).

Below is the illustration of the impact of changes in fair value due to changes in credit risk.

Example 3.3: Illustration of the calculation of the amount due to changes in credit risk of a financial liability

Facts: Blue Bank has designated financial liabilities to be measured at fair value through profit or loss. These liabilities are worth R100 million at the beginning of the year and are worth R120 million at the end of the year. Over this period the credit rating of Blue Bank has improved and resulted in the financial liabilities increasing in value by R5 million. The calculation of the amount that was recognised in other comprehensive income due to credit risk will be as follows:

Solution:

Blue Bank would recognise the following journal to reflect the change in fair value of the financial liabilities:

Debit: Other comprehensive income	*R5 million*	
Debit: Profit or loss	*R15 million*	
Credit: Financial liabilities		*R20 million*

Based on example 3.3 above, an amount of R5 million that should not have been subject to section 24JB of the Act because it was recognised in other comprehensive income, is now subject to section 24JB(2A) of the Act for years of assessment beginning on or after 1 January 2018.

Source: Adapted from "Financial Accounting and Reporting" by Elliot & Elliot, 2017

This section discussed amendments that were made due to the change from IAS 39 to IFRS 9 and the following section deals with sections 24JB(3) to (8) of the Act.

3.3.4 SECTION 24JB(3) TO (8)

Section 24JB(3) to (8) of the Act are not considered in detail because the charging section is section 24JB(2) of the Act , hence these provisions will only be discussed briefly.

Section 24JB(3) states that:

> *'any amount required to be taken into account in determining the taxable income in terms of any provision of Part I of Chapter II, or in determining any assessed capital loss of a covered person in respect of a financial asset or a financial liability contemplated in subsection (2) must only be taken into account in terms of this section.'*

In effect this section takes preference over all other sections in the Act as the test lies with financial instruments where the gains or losses are recognised in the statement of

profit or loss and other comprehensive income under section 24JB(2) of the Act, therefore the amounts cannot be dealt with under any section of the Act other than section 24JB of the Act. Section 24JB of the Act will take preference since section 5 of the Act, which subjects taxable income to income tax, falls within Part I of Chapter II (section 24JB(3) of the Act). If the wording used in other sections of the Act that follows accounting principles is investigated and compared to section 24JB of the Act, such as section 24I
, the language used in the two sections differ. Section 24I of the Act provides for the tax treatment of gains and losses on foreign exchange transactions which correspond to the accounting treatment thereof for most transactions. However, section 24I(6) of the Act prevents the double deduction or double taxation of any exchange difference. Broadly, this is accomplished in section 24I(6) by providing that where such inclusion in, or deduction from income can also be dealt with under any other provision of the Act, then the inclusion or deduction must be made in terms of section 24I of the Act instead of in terms of such other provision of the Act. Although, section 24JB(3) of the Act should mirror what section 24I of the Act provides in terms of taking preference over other provisions of the Act, the wording is not entirely the same. The broad suggestion that section 24JB of the Act should follow section 24I of the Act is because both sections follow accounting and should in certain circumstances, such as the avoidance of double taxation, have the same objective. Section 24I(6) of the Act provides that any inclusion in or deduction from income under section 24I(3) of the Act shall be in lieu of any deduction or inclusion which may otherwise be allowed or included under any other provision of the Act while section 24JB(3) of the Act overrides the application of the normal principles that determine the timing of the taxation of gains or losses from financial instruments. Section 24JB(3) of the Act effectively replaces the general tests to determine whether the amount is or is not gross income, an allowable deduction or a capital amount or loss.

The implications of the provisions of section 24JB(3) highlights the importance of section 24JB of the Act because section 24JB will take preference over other sections of the Act (all the basic taxation principles) and accounting rules will be followed. This net effect becomes interesting when considering the interaction between section 24JB and section 10(1)(*k*)(i)(*hh*) where the latter section denies the dividend exemption received by

or accrued to a company in respect of a share to the extent that any amount has already been taken into account that has the effect of reducing income when applying section 24JB(2) of the Act. It may be argued that the reference to section 24JB(2) in section 10(1)(*k*)(i)(*hh)* is important since it applies to the dividend exemption which is not covered by section 24JB of the Act. There won't be any "double taxation" that may arise as dividends are not taxed in section 24JB of the Act.

There is an anti-avoidance rule in section 24JB(4) for agreements entered into between a "covered person" and a person that is not a "covered person" with the sole or main purpose of abusing the current provisions that may arise between the two parties and the way in which the taxation provisions would apply. According to National Treasury, the mark-to-market system could potentially be abused to cause tax mismatches and this possibility exists because most taxpayers remain outside the new system, with the potential for a tax mismatch being the greatest within a consolidated group. They further state that, to protect the fiscus, certain unhedged derivative contracts with consolidated members will fall outside the new mark-to-market system. More specifically, the mark-to-market regime will not apply to a "covered person" if:

- the financial instrument is a derivative as defined in IFRS;
- the counter-party to the derivative is another member of the same consolidated group under IFRS;
- the counter-party is not subject to the mark-to-market regime; and
- the derivative is unhedged by the bank or broker. (National Treasury, 2012: 58).

Section 24JB(5) and (6) of the Act deal with the transitional rules based on the initial implementation of section 24JB of the Act. These transitional rules were aimed at ensuring that there is a minimal disruption for companies that were not fair valuing their financial assets as per IAS 39 when section 24JB was introduced. The difference between the financial reporting values for purposes of IFRS and the tax base amounts of financial instrument calculations had to be added in or subtracted from taxable income over a three-year period to spread the effect of these differences (National Treasury, 2013:59).

Section 24JB(7) of the Act was aimed at all untaxed amounts associated with the spread differential mentioned above in section 24JB(6). The intention of this sub-section was to ensure that there was a phasing in or phasing out of amounts when a "covered person" enters this new system and is now liable for tax or can claim tax back from SARS. It implied that if a "covered person" ceases to be a "covered person" before the end of three years (transitional period), it would trigger, in the year of cessation, all untaxed amounts associated with the transitional period (the net difference) to be taxed in the year of cessation. In contrast, section 24JB(8) of the Act is a 'deemed disposal' rule for cases where a "covered person" ceases to be a "covered person", and is no longer subject to section 24JB of the Act. This exit from the section 24JB rules will trigger a deemed disposal and a re-acquisition of financial instruments on the last day of the immediately preceding year of assessment in which that "covered person" is no longer subject to section 24JB of the Act.

Section 24JB(8) of the Act has the same effect (contains 'deemed disposal rule at market value') as section 24JB(9) of the Act discussed below, the only difference is that section 24JB(8) of the Act refers to a "covered person" ceasing to be a "covered person" while section 24JB(9) of the Act refers to cases where a financial instrument previously subject to section 24JB of the Act ceases to be subject to section 24JB of the Act.

3.3.5 SECTION 24JB(9)

Section 24JB(9) was introduced into the Act by section 44(1)(*f*) of the Taxation Laws Amendment Act of 2017 and is effective for years of assessment beginning on or after 1 January 2018. This subsection was introduced due to the changes in the type of financial instruments that would be covered by the provisions of section 24JB. Due to IFRS 9 becoming effective for financial years beginning on or after 1 January 2018, some financial instruments that were previously subject to section 24JB of the Act would, after the adoption of IFRS 9, no longer be subject to the provisions of section 24JB of the Act. It had the effect that if a financial asset held by, or financial liability owed by, a "covered person" at the end of the year of assessment before the year of assessment beginning

on or after 1 January 2018 would have either ceased to be, or would have become subject to tax in terms of s 24JB(2) of the Act, had IFRS 9 been applicable on the last day of the previous year if assessment, that a “covered person” is deemed for purposes of the Act to have–

a. disposed of that financial asset or redeemed that financial liability; and
b. immediately reacquired that financial asset or incurred that financial liability,

for an amount equal to the market value of that financial asset or financial liability on that day (National Treasury, 2017:51). This deemed disposal rule will ensure that all unrealised gains and losses in respect of financial instruments that are held at fair value through profit or loss and that were subject to section 24JB(2) of the Act are accounted for before exiting the section 24JB system and that all those instruments can thereafter be taxed by using the general rules. In terms of the general rules, it must be determined whether a financial instrument is held by a taxpayer as trading stock, or a capital asset held on revenue or capital account. This determination of the nature of a financial instrument in the hands of a taxpayer then determines the tax treatment of that instrument upon its subsequent realisation or disposal.

In the instance that a financial instrument is determined to be held as trading stock, subsequent to the application of the deemed disposal and acquisition at market under section 24JB(9), the provisions of section 22 will apply to that financial instrument. Thereunder, it will be necessary to determine the cost price of the financial instrument in terms of section 22(3)(*a*)(ii) in order to account for the taxable income of the taxpayer in relation to the financial instrument held as trading stock in the year that section 24JB(9) applies. Should at the end of the year of assessment, the taxpayer still holds the financial instrument, the taxpayer must treat that financial instrument as closing stock in terms of section 22(2).

Where the financial instrument is held by a taxpayer on revenue account, but not as trading stock, the deemed market value cost prescribed by section 24JB will be considered as a deduction against the proceeds (that will be treated as gross income)

that arise in respect of any subsequent disposal of the financial instrument. On the other hand, in the instance that the financial instrument is held on capital account, the deemed market value cost will constitute base cost that can be applied to reduce any future proceeds (that will be subject to capital gains treatment).

The following section will address the treatment of impairment losses prior to the amendments incorporated by the 2017 Taxation Laws Amendment Act (Act No. 17 of 2017) and after those amendments. This section seeks to highlight the two contrasting treatments where prior to the 2017 amendments to section 24JB of the Act, section 24JB was silent on impairment losses and after the 2017 amendment, where there is a specific section dealing with impairment losses. Therefore, the following section is based on the principle that a "covered person" was eligible for a deduction of impairment losses based on the fact that the deduction of a loss (impairment loss) was in relation to: (1) a financial asset (2) the amount was measured at "fair value" and (3) this amount was recorded in the statement of profit or loss and other comprehensive income in terms of IAS 39 (see section 2.4.3 which covers IAS 39). In addition, one of the reasons for the introduction of IFRS 9 was to strengthen accounting recognition of loan-loss provisions hence IFRS 9's 'three-stage' model for impairment provisioning for financial assets that was introduced for years of assessment commencing on or after 1 January 2018 (IFRS 9:7.1.1, also see section 2.5.4 which covers IFRS 9).

3.3.6 IMPAIRMENT LOSSES

As stated above, this section affirms that impairment losses were always recognised in profit or loss for accounting purposes (see section 2.4.3). However, prior to the 2017 tax amendment (Act No. 17 of 2017), section 24JB of the Act did not have an explicit rule to carve out the tax treatment of impairment losses. It may be argued that prior to the 2017 tax amendments to section 24JB, an impairment loss recognised by a "covered person" due to a decline in the fair value of an available-for-sale financial asset (as envisaged in Chapter 2) was deducted in terms of section 24JB of the Act, given this lack of guidance.

This could be the reason that led the Minister of Finance to announce in the 2017 Budget Review (2017:141) that there will be a review of section 24JB of the Act to align it with IFRS 9 and therefore exclude impairment losses from this section. It was not clear if a "covered person" was eligible for a deduction of impairment because section 24JB's intention was to cover only financial instruments that are recognised at fair value through profit or loss (see chapter 2.4.3). Even though the SARS issued a Directive for the tax treatment of doubtful debts (impairment) by banks as from 2011 year of assessment, there was no explicit guidance prohibiting further deductions under section 24JB of the Act (National Treasury, 2017:51).

The 2017 Taxation Laws Amendment Act considered the three categories of impairment provisions for financial assets under IFRS 9 that were discussed in Chapter 2, (see section 2.5.4). Guided by the announcement in the *Budget Review* the 2017 Taxation Laws Amendment Act introduced a separate section in the Act, section 11(*j*A), that will be applicable to a "covered person" that is a bank for years of assessment beginning on or after 1 January 2018. Although, the section utilises the definition of a "covered person" in section 24JB of the Act to clarify who are the affected parties, this section is limited to (i) banks, (ii) branches, (iii) branches of the banks and (iv) any company or trust that forms part of a banking group as defined in section 1 of the Banks Act. This section clarifies the deduction of the section 11(*j*A) tax allowance for impaired financial assets.

Although the adoption of IFRS 9 in the calculation of impairment is not limited to financial institutions (due to the amendments affected by the Amendment Act No. 23 of 2018 which widen the scope. The amendment made by section 25 (1)(*e*) of the Amendment Act No. 23 of 2018 to section 11(*j*) of the Act, that previously gave a discretion to the SARS Commissioner on the amount of the allowance for doubtful debts, resulted in ensuring that if a taxpayer is applying IFRS 9 for financial reporting purposes to determine a loss allowance relating to impairment, they can deduct the same percentages as the banks as a doubtful debt allowance subject to the provisions of section 11(*j*) of the Act.), the study is limited to banks because the impairment impact will be most substantial for banks given the volume and types of financial instruments that they are involved in. This study took a

similar approach as Sarah (2017:1) who also conducted a thesis on impairment in Luxembourgish banks and stated that Luxembourgish banks are the ones that will be most affected by IFRS 9.

The IFRS 9 impairment model applies to financial assets that are measured at amortised cost (e.g., loans receivables, lease receivables, trade receivables) and other debt instruments that are measured at fair value through other comprehensive income. The impairment provisions in paragraph 5.5.1 of IFRS 9 provide for the lease receivable to be included in the calculation of an impairment allowance (see Chapter 2.5.4). However, if certain requirements set in section 11(*e*) are met, a taxpayer may be allowed to deduct from its income the amount by which the value of any leased machinery, plant, implements, utensils and articles under a financial lease, used for the purpose of its trade have been diminished because of wear-and-tear or depreciation. To clarify, it was proposed that the allowances relating to impairment in section 11(*j*A) of the Act excludes "lease receivables' contemplated in IFRS 9.

Since the impairment requirements in IFRS 9 are based on a 'three stage' expected credit loss model (see Chapter 2.5.4.1), section 11(*j*A) of the Act makes provision for the following allowances (in three stages) relating to impairment when determining the taxable income of a specific "covered person" as defined in section 24JB(1) of the Act:

a. 25 per cent of the loss allowance relating to impairment contemplated in IFRS 9 (stage 1);
b. 40 per cent of the loss allowance relating to impairment as is equal to the difference between:
    i. the amount of the loss allowance relating to impairment that is measured at an amount equal to the lifetime expected credit losses; and
    ii. the amount that is in default as determined under paragraph (c) below (stage 2);
c. 85 per cent of the loss allowance that is equal to the amount that is in default as determined by applying the criteria in paragraphs (a)(ii) to (vi)

and (b) of the definition of *default* as defined in Regulation 67 of South African Reserve Bank contained in Government Gazette No 35950 of 12 December 2012 (stage 3).

For purposes of applying the 85 per cent category, the definition of default is defined in Regulation 67 as follows:

"default" in relation to the IRB approach for the measurement of a bank's exposure to credit risk shall in the case of-

a. *“exposures other than retail exposures, be deemed to have occurred when the bank is of the opinion that an obligor is unlikely to pay his/her/its credit obligations in full without any recourse by the said bank to actions such as the realisation of security, which opinion of the bank, as a minimum, shall be based on the matters specified below.*
   i. *The bank has assigned non-accrued status to the relevant credit obligation;*
   ii. *The bank has written off a portion or raised a specific provision in respect of the relevant credit exposure due to a significant perceived decline in the credit quality of the obligor since the bank incurred the said exposure;*
   iii. *The bank is about to sell the credit obligation at a material credit-related economic loss;*
   iv. *The bank has consented to a distressed restructuring of the credit obligation, which restructuring is likely to result in a reduced financial obligation caused by, for example, the postponement of principal, interest or fees;*
   v. *The bank has applied for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation;*
   vi. *The obligor has applied for or has been placed in bankruptcy or similar protection and the said event is likely to avoid or delay repayment of the credit obligation to the banking group.*
b. *exposures other than retail exposures be deemed to have occurred when a*

material obligation of an obligor is overdue for more than 90 days;

c. *retail exposures be deemed to have occurred when the criteria specified in paragraph (a) or (b) above are present at a facility level instead of an obligor level;*
d. *an overdraft facility be deemed to have occurred when-*
    i. *an obligor exceeded an advised limit for more than 90 days, that is, the relevant obligor failed to reduce the outstanding amount within the said period of time to an amount that is within the authorised limit; or*
    ii. *an obligor is advised of a limit smaller than the obligor's existing outstanding amount and the relevant obligor failed to reduce the outstanding amount within a period of 90 days to an amount that is within the newly advised limit;*
    iii. *the reporting bank extends credit to a person with no authorised limit, which credit is not repaid within 90 days;"*

Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09 (Georg, 2011:3). The measures aim to strengthen the regulation, supervision and risk management of banks. In South Africa, the Basel capital framework has been implemented through a three-tier regulatory structure. The Tier 1 legislation consists of an amendment of a parliamentary Act called "Banks Act, 1990". While the Banks Act, which contain the key Basel provisions, serves as the primary legislation, the operational details that constitute the bulk of the Basel framework are contained in the Tier 2 legislation called "Regulations relating to Banks (the Regulations)" issued through Government Gazette No. R. 35950 dated 12 December 2012 and subsequently amended through Government Gazette No. 38682. The Banks Act and the Regulations framed thereunder are administered by the SARB. The Banks Act provides enabling legislation that allows the SARB to prescribe the minimum requirements and a selected supervisory review and evaluation process (SREP) in the Regulations relating to Banks and in directives, circulars and guidance notes issued in terms of the Banks Act. The Regulations specify the internationally agreed minimum prudential and other requirements necessary to implement and comply with

internationally agreed frameworks, such as Basel III. It is this regulation that contains the definition of “default” that is referred in the Act.

Below is an example of the calculation of the impairment allowance in section 11(*j*A) of the Act that will be deductible in stages 1, 2 and 3. The introduction of section 11(*j*A) of the Act led to the alignment of the tax treatment of doubtful debt allowances to the loss allowances determined under the “three stage model” of IFRS 9. According to the 2017 Taxation Laws Amendment Act, a “covered person” who is a bank, branch, branch of a bank and any company or trust that forms part of a banking group as defined in section 1 of the Banks Act must, when determining the 25 and 40 per cent tax allowances, apply the principles of IFRS 9 to arrive at the loss allowance as contemplated in IFRS 9 relating to impairment. However, when determining the 85 per cent allowance the principles set out in Regulation 67, issued under the Banks Act, should be applied. The allowances allowed in a year of assessment must be added back to income in the following year of assessment (Income Tax Act. 1962: section 11(*j*A), National Treasury, 2017:54).

Example 3.4: Illustration of the calculation of an impairment allowance:

Facts:

(a) Bank Y’s IFRS 9 loss allowance relating to impairment at the end of December 2020 is R2 billion.

(b) The amount at default under paragraphs (a)(ii) to (vi) and (b) of the definition of “default” in the Regulations issued under the Banks’s Act is R500 million.

(c) The portion of the IFRS 9 loss allowance that is measured at an amount equal to the lifetime expected credit losses is R1.2 billion.

Solution:

*The allowance allowed in the 2020 year of assessment of Bank Y, according to section 11(*j*A) of the Act, are determined as follows:*

(a) The amount of the IFRS 9 loss allowance relating to impairment at the end of December 2020 represents stage 1 of the three categories of impairment mentioned above. As per IFRS 9, companies are required to provide a 25 per cent

*allowance for credit losses that result from default events that are possible within the next 12 months. Therefore, the tax deductible impairment allowance will be calculated as follows (section 11(j*A*)): R2 billion X 25% = R500 million.*

*(b) To determine stage 2 of the three categories of impairment mentioned above, as per IFRS 9, a loss allowance is required for credit losses expected over the remaining life of the exposure without considering the timing of the default. Therefore, this amount will be calculated as follows (section 11(j*A*)(b)): R700 million [R1.2 billion – R500 million] X 15% [40% - 25%] = R105 million. Also, section 11(j*A*) of the Act states that the original 25 per cent allowance will be increased to 40 per cent for stage 2, hence the amount is multiplied by the difference between 40 per cent and 25 per cent.*

*(c) To determine the last stage of the three categories of impairment mentioned above, the IFRS 9 requirements with respect to the treatment of the stage 3 category are not followed. National Treasury's response on the reason for not following IFRS 9 was stated as, firstly, that banks apply sophisticated models to determine impairment of loans which are highly regulated by the South African Reserve Bank and this reference is deemed to be necessary. Secondly, the concept "default" is critical to the implementation of IFRS 9 but IFRS 9 does not define the term "default". The suggested definition of "credit impaired financial asset" includes references to defaults but largely, IFRS 9 requires each entity to define the term and this subjectivity would not result in alignment between banks (National Treasury. 2017:35). Therefore, it seems that the accounting wording was too subjective and vague. This amount will be calculated as follows (section 11(j*A*)(a)): R500 million X 60% [85% - 25%] = R300 million. Again, the original allowance will be increased to 85 per cent for stage 3, hence the amount is multiplied by the difference between 85 per cent and 25 per cent.*

*The total amount that would be allowed as an allowance (deduction against taxable income) in the 2020 year of assessment in accordance with section 11(j*A*) of the Act will be R905 million (R500 million (stage 1) plus R105 million (stage 2) plus R300 million (stage 3)). This allowance must be added back to the income of a bank in the following*

year of assessment.

Source: Adapted from "Explanatory Memorandum" to the 2017 Taxation Amendment Act, 2017 (2017:53)

The term 'default' is used in section 11(*j*A) but it is not defined in IFRS 9 (see Chapter 2.5.4) and therefore there will be a deviation from accounting principles in this regard. The reference to "amounts that is default" in section 11(*j*A) of the Act for allowing stage 3 of the loss allowance in IFRS 9, is not following IFRS 9 principles, it considers certain prescripts of Regulation 67. It was previously mentioned that the basic rules in tax legislation do not exhaustively explain the association between financial accounting and tax accounting (Norberg, 2007:3). The relationship must be analysed considering how tax accounting questions are covered by specific tax rules, when is the basic rule still used and is this basic rule connected to financial accounting. The definition of "default" as defined in section 3.3.6 above, creates divergent practices as it is not related to the entire definition in Regulation 67 but only relates to certain paragraphs. The concept of 'default' is critical to the implementation of IFRS 9 in assessing whether there has been a significant increase in credit risk as stated in Chapter 2.5.4 (Basel Committee Guidance on credit risk and accounting for expected credit losses. 2016:26). The European Banking Authority (2017:37) reiterates that IFRS 9 does not define the default and suggested that credit institutions should be guided by the definition used for regulatory purposes.

Given the broader guidelines and principles provided for in IFRS 9, this deviation from following the regulations issued by the SARB may be justified in section 11(*j*A) of the Act given that the IFRS 9 standard does not define default. The following section deals with other amendments that have an impact on section 24JB of the Act.

3.3.7 OTHER AMENDMENTS AFFECTING SECTION 24JB OF THE ACT

According to Weidmann (2015:28), there are concerns when there is a distinction between the definition of structured products versus non-structured products for tax purposes to distinguish these products reliably from non-structured financial instruments

as they may have to be taxed in a different manner. Weidmann mentions structured products and hybrid instruments as examples that pose a particular challenge to a tax system since these items are largely organised along the traditional categories of equity and debt.

With respect to hybrid instruments, a particular challenge for a tax system that are either fully or partly based on a distinction between debt and equity, are that those systems usually incorporate several fundamental differences between the tax treatment of instruments qualified as debt or equity. Furthermore, hybrid instruments can pose a challenge for those tax systems that apply the valuation of hybrid instruments under IFRS for tax purposes but nevertheless keep the traditional distinction between debt and equity in their taxation rules of those instruments (Weidmann, 2015: 29).

Stated differently, Weidmann (2015:29) mentioned above that there should be an interaction between hybrid instruments and other rules that apply to financial instruments. In the 2017 Taxation Laws Amendment Act, the Act clarifies the interaction of hybrid instrument rules and fair value taxation under section 24JB. According to the Explanatory Memorandum on this proposed amendment, in certain instances a "covered person" as defined in section 24JB of the Act may issue structured products such as credit linked notes into the market that are dependent on the "covered person's" solvency (National Treasury, 2017:43). An example that is given, is when investors buy securities from the credit link note issuer that is a "covered person" and in exchange they receive a fixed or floating coupon payment over the term of the security and at maturity (National Treasury, 2017:43). Although the hybrid debt rules characterise interest as a dividend *in specie* and that interest does not qualify for a tax deduction, in terms of IFRS 9 (or previously under IAS 39), the hybrid debt instruments would be accounted for at fair value through profit or loss and be subject to tax under section 24JB of the Act. Therefore, the denial of the interest deduction could be overruled by section 24JB of the Act. It was stated in Chapter 3.3.4 that section 24JB(3) of the Act overrides the application of the normal principles that determine the timing of the taxation of gains or losses from financial instruments, however this created confusion as to which section should apply first when

there is a hybrid debt instrument that is also subject to sections 8F and 8FA of the Act. Subsequent amendment was made to state that section 24JB(2) of the Act is now subject to sections 8F and 8FA. This amendment was introduced to eliminate this divergent practice caused by section 24JB of the Act.

3.4 CHAPTER SUMMARY

It was stated in Chapter 1.2.7 that to interpret section 24JB of the Act, a detailed knowledge of the relevant accounting principles relating to financial instruments are required. The accounting principles were discussed in Chapter 2. This chapter dealt with the interaction between section 24JB of the Act and the accounting treatment of financial assets and financial liabilities under IFRS 9 (and previously IAS 39).
This chapter was aimed at assisting in answering the main research question of this study that is:

Could the adoption of accounting principles in section 24JB of the South African tax legislation give rise to divergent practices relating to interpretations and inappropriate applications?

This chapter highlighted some of the divergent practices relating to interpretations and inappropriate applications, and concluded that the definition of financial asset and financial liability should be interpreted based on the IFRS 9 principles. Furthermore, the definition of a financial asset includes a commodity which is defined in another accounting standard (IAS 2) without a clear explanation.

Secondly, the definition of authorised users as defined in section 1 of the Financial Markets Act excludes a company of which the principal trading activities constitute the activities of a treasury operation. The purpose of the principal trading activity requirement is to ensure that an authorised user is not merely a finance or a treasury operation with a better label designed to avoid section 24JB of the Act. However, the meaning of treasury operation is not defined but is also used in other parts of the Act, for example section 9D.

This chapter further discussed the changes made by the 2020 Taxation Laws Amendment Act to section 24JB of the Act to ensure that it is in line with IFRS 9, which is applicable for periods beginning on or after 1 January 2018.

This chapter also discussed the introduction of s11(*j*A). Prior to the 2017 Taxation Laws Amendment Act, section 24JB(2) of the Act did not exclude the impairment loss that was recognised in profit or loss in the statement of profit or loss and other comprehensive income. Therefore, section 11(*j*A) of the Act was introduced and it seeks to clarify that impairment losses are excluded from section 24JB of the Act and will be treated in accordance with the principles set out in section 11(*j*A).

This chapter continued by highlighting the changes that were made to section 24JB of the Act to clarify its application when applied with other provisions of the Act.

The following chapter will present an international comparison between South Africa and the following countries, Australia, Canada and United Kingdom, on the taxation of financial instruments.

CHAPTER 4: INTERNATIONAL COMPARISON

4.1 INTRODUCTION

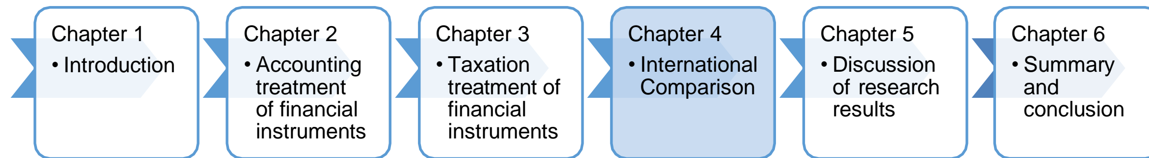
Section 24JB of Act requires amounts used for taxation purposes to be calculated using the accounting principles. The focus of this study is to investigate section 24JB of the Act relating to the taxation of financial instruments.

Section 24JB introduced annual fair value taxation of financial instruments in respect of banks and brokers (defined as a ”covered person” in section 24JB of the Act) that will be taxed in accordance with accounting principles. The relevant accounting principles for such analyses are encompassed in IAS 32, IAS 39, IFRS 7 and IFRS 9 (which is effective for annual periods beginning on or after 1 January 2018) of the accounting standards (see chapter 2). This study also investigates the relevant taxation policies in Australia, Canada and the United Kingdom where their income tax legislation has sections under which gains and losses from financial assets and financial liabilities are dealt with.

The aim of this comparative analysis is to identify the similarities and differences to highlight possible improvements to section 24JB of the Act to assist tax practitioners, financial statement preparers and other preparers with the interpretation of section 24JB of the Act that is based on the accounting principles.

The following diagram provides an overview of the structure of the dissertation and specifically where the discussion in this chapter fits into the study:

Figure 4.1: Study Outline



Source: Author's own

This chapter will provide a detailed discussion of the taxation of financial instruments in the selected countries, namely, Australia, Canada and the United Kingdom and how it compares to section 24JB of the Act. This comparison is intended to identify similarities and differences to highlight possible problems or recommendations for improvement to section 24JB of the Act.

These countries were selected based on the following principles, namely

- the income tax legislation "taxes" gains and losses on financial assets and financial liabilities based on the amounts reflected in IFRS 9; and
- legislation in these countries does not cover just any financial asset or financial liability category but the ones where gains or losses will be reflected in the profit or loss section in the Statement of profit or loss and other Comprehensive Income.

The following section will provide a short overview of Australia's tax regime.

4.2 AUSTRALIA

4.2.1 INTRODUCTION

This section provides an overview of the position taken by Australia on fair value (mark-to-market) taxation gains and losses on financial instruments (in Australia, financial instruments is called financial arrangements) afforded to financial institutions. The financial institution is defined as (a) a bank; or (b) a co-operative housing society in section 202A of Commonwealth Consolidated Acts (1936: section 202A).

4.2.2 AUSTRALIAN POSITION

In Australia, Division 230 of the Income Tax Assessment Act 1997 ("ITAA") defines 'financial arrangement' and describes the methods under which gains and losses from financial arrangements will be taxed. The Division 230 starting value of an asset or liability that is, or is part of, a Division 230 financial arrangement to which Subdivision 230-C (fair value method) applies is the amount of the asset or the amount of the liability according to the relevant standards mentioned in section 230 that apply in relation to the arrangement.

The definition of a financial arrangement is defined in section 230-45(1) to mean a financial arrangement. An arrangement has:

a. *"a cash settlable legal or equitable right to receive a *financial benefit; or*
b. *a cash settlable legal or equitable obligation to provide a financial benefit; or*
c. *a combination of one or more such rights and/or one or more such obligations; unless:*
d. *you also have under the arrangement one or more legal or equitable rights to receive something and/or one or more legal or equitable obligations to provide something; and*
e. *for one or more of the rights and/or obligations covered by paragraph (d):*

i. the thing that you have the right to receive, or the obligation to provide, is not a financial benefit; or

ii. the right or obligation is not cash settlable; and

iii. the one or more rights and/or obligations covered by paragraph (e) are not insignificant in comparison with the right, obligation or combination covered by paragraph (a), (b) or (c).

The right, obligation or combination covered by paragraph (a), (b) or (c) constitutes the financial arrangement."

The definition of a financial arrangement relies on, and resembles the definitions of financial instruments in the accounting principles as defined in subsection 995-1(1).

Companies can choose to use one or more of the elective methods if the financial reports are in accordance with accounting principles. Subsection 995-1(1) of the ITAA 1997 provides that a matter is in accordance with accounting principles if it is in accordance with accounting standards; or if there are no accounting standards applicable to the matter, authoritative pronouncements of the Australian Accounting Standards Board would apply to the preparation of financial statements. The Division 230 of the ITAA 1997 considers many of the Australian accounting standards. The relevant method that will be analysed for purposes of this study is the 'elective fair value method' which is a taxation method where gains and losses from the financial arrangements that are reflected in the statement of profit or loss and other comprehensive income, and that are determined by using the fair value measurement, are used to determine the taxpayer's liability.

4.2.3 DETAILED EXPLANATION OF THE ELECTIVE METHODS

According to the Commonwealth of Australia explanatory memorandum (2008:115) on the taxation of financial arrangements, when designing these amendments, the most feasible approach on defining financial arrangements was to rely on definitions envisaged in the accounting standards. However, a full alignment to accounting principles was not

considered because:

a. the definition of a financial instrument is found in Australian Accounting Standard AASB 132 Financial instruments: Disclosure and Presentation (AASB 132). However, this definition of a financial instrument was formulated using a different context compared to the tax legislation. In addition, this standard forms part of a number of interrelated standards that constitute a larger financial accounting framework and the standards have a different purpose to the income tax system according to the Guide to Taxation of Financial Arrangements (2016:12).
b. secondly, the approach of AASB 132 and AASB 139 appeared to be established on rights and obligations under individual contracts while the provision of finance and risk-shifting occurred through arrangements that comprise one or more contracts and by way of rights and obligations that were not necessarily founded on a contract.
c. lastly, not all entities were going to be subject to Division 230 of ITAA 1997 and be required to prepare financial accounts which classify arrangements based on the definitions in AASB 139.

It was stated in Chapter 3.2.3.1 that the definition in section 24JB of the Act of financial asset or financial liability for tax purposes only refers to the accounting definition in IFRS 32. It was therefore clear that the tax legislators opted to 'borrow from other legislation' and the chapter concluded that the meanings of financial asset or financial liability should be interpreted based on the accounting point of view. It was further stated that the definition of a financial asset includes a commodity considered in terms of IFRS at fair value less cost to sell in profit or loss in the statement of profit or loss and other comprehensive income. A commodity is not specifically defined however for accounting purposes; a commodity is accounted using accounting standard IAS 2.

In Australia, there are four elective subdivisions under which taxpayers may elect to apply a tax-timing method to relevant financial arrangements (subject to meeting certain requirements) when calculating the tax implications. These elective subdivisions allow a

taxpayer to calculate the gains and losses from their financial arrangements using one of the following methods:

i. the fair value method explained in subdivision 230-C that involves a specific election to rely on gains and losses determined by relevant accounting standards for tax purposes if certain specified requirements were met. The fair value method is a tax-timing method that measures a gain or loss from a financial arrangement as the change in its fair value between two points in time. The gain or loss for a particular period is the increase or decrease in its fair value between the beginning and end of the period, adjusted for amounts paid or received during the period. The term 'fair value' is not a defined term under the Australian Tax Acts, however, a meaning is referred to in AASB 139 Financial Instruments: Recognition and Measurement (AASB 139) (this standard is similar to IFRS 9 which uses the definition of ‘fair value that is defined in IFRS 13 as 'the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction (Australian Taxation Office, 2016);
ii. the foreign exchange retranslation method explained in subdivision 230-D that relates to general foreign exchange retranslation election (measures the gain or loss that arises from translating a given number of units of one currency into another currency, which is due to different prevailing exchange rates at different points in time) only. The foreign exchange retranslation method is relevant to entities with arrangements denominated in, or determined by, reference to a foreign currency. Under AASB 121 The Effects of Changes in Foreign Exchange Rates (AASB 121) or a comparable accounting standard made under a foreign law, certain gains and losses attributable to currency exchange rate movements must be recognised in profit or loss in an entity's financial reports. The foreign exchange retranslation method only applies to these gains and losses (Australian Taxation Office: online);
iii. subdivision 230-E that explains the tax treatment for entities that enter into various hedging arrangements to manage their exposure to risks such as interest rate and currency exchange rate fluctuations. To be a ‘hedging financial arrangement’, the arrangement must be either a ‘derivative financial arrangement’ or a ‘foreign

currency hedge' (Schedule 1, item 1, section 230 335).

There are two ways in which a derivative financial arrangement or foreign currency hedge can be a hedging financial arrangement. The first is by the financial accounting route, that is, essentially by being a hedging instrument for financial accounting purposes [Schedule 1, item 1, subsection 230 335(1)]. The second is where the financial arrangement is not a hedging instrument for financial accounting purposes but meets certain other requirements [Schedule 1, item 1, subsection 230 335(3)]; and

iv. lastly, the method which relies on the relevant accounting standards more broadly is found in subdivision 230-F. A company that makes a valid reliance on financial reports election can rely on its financial reports for purposes of complying with its tax obligations relating to its financial arrangements. This election aligns the tax treatment of the relevant financial arrangements to the accounting treatment of those arrangements.

The fair value method in sub-division 230-C (discussed under (i) above) will be highlighted further in this chapter because section 24JB of the Act is applicable to financial instruments measured at fair value.

According to a Commonwealth of Australia Explanatory Memoranda (2008), the application of the elective subdivisions will assist in reducing taxpayers' compliance costs. It was stated in the South African Explanatory Memorandum that the objective of section 24JB was to reduce compliance cost, therefore this reason is similar to the Australian view of the operation of elective subdivisions (South Africa. National Treasury, 2013:53). However, the elective method in South Africa allowed prior to section 24JB of the Act (section 24J(9) of the Act discussed in Chapter 3) was discontinued because it gave rise to uncertainty and confusion.

The following section explains the general requirements that need to be met before being eligible to apply the four elective methods mentioned above.

4.2.4 COMMON REQUIREMENTS FOR MAKING AN ELECTION

For any of the elective methods mentioned above to apply, companies must ensure that their financial reports are:

i. prepared in accordance with relevant accounting standards; and
ii. audited in accordance with relevant auditing standards (Schedule 1, item 1, subsections 230-210, 230-315 and 230-395).

The relevant accounting standards are Australian Accounting Standard AASB 139 Financial Instruments: Recognition and Measurement which covers recognition and measurement of financial assets and liabilities (hereafter AASB 139), Australian Accounting Standard AASB 121 The Effects of Changes in Foreign Exchange Rates which covers certain gains and losses attributable to changes in foreign exchange rates (hereafter AASB 121) and Australian Accounting Standard AASB 127 Consolidated and Separate Financial Statements (hereafter AASB 127) which covers the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent company if applicable.

The Australian Income Tax Act refers to the Australian accounting standards which is the same as IAS 39 and IFRS 9; therefore, there is a similarity with section 24JB of the Act. However, with respect to auditing it is explicitly stated in the Australian Act that the financial statements should be audited. In section 24JB of the Act the auditing requirement is not explicitly stated but, it is expected that a “covered person” will have to be audited because in general a “covered person” is listed on the JSE. It can also be argued that this requirement was not necessary because the PIS score could require an audit as discussed in Chapter 2.2.

4.2.5 GENERAL RULE FOR TAXATION OF GAINS AND LOSSES

As stated above, where the Australian accounting standards or comparable foreign accounting standards require that a fair value measurement through profit or loss be used

to determine the gain or loss on a financial arrangement that is classified as at 'fair value through profit or loss' in that year, these gains or losses will be used to determine the income of the taxpayer (Schedule, item 1. section 230-235).

This Australian general rule is the same as what is contained in section 24JB(2) of the Act. Note that although Australia has adopted the IFRS Standards for all companies, their Income Tax Act still refers to Australian accounting standards. However, in Chapter 3.3.2, the list of exclusions from section 24JB of the Act were mentioned, no similar exclusions were found in the Australian Income Tax.

4.2.6 COMPANIES ELIGIBLE FOR FAIR VALUE METHOD ELECTION

This section highlights companies that are eligible to elect the fair value method. Any company that prepares audited financial reports can make a fair value election (Schedule 1, item 1, section 230-210). However, according to the Commonwealth of Australia Explanatory Memorandum only certain taxpayers may want to elect to use the fair value tax-timing method. The Explanatory Memorandum (xx.163) lists the following taxpayers:

i. "*traders holding instruments or commodities for relatively short times, and buying and selling commodities or financial instruments primarily for market-making purposes"*. Traders were chosen because these are financial institutions that are regarded to have separate trading books and large portfolios of financial arrangements which are fair valued through profit or loss for financial accounting purposes. It was argued that overall compliance costs are expected to be reduced because of the election; and

ii. other taxpayers that are not part of the financial sector that have a sophisticated risk management system, which would allow them to handle any price risk and tax volatility that may arise from using the fair value tax-timing method. In addition, companies "*that record gains and losses on a fair value basis in their audited profit or loss statements may also want to elect fair value tax treatment to reduce overall compliance costs."*

Comparing the companies that can elect the fair value method in Australia with section 24JB of the Act, there is similarity with respect to traders and one can also infer that banks will be included. However, in South Africa section 24JB of the Act cannot be applied by other companies even if they have sophisticated risk management systems.

4.2.7 CLASSIFICATION OF FINANCIAL ARRANGEMENTS UNDER THE ELECTIVE METHOD

This section highlights that the application of the elective fair value tax method is limited to those financial arrangements which are classified as at fair value through profit or loss (Schedule 1, item 1, paragraph 230-220(1)). In the event where part of the financial arrangement is subject to fair value (e.g., the financial arrangement may comprise a financial asset or liability that is fair valued through the profit or loss and include another financial asset or liability which is not), the fair value part will be subject to the fair value taxation method. The remaining part of the financial arrangement will be treated as a separate financial arrangement and will be subject to other tax provisions (Schedule 1, item 1, section 230-235). The requirement that financial instruments should be classified as at fair value through profit or loss is the backbone of section 24JB of the Act (see Chapter 3.3), it can be deduced that this requirement is the same in Australia. However, section 24JB of the Act is silent on the financial instruments that may in part be subjected to section 24JB of the Act while the other part is not.

4.2.8 INTERACTION OF FAIR VALUE METHOD WITH OTHER METHODS

There is a clear interaction between the fair value method and the other elective methods. To illustrate, if a financial arrangement is subject to a fair value election, any gains or losses attributable to changes in currency exchange rates will be treated under the fair value method despite the foreign exchange retranslation method in section 230-D being elected (Schedule 1, item 1, paragraph 230-40(6)(a)). In South Africa, it is not clear how the interaction between section 24I of the Act that deals with foreign currency rules and section 24JB of the Act works. It is therefore clear that the inclusion of some foreign

currency denominated derivatives on a “fair value through profit or loss” basis in accordance with the accounting standards was in effect trying to tax both realised and unrealised forex gains and losses. To provide clarity, section 24JB of the Act should state the interaction between section 24I and section 24JB of the Act.

4.2.9 COMPARING AUSTRALIA WITH SOUTH AFRICA

This study considers the taxation of financial instruments (referred to as financial arrangements in Australia) in Australia, which are fair valued in terms of section 230-C. In general terms, the taxation of these financial instruments appears to be the same as the application of South Africa’s section 24JB of the Act. While the reasons provided by Australia for not following accounting definitions when defining a financial instrument is understandable, because they believe that the definition of ‘financial arrangement’ in Division 230 is based on characteristics common to all financial arrangements and it will cope better with future financial innovation than would a definition based on legal form or on lists of arrangements, this Australian tax definition might be limiting while the accounting definition adopted by South Africa are wider.

In terms of the interaction with other provisions of the Act in Australia, Division 230 takes preference over other taxation rules unless specifically provided otherwise (Australian Master Tax Guide, 2014:1267). When comparing with South Africa, it can be concluded that section 24JB of the Act applies also takes preference over other taxation rules based on the wording of section 24JB(3) when read with other provisions of the Act since section 24JB(3) take preference over all other sections of the Act with regards to financial instruments.

Section 24JB of the Act contains certain exclusions for financial instruments that are held for a longer period, however, in Australia it is not clear what should happen to those financial instruments that are held for a longer period by a “covered person” and yet are classified as at fair value through profit.

It is very clear in the Australian Act that the elective fair value tax method is limited to those financial arrangements which, in whole or in part, comprise assets or liabilities classified in the relevant accounts as at fair value through profit or loss. However, if there is part of the financial arrangement that is not subject to fair value, that remaining part of the financial arrangement will be treated as a separate financial arrangement and will be subject to the other provisions of the Australian Act. In South Africa, such financial arrangement will be excluded from section 24JB of the Act.

The following section provides a better understanding of Canada's regime relating to the taxation of financial instruments.

4.3 CANADA

4.3.1 INTRODUCTION

This section deals with the position taken by Canada on the fair value (mark-to-market) taxation of financial instruments afforded to financial institutions.

4.3.2 CANADA'S POSITION

The mark-to-market rules (fair value taxation rules) are contained in sections 142.2 to 142.6 of Canada's Income Tax Act. These rules were enacted to govern certain securities and apply on an institutional basis rather than a transactional basis. The fair value taxation rules require a taxpayer that is a "covered person" (our version of "covered person" in section 24JB of the Act is defined in Canada as "financial institution" – see full definition below) to report all gains or losses from the "mark-to-market property" (mark-to-market property" is explained below but it is intended to cover a financial instrument) held by it in its income account. In terms of section 142.5, a taxpayer that is a financial institution shall include annually in computing income the increase or decrease in value of securities that are regarded as mark-to-market property. Stated differently, section 142.5 of Canada's Income Tax Act requires shares and certain debt obligations to be marked-to-market each year, and puts the gain or loss so realized to be on income account. The Canadian Income Tax Act applies this rule by deeming a financial institution to have disposed of the property immediately before the end of each tax year for proceeds equal to fair market value and to have reacquired the property at the end of the year at the cost equal to those proceeds which is fair market value. Chaudhary (2019:191) stated the same in relation to any derivative held by the taxpayer, that, it has to be put on sale on the last day of the year of assessment and reacquired on the first day of the next year and this allows any gain or loss on mark-to-market to be treated as an ordinary gain or loss for taxation purposes.

In 2017, income tax introduced a new mark-to-market election that is principally found in section 10.1(15). This rule affects the computation of income from a business or property

and it seems like it was the government's second response to the decisions taken on the *Kruger case*. In the Tax Court of Canada (TCC) in the judgment of *Kruger Inc. v. The Queen*, 2015 TCC 119, the question was whether "mark-to-market" accounting is an acceptable method for computing the profit for tax purposes when trading foreign currency option contracts. The Tax Court of Canada released a decision that indicated derivatives could be carried at the lesser of cost or market value in accordance with the inventory rules. However, the 2017 amendments ensured that "eligible derivatives" which include "agreements" that are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, option agreements or similar agreements are catered for on the mark-to market regime reversing the Federal Court of Appeal decision in *Kruger* that held that derivatives were not normally inventory to which lower of cost or market accounting could apply.

If a taxpayer, including a financial institution as defined in subsection 142.2(1) holds an eligible derivative, it can elect to treat the derivative on a mark-to-market basis for a particular taxation year and all subsequent taxation years by filing an election under subsection 10.1(1). The election cannot be revoked without the consent of the Minister of National Revenue. Alternatively, if the taxpayer does not elect to use mark-to-market accounting, subsection 10.1(7) provides that a taxpayer that is not a financial institution cannot use mark-to-market accounting in respect of the types of agreements that may be eligible derivatives.

A non-financial institution that elects to have the new rules apply will be subject to subsection 10.1(6) which will result in annual mark-to-market treatment through a fair market value deemed disposition or settlement and reacquisition, reissuance or renewal of eligible derivatives.

Sections 4.3.3 and 4.3.4 below details in full which companies are a "covered person" and what will be classified as a financial instrument in Canada over and above the rules mentioned above.

4.3.3 COVERED PERSON UNDER MARK-TO-MARKET RULES AS PER SECTION 142(2)

Since section 24JB of the Act is in general applied by banks and brokers termed “covered person”, it is imperative to understand the meaning of a “financial institution” so as to understand which institutions are eligible for fair value taxation in Canada. The definition of "financial institution" is used to identify the taxpayers that are subject to the fair value taxation rules in section 142 of Canada’s Income Tax Act for shares and debt obligations. A financial institution is any of the following (unless listed in the exclusions described below):

i. a company referred to in any of paragraphs (a) to (e) of the definition of "restricted financial institution" in subsection 248(1) of the Act which is a bank, a trust company, a credit union, an insurance company or a company whose principal business is any combination of the lending of money to, and the purchasing of debt obligations issued by, arm's length persons (Canada Income Tax Act. Section 142.2(1)); or
ii. an investment dealer which is defined as a company that is a registered securities dealer. “Registered securities dealer" is defined in subsection 248(1) of the Act to be a person who is registered or licensed in a province to trade in securities without any restriction on the type or kind of securities in which the person may trade (Canada Income Tax Act. section 142.2(1) and section 248(1)); or
iii. a company controlled by one or more financial institutions, unless the control was acquired because of the default of a debtor and control is being retained in order to minimise losses in respect of the debtor’s default (Canada Income Tax Act. section 142.2(1)); and
iv. a trust or partnership if financial institutions hold interest totalling more than 50 per cent of the fair market value of all interest (Canada Income Tax Act. section 142.2(1)).

The following are excluded from the definition of 'financial institution' for purposes of the Canadian's fair value taxation:

i. investment companies and mortgage investment companies;
ii. mutual fund companies;
iii. deposit insurance companies;
iv. mutual fund trusts; and
v. prescribed persons and partnerships (Canada Income Tax Act. section 142.2(1))

From this definition of a "financial institution" the following differences can be identified when comparing to the definition of a "covered person" in section 24JB of the Act, namely that firstly, there is an inclusion of companies such as credit unions and insurance companies while in South Africa, these companies are excluded from section 24JB of the Act. Secondly the test that a financial institution will not include a controlled company, if it is a controlled company because of a default, is not available in section 24JB of the Act, possibly because the focus is on whether that company is registered under the Banks Act or not. Thirdly, although a trust that forms part of a banking group in South Africa is eligible to apply the provisions of section 24JB of the Act; the 50 per cent threshold does not apply.

There are also some similarities to "covered person(s)" (see chapter 3.2.4.2) as defined in section 24JB, specifically to 'banks and investment dealer' as section 24JB of the Act is applied by banks and an authorised user (broker) who is a member of the JSE responsible for buying or selling securities for own account or on behalf of another person as a business.

As stated above, this comparison is intended to identify similarities and differences to highlight possible improvements to section 24JB of the Act. Based on above exclusions, there are no similarities between Canada and South Africa. It was discussed in Chapter

3.2.4.2 that in relation to the authorised user (broker), that large corporates that are not brokers but are authorised users as defined in section 1 of the Financial Markets Act and have approval from the JSE to trade are not eligible to apply section 24JB of the Act. In addition, in relation to a bank, any subsidiary of a bank that is a long-term insurer or short-term insurer together with the subsidiaries of a long-term insurer or short-term insurer is also not eligible to apply section 24JB of the Act.

The Canadian's fair value taxation rules require financial institutions mentioned above to report all gains or losses from the "mark-to-market property". The following section will mention the "mark-to-market property" that is fair valued and "mark-to-market property" that is outside the ambit of the fair value taxation rules. The effect of the mark-to-market election depends on whether the taxpayer is a financial institution. If the taxpayer is a financial institution, section 10.1(3)(a) would deem the derivative agreement to be a mark-to-market property. Many derivatives held by a financial institution are already mark-to-market property as a result of the tracking property rules in subsection 142.2(1).

4.3.4 DEFINITION OF A MARK-TO-MARKET PROPERTY

For purposes of the mark-to-market rules applicable in Canada, a mark-to-market property is defined in subsection 142.2(1) of Canada's Income Tax Act and generally includes the following:

i. shares;
ii. in the case of a taxpayer who is not an investment dealer (broker), a specified debt obligation that has been marked to market and is reflected at fair market value in the taxpayer's financial statements for all fiscal periods before the taxation year. A specified debt obligation that is sold in the same year in which it is acquired is a mark-to-market property if it is reasonable to expect that it would have been marked to market in the financial statements if it had been held at year end;
iii. if a taxpayer is an investment dealer, a specified debt obligation. A "specified debt obligation" of a taxpayer is the taxpayer's interest in a loan, bond, debenture,

mortgage, note, agreement of sale or any other indebtedness.

Note that, the definition of a “mark-to-market property” excludes shares of a company in which the taxpayer has a significant interest at any time during the year. The significant interest is defined in section 142.2 (2) of the Canadian Income Tax Act to mean the case where a taxpayer holds shares of the company that carries at least 10% of the votes and representing at least 10% of the fair market value of all issued shares. “Mark-to-market property also excludes a share in a “small business company”.

The 2017 amendments mentioned above in effect extend mark-to-market treatment to classes of derivatives that are not already covered by the definition of tracking property such as interest rate swaps, forward purchase or sale agreements, forward rate agreements, futures agreements, option agreements or similar agreements.

In comparison to South Africa, Canada did not follow the principles set by accounting when defining a financial asset and a financial liability, instead the definition of "mark-to-market property" used in Canada includes certain debt obligations that have always been accounted for on a mark-to-market basis for financial statement purposes (Department of Finance Canada. 1994:53). The definition of a financial asset (see chapter 2.4.1.2) will include a share and the definition of a financial liability refers to a “contractual obligation” in a loan for an example, therefore there are similarities between Canada and South Africa although South Africa uses accounting principles to define “mark-to-market property” as concluded in Chapter 3.

Unlike Canada, the exclusions afforded in section 24JB(2)(*a*) of the Act, does not have a threshold, instead the Act list these exclusions (being the interest held by a “covered person” that is a share, an endowment policy, an interest held in a portfolio of a collective investment scheme, an interest in a trust and interest in a partnership) and used accounting principles as basis for these exclusions when reading the Act prior to the 2017 Taxation Laws Amendment Act. For South Africa, these exclusions will still apply from 1 January 2018 to the extent that they do not constitute “trading stock” defined in

section 1(1) of the Act. Unlike the Canadian legislation, South African legislation offers no exclusion for an interest in a "small business company" in section 24JB of the Act.

4.3.5 OTHER RULES PERTAINING TO MARK-TO-MARKET

Some of the provisions will not be discussed fully here, since a comprehensive understanding of these provisions are not necessary for purposes of the study, these include subsections 142.5(4) to (7) that relate to transition rules for the mark-to-market requirement and subsection 142.6(1) that relates to a taxpayer that becomes or ceases to be a financial institution (Canada Income Tax Act: 1985). Section 24JB(5) to section 24JB(6) of the Act dealt with the transitional rules based on the initial implementation of section 24JB of the Act and sections 24JB(7) and (8) of the Act were aimed at all untaxed amounts associated with the spread differential that were triggered in the year of cessation during the transitional phase and if a "covered person" ceases to be a "covered person". When comparing the transitional rules, the transitional rules catered for in section 24JB(5) to section 24JB(6) of the Act are similar to the Canadian rules as it pertains to the initial implementation of section 24JB of the Act. However, it is interesting to note that Canada inserted additional rules pertaining to "becoming or ceasing to be a financial institution" while section 24JB of the Act only have rules when a "covered person" is ceasing to be a "covered person" in section 24JB(9).

4.3.6 INTERACTION OF CORPORATE ROLL-OVER RULES WITH SECTION 142 OF CANADA'S INCOME TAX ACT

Haupt (2021:542) states that "*mergers and acquisitions (corporate roll-over rules) are an important part of the corporate landscape. Even small business acquisitions need to be managed in the most tax-efficient way and the Income tax act contains rules which make business acquisitions easier from a tax point of view. In order to use these rules, mergers and acquisitions have to be carried out in a particular way and within a rigid time frame*". The Canadian Master Tax Guide (2014:586) indicates that in general a capital gain or capital loss must be recognised for tax purposes in the year that an asset is realised by

the taxpayer. However, in certain circumstances where a taxpayer's interest in that asset remains unchanged, a deferral of any capital gain is permitted until the time of disposal of that asset is received. This instance where such deferral is allowed is commonly known as a "roll-over".

Subsection 85(1) of the Canadian Act contains rules that enable a taxpayer to transfer "eligible property" on a roll-over basis to a taxable Canadian company in exchange for a consideration that includes shares of the company however, subsection 85(1)(g) excludes property that is a "mark-to-market property" as defined in section 142 of the Canadian Act of a "financial institution" (Canada Income Tax Act:1985) from this provision.

Canada therefore has a specific exclusion for the "mark-to-market property" that is defined in section 142.2(1) when one company transfer "eligible property" on a roll-over basis to a taxable Canadian company in exchange for a consideration that includes shares of the other company while South Africa is silent on the treatment of financial instruments covered by section 24JB of the Act despite the importance of mergers and acquisitions highlighted above by Haupt (2021:542).

The following section will summarise the similarities and differences between Canada and South Africa with respect to taxation of financial instruments that are fair valued.

4.3.7 SUMMARY OF THE COMPARISON BETWEEN CANADA AND SOUTH AFRICA

For mergers and acquisitions (corporate roll-over rules), Canada contains rules that enable a taxpayer to transfer "eligible property" on a roll-over basis to a taxable Canadian company in exchange for a consideration that includes shares of the company however, the property that qualifies as a "mark-to-market property" defined in section 142 of the Canadian Act is excluded from corporate roll-over rules while South Africa is silent on the treatment of financial instruments covered by section 24JB of the Act despite the importance of mergers and acquisitions highlighted above by Haupt (2021:542).

In South Africa, it is inferred indirectly that there is an exclusion of small medium enterprises from mark-to-market taxation. In chapter 2.2, it was established that a “covered person” cannot be eligible to use IFRS for SMEs as it will fail the “public accountability” test. whereas in Canada the exclusion for a share in a ‘small business company” is explicitly stated.

Canada has rules for non-financial institution such that if these non-financial institutions elect to be on a mark-to-market regime, they will be subject to subsection 10.1(6) which will result in annual mark-to-market treatment through a fair market value deemed disposition or settlement and reacquisition, reissuance or renewal of eligible derivatives. However, South Africa does not have similar rules, section 24JB of the Act is only applicable to banks and brokers.

This section provided the Canadian tax regime on the taxation of financial instruments. The following section will gain a better understanding of United Kingdom’s regime relating to the taxation of financial instruments.

4.4 UNITED KINGDOM ("UK")

4.4.1 INTRODUCTION

This section seeks to deal with the position taken by the UK on fair value (mark-to-market) taxation of financial instruments.

The UK tax legislation for companies stipulates that the profits of a trade are calculated in accordance with generally accepted accountancy practice, subject to any adjustment required or authorised by law in calculating profits for Corporation Tax purposes (section 46 of the Corporation Tax Act 2009).

Generally accepted accountancy practice for Corporation Tax purposes is defined in section 1127 of the Corporation Tax Act 2010 and is:

- UK generally accepted accountancy practice – generally accepted accountancy practice in relation to accounts of UK companies (other than IAS accounts) that are intended to give a true and fair view. This section was also cited by McGowan (2021:11) on the study about the classification of entities, and the meaning of tax transparency.
- In relation to a company that prepares IAS accounts means generally accepted accountancy practice in relation to IAS accounts.

In the Corporation Tax Acts "international accounting standards" has the same meaning as in Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards which in essence is IFRS (section 1127 Corporation Tax Act, 2010).

Section 600 of the Corporation Tax Act of 2009 and 2010 applies to financial instruments that are not treated as a derivative for accounting purposes because they fail the requirement of the relevant accounting standard as regards the initial net investment required by the contract but are nevertheless treated as a financial asset or liability for

accounting purposes.

The basis of accounting that are approved by the Corporation Tax Act, 2009 as envisaged in section 313 are “amortised cost basis” and “fair value accounting”. This study will focus on “fair value accounting” treatment. UK defines “fair value accounting” as a basis of accounting under which assets and liabilities are shown in the company's balance sheet at their fair value. In general, the IFRS calculation forms the base at which the tax is levied on gains and losses from financial instruments.

Given that the UK rules are complicated and yet the outcome is similar to what is envisioned by the South African tax legislation (financial instruments reflect the gains and losses arising from changes in fair value and those gains and losses are included in the statement of profit or loss and other comprehensive income in the period in which they occur and be taxed under section 24JB of the Act), only a short summary of the tax treatment in the UK will be provided.

4.4.2 UK'S POSITION

Tiley and Loutzenhiser (2013:99) argue that as a general matter, there are four sets of tax rules which draw heavily on accounting concepts. These sets of rules are loan relationships including foreign exchange transactions, financial instruments, fixed asset intangibles and rules relating to trading currency.

These sets of legislation share these key common approaches, amongst others:

i. use accounting principles to measure and tax real economic gains and losses;
ii. they do not distinguish between capital and revenue; and
iii. profits and losses are recognised on a mark-to-market basis.

The analysis of Tiley and Loutzenhiser (2013:100) clearly shows the four sets that the tax system faces due to a modern financial world that offers products which fragment a transaction into different elements and then reconstitute them in a different way with

different tax results. It was based on these fragmented transactions that the UK Corporation tax law opted to move away from the traditional basis of taxing income when realised and a capital gain only when an asset is disposed in favour of taxing amounts calculated on the accounting basis such as mark-to-market taxation.

In the UK, the derivative contract must meet one of these three tests to be subject to financial instruments taxation rules:

i. The contract must be treated as derivative financial instruments for accounting purposes;
ii. It must be treated as a financial asset or financial liability for accounting purposes; or
iii. when the underlying subject matter of the contract is either commodities or a contract for difference whose underlying subject matter is land, tangible movable property, other than commodities which are tangible assets, intangible fixed assets, weather conditions, or creditworthiness.

The application of fair value accounting is described in section 600 and state that the amounts to be brought into account in accordance with this Part for tax purposes in respect of the contract which is or forms part of a financial asset or liability for accounting purposes are to be determined based on fair value accounting (Corporation Tax Act 2009, section 600). The amounts from the financial asset or liability must be recognised in the company's profit and loss account, the statement of recognised gains or losses or statement of changes in equity, or in some other statement for the period (Corporation Tax Act 2009, section 597(1)).

The scope of these rules is mainly limited to taxpayers that are liable for company's tax and generally include UK resident companies and non-resident companies carrying on trade in the UK through a UK branch. There are specific rules that apply to financial instruments that are entered into by the qualifying company with a person who is not resident in the UK, whether they are parties form the outset or becomes parties to the contract later (Corporation Tax Act 2009, section 696). This section applies in relation to

a UK company if, as a result of any transaction,—

(a) a UK company becomes a party to a derivative contract to which a non-UK resident is a party,

(b) Non-resident becomes a party to a derivative contract to which a UK company is a party, or

(c) UK company and non-resident company both become a party to a derivative contract.

For each accounting period for any part of which a UK company and non-resident company are both a party to a derivative contract which makes provision for notional interest payments, the credits and debits which are brought into account in accordance with section 696 in respect of the contract in the case of a UK company do not include the amount of any excluded debit in relation to that contract. The amount of an excluded debit is calculated by determining for the accounting period the amount (if any) by which—

(a) the sum of any notional interest payments made by a UK company to a non-resident company while the UK company and the non-resident company are both a party to the contract,

exceeds

(b) the sum of any notional interest payments made by non-resident company to a UK company during that time.

For the purposes of section 696, a payment is a notional interest payment if—

(a) a derivative contract specifies—
    (i) a notional principal amount,
    (ii) a period, and
    (iii) a rate of interest,

(b) the amount of the payment is determined (wholly or mainly) by applying a rate to the specified notional principal amount for the specified period, and

(c) the value of the rate is always the same as that of the specified rate of interest.

However, these specific rules do not apply where the UK company is a bank, building

society or financial trader and it holds the qualifying contract solely for the purposes of a trade or part of a trade carried on by it in the UK provided it is not party to the contract as an agent or nominee of another person (Corporation Tax Act 2009, section 697(1)). In addition, section 696 does not apply if the non-resident company is chargeable to corporation tax or income tax in respect of income arising from the derivative contract (or would be if there were any such income) and is a party to the derivative contract otherwise than as agent or nominee of another person.

These sets of rules have special savings vehicles provisions that cater for collective investment funds and insurance companies, such that these special savings vehicles are treated as if they are required to use an authorised mark-to-market regime (Corporation Tax Act 2009, 587).

When comparing the UK regime with South Africa's regime on who is covered by these mark-to-market rules, section 24JB of the Act caters only for the banks and brokers, there is no specific provision relating to other taxpayers and how they should account for financial instruments. In addition, South Africa's regime appears to be simpler when one looks at the drafting of the legislation.

4.4.3 METHOD OF ACCOUNTING

For companies, most financial instruments will be classified as a loan relationship (under Part 5 CTA 2009), non-lending money debt (treated as loan relationships under Chapter 2 of Part 6 CTA 2009) or a derivative contract (under Part 7 CTA 2009). In general, UK tax law provides that the accounting treatment of these types of instruments is used for tax purposes (HMRC. 2017).

For purposes of loan relationship rules, the gains and losses are calculated by reference to each accounting period while under the foreign currency exchange and financial instrument rules, the gains or losses are calculated with reference to each separate contract, asset or liability. A mark-to-market basis of accounting under any derivative

contract to which that basis is applied is brought into account in each accounting period at a fair value (Finance Act. 2002. Schedule 26, Part 4:17).

The tax legislation for companies requires that the profits of a trade are calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for Corporation Tax purposes (section 46 Corporation Tax Act 2009).

Unlike South Africa that specifically stated only the taxation of the gains or losses that are recognised in the statement of profit or loss and other comprehensive income in terms of accounting standard IFRS 9 (Income Tax Act, section 24JB(1)), UK tax legislation did not make clear which accounting standard needs to be applied in these interrelated rules except to say, profits should be calculated in accordance with generally accepted accounting practice.

4.4.4 SUMMARY OF THE COMPARISON BETWEEN THE UK AND SOUTH AFRICA

Similar to section 24JB of the Act, the UK follows the accounting treatment for financial instruments to calculate the taxable amounts because where the accounting principles requires the measurement of the instruments at fair value, either with profits going to profit or loss, or as items of other comprehensive income, these fair value movements will typically be brought into account for tax. The UK rules are clear on the treatment of a financial instrument where the underlying subject matter of the contract is either a commodity or where the underlying subject matter is intangible fixed assets. However, it was noted in Chapter 3 that in South Africa, the definition of a financial asset includes a commodity which is defined in another accounting standard (IAS 2) without a clear explanation (see Chapter 3.4).

The anti-avoidance provisions in UK contains specific rules that apply to financial instruments that are entered into by the qualifying company with a person who is not resident in the UK whether they are parties form the outset or becomes parties to the

contract later. When comparing the anti-avoidance rule in section 24JB(4) of the Act, it covers agreements entered into between a "covered person" and a person that is not a "covered person" whose agreements are entered into with the sole or main purpose of abusing the timing differences that may arise between the two parties. Although on the face value, these two anti-avoidance provisions are not the same, they possess similar views because to be a "covered person", that company should be recognised by the SARB to be a bank, branch, branch of the bank or controlling company as defined in section 1 of the Banks Act. Therefore, South Africa does have rules for a person who is not a resident in South Africa because a 'branch of the bank' is defined in section 1 of the Banks Act as an institution by means of which a bank conducts the business of a bank outside the Republic (Banks Act.1990:5).

Despite vast differences between South Africa's regime and the UK in terms of drafting and the detail in the treatment of financial instruments (UK is more detailed), the UK legislation has rules that deals with a company ceasing to be a party to a derivative contract. This section applies if—

(a) a company ceases to be a party to a derivative contract in an accounting period (the "cessation period");
(b) profits or losses arise for the company from the derivative contract or a related transaction in that period; and
(c) the credits or debits brought into account in accordance with this Part for that period do not include credits or debits representing the whole of those profits or losses (section 608 Corporation Tax Act 2009).

These rules are clear for the tax treatment of the gains or losses when a company ceases to be a party to the financial instrument, however, these rules are not that clear as to the treatment of the financial instrument itself as the company may cease to follow accounting rules that recognise gains or losses in the statement of profit or loss and other comprehensive income. South Africa has similar rules in section 24JB(9) of the Act. Under the cessation rules in section 29JB(9) of the Act, a "covered person" is deemed to have disposed of that financial asset or redeemed that financial liability

and immediately reacquired that financial asset or incurred that financial liability for an amount equal to the market value of that financial asset or liability.

4.4.5 CHAPTER SUMMARY

This chapter discussed the taxation of financial instruments in the selected countries to gather a basic understanding of its tax treatment to identify the similarities and differences in the taxation of financial instruments in the selected countries in comparison to South Africa. Notably, these selected countries did not follow accounting when defining financial assets and financial liabilities but chose to state specific types of financial assets or financial liabilities that would qualify. This method of identifying various specific types is called the “enumerative approach” discussed in Chapter 3.2.4.1 and will apply when legislators do not define a financial asset or financial liability comprehensively based on established definitional criteria but simply states the various forms of financial assets or financial liabilities.

As a general matter, the selected countries are aiming for a closer alignment between tax and accounting that could be beneficial for both taxpayers and revenue services in the tax treatment of financial instruments.

From the comparison above, it is evident that despite the similarities that exist there are also differences that legislators could also consider and that could highlight possible improvements to section 24JB of the Act.

The table below reflects the summary of the countries discussed in chapter 4 in relation to South Africa, focusing on the approach taken by each country in defining the financial instrument, companies that are eligible to fair value taxation and other rules that this study regards as important.

Table 4.1: Summary of the comparison between South Africa, Australia, Canada and the United Kingdom

	South Africa	**Australia**	**Canada**	**United Kingdom**
Mandatory versus elective mark-to-market regime	No election for banks and brokers.	No election to mark-to-market regime.	Election to mark-to-market regime.	No election to mark-to-market regime.
Definition of financial instrument	Definition follows accounting standard, IFRS 9.	The definition draws on, and closely corresponds with definitions of financial instruments in the accounting principles but does not align completely with those definitions.	The definition does not follow accounting. There is a "mark-to-market property" definition.	Definition follows accounting without specifying the accounting standard that deals with financial instruments.

	South Africa	**Australia**	**Canada**	**United Kingdom**
Basis of taxing financial instruments	Only financial instruments that are measured at fair value through profit or loss.	Only financial instruments that are measured at fair value through profit or loss.	Increase or decrease in value of a "market-to-market" property.	Amounts from financial instruments that are recognised in a company's profit or loss account.
Parties affect ted by fair value taxation	Banks and brokers (traders).	Traders and other taxpayers that have a sophisticated risk management system.	Financial institutions that include insurance companies and brokers and other non-financial institutions.	Any company.
Ceasing the fair value taxation	There are rules on cessation that revert the financial instrument to "market value".	There are specific rules on cessation.	No rules found during analysis.	There are rules on cessation for a company that ceases to be a party to the financial instrument.

Source: Author's own

The following chapter will discuss the implications of the research results gathered from the discussions in the previous chapters and explain the findings.

CHAPTER 5: DISCUSSION OF RESEARCH RESULTS

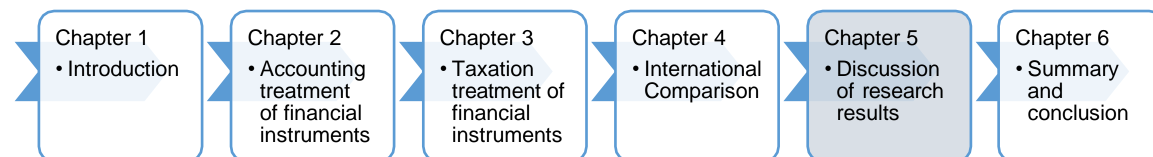
5.1 INTRODUCTORY REMARKS

The focus of this study was to compare the accounting terms and principles to the application thereof in section 24JB of the Act to establish if there are divergent interpretations and inappropriate applications between accounting and taxation of financial instruments.

This chapter discusses the implications of the research results gathered from the discussions in the previous chapters and explain the findings. Chapter 5 highlights major issues that impact section 24JB of the Act to address the research question in Chapter 1, on whether the adoption of accounting principles in section 24JB of the South African tax legislation gave rise to divergent interpretations and inappropriate applications.

The following diagram provides an overview of the structure of the dissertation and specifically where the discussion in this chapter fits into the study:

Figure 5.1: Study Outline



Source: Author's own

Although some of the limitations of the current tax treatment of financial instruments have been identified in the previous chapters, this chapter re-evaluates the major issues identified and makes recommendations. The findings are mainly based on the questions raised by Norberg (2007:3), the literature review performed and the comparison made with other countries (see Chapter 4) to ascertain whether the adoption of accounting principles in section 24JB of the South African tax legislation could lead to divergent practices. In the article by Norberg (2007:3), it is stated that the basic rules in tax legislation does not, on its own, explain the association between financial accounting and

tax accounting. The relationship is analysed by taking the following factors into account:

i. To what degree are fundamental accounting principles covered by specific tax rules, when is the basic rules still used and is this basic rule connected to financial accounting, or not? (see section 5.2 below)
ii. To what degree do specific tax rules mentioned above deviate from financial accounting? (see section 5.3 below)
iii. To what degree are tax legislation interpreted taking International Financial Reporting (IFRS) principles into account? (see section 5.4 below)
iv. Are gaps in tax legislation addressed taking IFRS principles into account or is there some guidance or interpretation note to address the gaps? (see section 5.5 below)

The following paragraph provides the general overview of the findings regarding the introduction of section 24JB to the Act.

5.2 GENERAL OVERVIEW OF SECTION 24JB of THE ACT

Based on the evidence in the preceding chapters, it can be generalised that the adoption of accounting standards by section 24JB of the Act to require the amounts that was determined using accounting principles to be used for tax suggests that a complete alignment is not appropriate in certain instances. Using an example, it is difficult to explain what the definitions of financial asset or financial liability really encompass. In Australia, a complete alignment to accounting principles on defining financial arrangements was not considered, amongst other reasons, due to the way the definition is being used and defined in different accounting standards. In Canada, the definition of what constitutes a “mark-to-market property” did not follow the accounting standards when it was defined. In this study, it was established that the term “financial asset” or “financial liability” that is referred to in section 24JB of the Act is defined with reference to IAS 32. However, an “asset” is not defined in the IFRS 9 standard as IFRS 9 only deals with the treatment of financial instruments; the definition of an asset is defined in the Conceptual Framework (see Chapter 2.4.1.2). For tax purposes, asset is defined in the Eighth Schedule to the Act for purposes of Capital Gains Tax (hereafter “CGT”) as CGT is, with few exceptions,

not triggered until an asset is disposed of. The asset is defined in paragraph 1 of Eighth Schedule to include:

"*(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and*

(b) a right or interest of whatever nature to or in such property;"

However, it should also be noted that there is no definition of "liability" in the Act because section 24JB (1) of the Act refer to IAS 32 when defining financial asset and financial liability.

In addition, IAS 32 defines a financial instrument as any contract that gives rise to a financial asset of one entity and financial liability or equity instrument of another entity. Based on the above, the creation of a tax definition to define financial asset or financial liability may not be fully aligned with accounting standards if the base of taxing this financial asset and financial liability does not follow accounting principles. Possibly, a reason for South Africa to use these terms may lie with one of the reasons of introducing section 24JB of Act in Chapter 1 (see section 1.1.3.1). In that section it was stated that from SARS point of view, the divergence between tax and accounting increased to such an extent that accounting was no longer useful for assessing risk versus the accuracy of taxable income. Thus, it was better to follow the accounting terms and treatment instead of also using tax principles. The second possible reason to follow accounting terms in the Act may be in Chapter 2 (see section 2.2), where it was stated that the validity of a "covered person's" financial statements is tested when that company's annual financial statements are audited or independently reviewed as determined by section 30 of the Companies Act No.71 of 2008 read with Regulations 28 and 29 of the Companies Regulation. These audited and independently reviewed annual financial statements may give the SARS some comfort that it has been audited and reviewed by an independent person and can be regarded as a useful benchmark for assessing taxable income.

This study agrees with Kuo and Lee (2016:1293) who argued that book-tax conformity

eliminates the gaps in the calculation of accounting income and taxable income and this correlation reduces the cost of compliance (see Chapter 1, section 1.1). However, it is doubtful whether there is equality between taxpayers given that the elective method that was eligible to all taxpayers under section 24J(9) of the Act was deleted with effect from 31 March 2014 and the current section 24JB is only applicable to banks and stockbrokers (see Chapter 3, section 3.2.1). Even though the extent of this statement cannot be quantified presently, it is possible that some listed companies (who are obliged to comply with IFRS as stated in Chapter 2, see section 2.2) may hold financial instruments for example in the form of shares for short-term gains but may not be eligible to utilise section 24JB of the Act. It can be concluded that there is no equality between taxpayers. In the context of taxation of financial instruments as mentioned in Chapter 3 (see section 3.2.2), the divergence between tax and accounting was profound, the lack of certainty in tax legislation, for other taxpayers could increase their operating costs by depleting the resources of both taxpayers and the government in working through various tax issues that relates to taxation of financial instruments.

Furthermore, the results of this study agrees with the report by Oats and Tuck (2008:ix) that tax practitioners and revenue service officials should be fully versed with accounting and tax skills as these skills are required for filing income tax return to SARS and during the audit and dispute process between SARS and taxpayers. For purposes of this study, it has been established that the main accounting standards applicable to section 24JB of the Act are IFRS 9 (Financial Instruments), IAS 32 (Financial Instruments: Presentation) and IFRS 7 (Financial Instruments: Disclosures) (see Chapter 2, section 2.1). Therefore, to ensure that SARS and taxpayers are not at odds with each other, knowledge on the accounting standards is required as the accounting treatment underpins the tax computations in section 24JB of the Act.

The following section discusses the extent to which the tax rules are connected to accounting. This section explores the exceptions and the indicative trading intention found in section 24JB of the Act, to name a few.

5.3 TAX RULES AND CONNECTIVITY TO ACCOUNTING

It was previously mentioned that the basic rules in tax legislation does not, on its own, explain the association between financial accounting and tax accounting, this section will look at the fundamental accounting principles that are covered by section 24JB of the Act and how these principles are connected to accounting.

Sections 24JB(5) and (6) of the Act dealt with the transitional rules based on the initial implementation of section 24JB of the Act. These transitional rules were aimed at ensuring that there is minimal disruption for companies that were not fair valuing their financial assets as per IAS 39 when section 24JB of Act was being introduced. These rules were so closely connected to accounting that a “covered person” had to simply use the reported accounting numbers without adjustments and compare these to tax values, then one-third of the excess must be included in the income of that person or one-third of the excess must be deducted from the income of that person. Although not discussed in detail in the study, this phasing-in was given to the “covered person” defined in section 24JB of the Act to lessen the impact and ensure buy-in and compliance to the introduction of the accounting principles as part of the tax rules (section 24JB (6)). The phasing in period that was allowed was 3 years. Given that this time period has lapsed and since the phasing in was connected to another accounting standard (IAS 39) catering for deferred tax, it was considered to be outside the scope of this study.

This basic rule that the “covered person” must hold the financial instruments as ‘either acquired or incurred for trading’ is not stated in the Act. This confirms the theory above that state that tax legislation does not on its own explain the association between financial accounting and tax accounting. However, the relationship must be analysed by considering important accounting requirement. It was discussed in Chapter 2.4.2.3 that for accounting, one of the important requirements was to establish whether the financial instruments reported at fair value through profit or loss are financial instruments that are either acquired or incurred for trading.

Section 24JB of the Act does not explicitly set out this requirement of financial instruments that should be either acquired or incurred for trading. However, it can be inferred that fair value taxation is intended for financial assets and financial liabilities that are ‘held for trading’ if one is basing the imposition of tax on gains and losses that are reported at fair value through profit or loss.

In Chapter 3 (see section 3.3.5), it was stated that section 24JB(9) of the Act was introduced due to IFRS 9 becoming effective for financial years beginning on or after 1 January 2018. This subsection was intended to cater for certain financial instruments that were previously subject to section 24JB of the Act before IFRS 9 and would, after the adoption of IFRS 9, no longer be subject to the provisions of section 24JB of the Act. It had the effect that if a financial asset held by, or financial liability owed by, a “covered person” at the end of the year of assessment before the year of assessment beginning on or after 1 January 2018 would have either ceased to be, or would have become subject to tax in terms of s 24JB(2) of the Act, had IFRS 9 been applicable on the last day of the previous year if assessment, that “covered person” is deemed for purposes of the Act to have–

a. disposed of that financial asset or redeemed that financial liability; and
b. immediately reacquired that financial asset or incurred that financial liability,

for an amount equal to the market value of that financial asset or financial liability on that day.

However, there is no clarification in the explanatory memorandum as to how section 24JB(9) interacts with other provisions of the Act, such as section 22(3)(*a*)(ii) of the Act in terms of the meaning of the market value of this financial instrument. However, it can be concluded that clarification is not necessary as the ‘normal tax rules’ will apply, that is, if this financial instrument falls outside the scope of section 24JB of the Act, normal taxation rules will apply.

The following section highlights the extent to which specific tax rules in section 24JB of the Act deviate from accounting.

5.4 DEVIATION OF TAX RULES FROM ACCOUNTING

In general, this study sought to answer the question that is raised in Chapter 1 (see section 1.3):

Could the adoption of accounting principles in section 24JB of the Income Tax Act give rise to divergent interpretations and inappropriate treatments?

At the main, is the fact that the introduction of accounting principles into the South African tax legislation by section 24JB of the Act, where the entire section rely on accounting, is a new landscape for taxpayers and without proper guidance, this could lead to divergent practices. It has been established in Chapter 3 (see section 3.2.3) and discussed further below in section 5.5 that it is not clear on what basis the definition of financial asset should include a commodity taken into account in terms of IFRS at fair value less cost to sell in profit or loss in the statement of profit or loss and other comprehensive income since a commodity is not specifically defined and is accounted for using the accounting standard, IAS 2, that prescribe the accounting treatment of inventories (IAS 2 section BC 6) . Van der Zwan (2017:125) argues that these agreements entered into by broker-dealers in the form of forward contracts to acquire or sell commodities at fixed prices on future dates as part of their strategies to obtain or dispose of such commodities at appropriate times does not constitute a financial instrument and therefore are outside the scope of section 24JB of the Act. It is suggested that clarification in this regard be provided because this anomaly may create opportunities for arbitrage where derivatives covering non-financial instruments will be fair valued while the underlying commodity is not. In addition to this, it is recommended that hedging rules be developed and incorporated in section 24JB of the Act to supplement this section ensuring that there is no manipulation between trading and investment.

The exclusion in section 24JB of the Act of the taxation of dividends from financial instruments seems like an anomaly because IAS 32 allows for dividends to be recognised

in profit or loss in the statement of profit or loss and other comprehensive income. However, there is no explanation in the Explanatory Memorandum nor in any publication from National Treasury why dividends from financial instruments were excluded. The possible scheme that was curbed by the 2020 Taxation Laws Amendment Act (Act No. 23 of 2020) gives an indication that if the dividends that emanates from these financial instruments that are held for trading, are not taxed a further anomaly could arise.

Section 24JB(2) of the Act is very clear that it follows accounting as it is only applicable to the gains and losses on financial instruments that are recorded in the statement of profit or loss and other comprehensive income for accounting purposes due to fair value changes of these financial instruments at year end. However, the exclusions that are currently found in section 24JB(2) of the Act after the 2017 amendment to the Act do not follow accounting. The treatment of exclusions in section 24JB of the Act can be summarised as follows:

- Before the 2017 Taxation Laws Amendment Act, the exclusions that were applicable to section 24JB(2)(*a*) of the Act were as a result of financial assets being upon initial recognition, designated in terms of IFRS or because that financial asset is managed and its performance is evaluated on a fair value basis in terms of accounting standard IAS 39. These exclusions were more in line with accounting because those are the financial assets that the accounting standard excludes i.e., financial assets being upon initial recognition, designated in terms of IFRS or because that financial asset is managed and its performance is evaluated on a fair value basis.
- After the 2017 Taxation Laws Amendment Act, the exclusions in section 24JB(2)(*a*) of the Act only allows the exclusion to the extent that those financial assets are not regarded as "trading stock" (which is defined in section 1(1) of the Act).

In general, "trading stock" is defined in section 1 of the Act to include:

(a) "anything

i. 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. the proceeds from the disposal of which forms or will form part of the taxpayer's gross income; and

iii. any consumable stores and spare parts acquired by the taxpayer to be consumed in the course of the taxpayer's trade.

The definition then excludes foreign currency option contracts or forward exchange contracts as defined in section 24I(1) of the Act."

Subsequent to the *De Beers (Pty) Ltd v CIR 1986 (1) SA 8 (A)* case, the definition of "trading stock" as it then stood, was split into two parts and later into three parts. The definition of trading was one paragraph when added to the Act in 1990 and included consumables (which is currently part (iii) of the definition). This definition was then split into (a) and (b) in the year 2000 and further split into (i) –(iii) in the year 2010.

Trading stock is currently defined in section 1 of the Act to (i) include anything produced, manufactured, purchased or (ii) in any other manner acquired by a taxpayer for the manufacture, sale or exchange and the second part being anything the proceeds from the disposal of which will form part of gross income, as well as (iii) consumables.

As the definition currently stands, the first part and the third part will have no relevance to the present discussion since a "covered person" will not fall within the first part (i) of the definition, as in general, these financial assets are not acquired for use in manufacturing, or to be assembled or exchanged, however these financial assets are intended to be sold in the short-term. Similarly, a "covered person" will not fall under (iii) of the definition as that part deals with goods acquired for use or consumption in a taxpayer's trade.

This discussion, therefore, only focusses on part (ii) of the current definition. For a "covered person" to fall within the second part, it must be shown that there are proceeds

from a disposal and that these proceeds form part of gross income. To calculate the taxable income amount of a taxpayer, the starting point is the gross income. This study could not identify the treatment of exclusions that are similar to section 24JB(2) of the Act in Australia (Australia is singled out because the Australian treatment of financial instruments or arrangements (as referred to in Australia) is similar to South Africa (see Chapter 4.2.5)). Whilst there is no formal approach that can be used as an international benchmark on this issue and IFRS 9 is effective for periods beginning on or after 1 January 2018, it is submitted that reverting to the tax concept (trading stock) is advisable.

The 2017 Taxation Laws Amendment Act considered the three categories of impairment provisions for financial assets under IFRS 9 that were discussed in Chapter 2, (see Chapter 2.5.4) and allowed an impairment allowance based on these categories. In general, the two categories that are allowed are following IFRS 9. However, the last category is not following IFRS 9, instead the identification of the impairment allowance follows the criteria in paragraphs (a)(ii) to (vi) and (b) of the definition of 'default' as defined in Regulation 67 of the regulations issued in terms of section 90 of the Banks Act. Following SARB criteria creates the first deviation to stage 3 of the impairment allowance. This definition of "default" will create the second divergent practice where this provision of doubtful debt allowance is extended to other companies in the future because those companies will not be subjected to the bank's regulations. This shortcoming may lead to legislators creating another special rule for non-covered person companies. It is recommended that this issue be investigated further in future research as it is difficult to predict how the "category 3 model" of IFRS 9 for non-covered persons will be treated.

5.5 INTERPRETATION WITHOUT REFERENCE TO ACCOUNTING

This study reviewed section 24JB of the Act that taxes financial instruments using the accounting standards that relates to or prescribes the accounting treatment of financial instruments in relation to a "covered person". This section considers scenarios or parts where section 24JB of the Act is silent and there is no interpretation or reference to

accounting principles. In Chapter 3.1.3, based on *Natal Joint Municipal Pension Fund v Endumeni Municipality (920/2010) [2012] ZASCA 13 case* it was stated that an expression such as “the intention of the legislature” is to be avoided, because it conveys that interpretation involves an enquiry into the mind of the legislature.

It was stated in Chapter 2.4.2.3 that a liability used to fund trading activities does not in itself make that liability one that is held for trading, it is clear that the silence on the classification of a liability that is used to fund trading activities may cause unnecessary debates and possibly SARS may consider issuing an interpretation note clarifying the context of this funding and the interaction with other provisions, such as section 24J of the Act. Section 24J of the Act governs the accrual and incurral of interest between the “holder” and the “issuer” of a financial instrument.

The following section highlights some gaps in section 24JB of the Act and whether those gaps are addressed with or without explicit reference to IFRS 9.

5.6 HOW ARE GAPS IN THE TAX LEGISLATION ADDRESSED?

In Chapter 1, it was argued by Mills et al (2002:3) that different rules applicable on the treatment of a particular transaction because of the different accounting and tax treatment can lead to different amounts being recorded or recognised because of the same transaction thereby not attaining the objective of having tax rules being aligned to IFRS principles. It is recommended that the gaps that have been identified in section 24JB of the Act be addressed so that there is a close association between tax and accounting.

The following table highlights the summary of the gaps between accounting and tax that have been identified during the analysis in chapters 2 to 4.

Table 5.1: Summary of the gaps that have been identified from chapters 2, 3 and 4

Gaps identified	**How is this gap currently addressed?**	**Reference to chapter**
The inclusion of commodities as part of the taxation of financial instruments even though there is no specific explanation for the inclusion of the inventory items into the scope of section 24JB of the Act in the Explanatory Memoranda (for example clarifying policy rationale as reason).	For accounting purposes commodity inventories that are held by commodity broker-traders are measured at fair value less costs to sell, as discussed in IAS 2. These words are “fair value less costs to sell” in section 24JB however it is not clear what costs should be deducted.	Chapter 2.4.2.2 and section 24JB(2)

Gaps identified	How is this gap currently addressed?	Reference to chapter
The definition of "authorised users" as defined in section 1 of the Financial Markets Act excludes a company of which the principal trading activities constitute the activities of a treasury operation. The purpose of the principal trading activity requirement is to ensure that an authorised user is not merely a finance or a treasury operation with a better label designed to avoid section 24JB of the Act. However, the meaning of treasury operation is not defined but is also used in other parts of the Act, for example section 9D.	Ordinary meaning of treasury operations should be used.	Chapter 3.4

Source: Author's own

5.6 FINDINGS FROM THE INTERNATIONAL COMPARISON

As it was highlighted in Chapter 4, Australian taxation of financial instruments is more aligned to section 24JB of the Act. Chapter 4 revealed notably a gap on the interaction of section 24JB of the Act with other provisions. Possibly an amendment may be needed in

corporate roll-over rules (which is sections 41- 47 of the Act), as this is not clarified by the legislators for the treatment of financial instruments measured at fair value through profit or loss where the fair value adjustments are recognised in the statement of profit or loss and other comprehensive income at year end of that “covered person” and that “covered person” performs corporate restructuring during that year. The exclusion to the application of corporate roll-over rules in section 41(2) of the Act does not include section 24JB of the Act. It was evident that in Canada, this exclusion from the corporate roll-over rules was because a revaluation to a fair market value is already done on a regular basis for tax purposes and therefore, as matter of clarification, South African tax legislation should do likewise (also clarify) in section 41(2) of the Act for purposes of corporate restructuring.

The anti-avoidance provisions in the UK contains specific rules that apply to financial instruments that are entered into by the qualifying company with a person who is not resident in the UK whether they are parties from the outset or becomes parties to the contract later.

When comparing the anti-avoidance rule in section 24JB(4) of the Act, it covers agreements entered into between a “covered person” and a person that is not a “covered person” whose agreements are entered into with the sole or main purpose of abusing the current rules that may arise between the two parties. However, if the UK rules are reviewed, their anti-avoidance provisions do not apply where the UK company is a bank, building society or financial trader. Secondly, UK’s anti-avoidance provisions state that for the purposes of this section a derivative contract of a company is matched if and to the extent that—
(a) it is in a matching relationship with another derivative contract or loan relationship of the company, or
(b) exchange gains or losses arising in relation to the derivative contract are excluded from being brought into account and “unmatched” is to be construed accordingly.

Lastly, it is stated that, a derivative contract is in a matching relationship with another derivative contract or loan relationship if one is intended by the company to act to

eliminate or substantially reduce the economic risk of the other. The "economic risk" is defined for purposes of this section to mean a risk which can be attributed to fluctuations in exchange rates between currencies over a period.

However, it was stated in Chapter 3.3.4 that the mark-to-market regime will not apply to a "covered person" if:

- the financial instrument is a derivative as defined in IFRS;
- the counter-party to the derivative is another member of the same consolidated group under IFRS;
- the counter-party is not subject to the mark-to-market regime; and
- the derivative is unhedged by the bank or broker.

The South African language in section 24JB(4) of the Act refers to any amount in respect of a financial asset or financial liability and not a financial instrument that is a derivative as defined in IFRS. Secondly, section 24JB(4) of the Act's language may be difficult to prove as this wording mimics the wording that was in section 103(1) of the Act which dealt with a general anti-avoidance rule (GAAR). GAAR is aimed at closing the tax avoidance gaps in legislation exploited by multinational companies. Before being replaced in 2006, the GAAR was in section 103(1) of the Act and consisted of four main requirements:

- there must be a transaction, operation or scheme
- that resulted in the avoidance, reduction or postponement of tax and
- was entered into or carried out in a manner not normally employed for business purposes, other than obtaining a tax benefit and
- the transaction must have been entered into solely or mainly for the purpose of obtaining a tax benefit.

The deleted section 103(1) of the Act required the existence of all four of these requirements before the GAAR could be applied to a transaction.

The challenge with GAAR was that it focused on arrangements which technically include "agreements" but the language focused mainly on transactions and schemes. This is

based on the current case law, only transactions and schemes were considered and not instruments. According to SARS (2005:44), one of the reasons for the deletion of section 103(1) of the Act was that the term "main" has generally been construed to mean predominant. In a simple example, if a transaction has both a tax and a commercial purpose, the Purpose Requirement can be satisfied only if it can be proven that the tax purpose was the predominant one. Since most transactions in a business context have at least a colourable commercial rationale, the Commissioner is placed in the difficult position of having to disprove a taxpayer's allegations through circumstantial evidence. However, this term "mainly" is used in section 24JB. Since there have been minimal tax cases involving the previous version of the GAAR (Mzila 2020:4), it will be interesting to see how the courts will interpret the wording of section 24JB(4) of the Act.

Other findings relate to the tax treatment of commodities. In Chapter 3.2.3, it was stated that the inclusion of commodities in the taxation of financial instruments brings contradiction because there was no specific explanation for the inclusion of the inventory items into the scope of section 24JB of the Act because the Explanatory Memorandum of 2012 and 2013 on section 24JB of the Act does not mention commodities. The UK rules are clear on the treatment of a financial instrument where the underlying subject matter of the contract is either a commodity or where the underlying subject matter is an intangible fixed asset.

Some countries seem to have clarified the interaction between taxation of financial instruments that are fair valued and taxation of exchange gains and losses from these financial instruments. However, in South Africa, there is no clear interaction of section 24JB of the Act and section 24I of the Act. It is suggested that urgent steps be taken to address this issue in the legislation.

It is clear in the Australian Act that the elective fair value tax method is limited to those financial arrangements which, in whole or in part, comprise assets or liabilities classified in the relevant accounts as at fair value through profit or loss. However, if there is a portion of the financial arrangement that is not subject to fair value, that remaining portion of the

financial arrangement will be treated as a separate financial arrangement and will be subject to the normal provisions of the Australian Act. In South Africa, there is no mention of the treatment of combined financial instruments where one part is fair valued and another part is not.

In Canada, the mark-to-market regime is applicable to non-financial institution that elects to have these rules which result in annual mark-to-market treatment through a fair market value deemed disposition or settlement and reacquisition, reissuance or renewal of eligible derivatives. Possibly, South Africa needs to consider an extension too of the rules to other non-financial institutions.

5.7 CONCLUSION

This chapter considered the implications of the research results gathered from the discussions in the previous chapters (chapters 2 to 4) and explains the findings as well as the findings gathered from the international comparison. This chapter's findings were based on the questions raised by Norberg (2007:3), the literature review performed and the comparison made with other countries (see chapter 4) to ascertain whether the adoption of accounting principles in section 24JB of the South African tax legislation gives rise to divergent practices? This chapter also analysed the association between financial accounting and tax principles by taking the following factors into account:

i. To what degree are fundamental accounting principles covered by specific tax rules, when is the basic rule still used and is this basic rule connected to financial accounting, or not? (see section 5.2)
ii. To what degree do specific tax rules mentioned above deviate from financial accounting? (see section 5.3)
iii. To what degree are tax legislation interpreted taking International Financial Reporting Standards (IFRS) principles into account? (see section 5.4)
iv. Are gaps in tax legislation addressed taking IFRS principles into account or is there some guidance or interpretation note to address the gaps? (see section 5.5)

In addition, this chapter investigated notable differences when comparing the South African regime of taxing financial instruments with Australia, Canada and the United Kingdom.

The following chapter presents the conclusion to the study, as well as recommendations and contributions made by this study.

CHAPTER 6 SUMMARY AND CONCLUSION

6.1 OVERVIEW

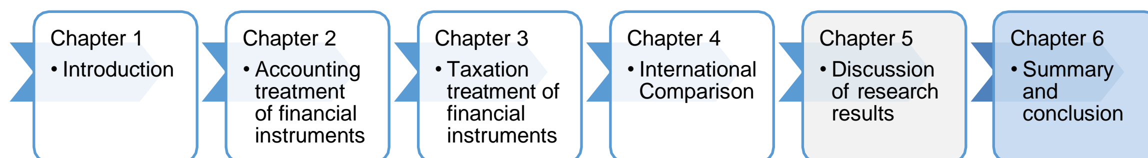
This chapter provides the conclusion to the research question

Could the adoption of accounting principles in section 24JB of the Income Tax Act give rise to divergent interpretations and inappropriate treatments?

This conclusion is based on the analysis performed in the previous chapters where the research results from the literature review was discussed and from the findings gathered from the international comparison.

The following diagram provides an overview of the structure of the dissertation and specifically where the discussion in this chapter fits into the study:

Figure 6.1: Study Outline



Source: Author's own

The alignments between tax and accounting have been researched extensively around the world. To the researcher's knowledge, in South Africa most studies dealt with the taxation of derivative financial instruments in section 24K which deals with interest rate agreements and section 24L which deals with option contracts. This study reviewed literature that was pertinent to the introduction of section 24JB of the Act by analysing the relationship between tax and accounting, the meaning of fair value, fair value

measurement, certain tax cases and accounting standards applicable to the treatment of financial instruments measured at fair value through profit or loss.

The close link between accounting and tax can lead to conflict and dilemmas when certain accounting principles are not clearly stated in the Act. This gap could lead to different interpretations by stakeholders who have to apply section 24JB of the Act. Put differently, differences in interpretation may lead to inconsistencies between the application of tax provisions and accounting principles. For example, the inclusion of commodities in the taxation of financial instruments is a misnomer because there was no specific explanation for the inclusion of the inventory items into the scope of section 24JB of the Act because the Explanatory Memorandum of 2012 and 2013 on section 24JB of the Act does not make mention of commodities. Another example is the definition of authorised users as defined in section 1 of the Financial Markets Act, which excludes a company of which the principal trading activities constitute the activities of a treasury operation. However, the meaning of treasury operation is not defined but is also used in other parts of the Act, for example section 9D.

In general, the accounting standards can be understood to be a rigid structure of principles and requirements that are defined and written into various standards by the IASB (Picker et al 2016:168). In addition, inputs are provided by standard setters, auditing firms, consulting firms, other interest groups and companies by comments provided on the initial draft standards issued for comments. These accounting standards have also become a listing requirement of the JSE because companies listed on this exchange must comply with the IFRS standards as stated in a previous chapter (see Chapter 2.2). It is, therefore, understood that the introduction of section 24JB to the Act and following of accounting principles is welcomed given the wide acceptance of accounting principles by institutions like the JSE.

6.2 SUMMARY OF FINDINGS

The research question was to establish whether the adoption of accounting principles in section 24JB of the Act give rise to divergent interpretations and inappropriate applications. This study accepts that section 24JB of the Act attempts to merge accounting principles and tax principles. However, there are also divergent interpretations and inappropriate applications that emerged because of the application of accounting principles in tax legislation in section 24JB of the Act.

6.2.1 DIVERGENT INTERPRETATIONS AND INAPPROPRIATE APPLICATIONS

In Chapter 1, (see section 1.1) reference was made to Alley and James (2005:2) where it was stated that the reasons why financial reporting rules and practices might not always be appropriate for determining tax liability lies with the difference in the purpose of accounting and taxation, difficulties in defining the concept of income, the continual evolution of accounting and taxation and the ever desirable aim for administrative effectiveness. The adoption of section 24JB of the Act brought the following to the fore:

The difficulty in defining the concept of income was explained in chapter 2 (see section 2.4.1.2), where from an accounting perspective, the meaning of a financial asset was not clear because in IAS 32 and IFRS 9, the term "financial asset" or "financial liability" (that is referred to in section 24JB of the Act) is defined with reference to the term "asset" or "liability". However, the word "asset" or "liability" is not defined in IAS 32 or IFRS 9 standard but in the Conceptual Framework.

It was established in Chapter 4 (see section 4.2.5) that the Australian Act is clear on the financial arrangements which, in whole or in part, comprise assets or liabilities classified in the relevant accounts as at fair value through profit or loss. In the event where there is a part within the financial arrangement that is not subject to fair value, that remaining part of the financial arrangement may lead to divergent interpretations and inappropriate

applications because of uncertainty as to whether section 24JB of the Act should be applied fully or only on a portion of the financial arrangement with the remainder being taxed using the normal rules of the Act.

Hopefully, the recent events that occurred in Canada where the Federal Court of Appeal held that, the “mark-to-market” method is an administrative concession to financial institutions and other regulated entities rather than a reflection of the Minister's view of the correct application of income computation principles for income tax purposes to the trading of options will not happen in South Africa.

6.3 SUMMARY OF THESIS

This study provided the extent to which the tax principles embodied in section 24JB conform to IFRS 9 and the previous accounting standard, IAS 39. In addition, it also indicated to what extent section 24JB of the Act deviates from the accounting standard and what areas still needs clarification or amendments.

Chapter 1 highlighted the reasons for performing this study on section 24JB of the Act and introduced the research question for this study. The main research question of this study was:

Could the adoption of accounting principles in section 24JB of the Income Tax Act give rise to divergent interpretations and inappropriate treatments?

The proposed methods and structure of the research were described in this chapter.

Chapter 2 investigated the accounting treatment of financial instruments to reflect the gains and losses arising from changes in fair value and how those gains and losses are included in the statement of profit or loss and other comprehensive income in the period in which they occur. This review was undertaken to establish the theoretical

understanding of IFRS 9 because section 24JB of the Act is following accounting standards regarding the taxation of financial instruments. Chapter 2 also highlighted various impairment models under IAS 39 (see section 2.4.3) however, under IFRS 9, there is a single impairment model that applies to instruments measured at amortised cost and at Fair Value Through Other Comprehensive Income. This confirms the reasons for having IFRS 9 (see section 2.5.1) where it was stated that the improvements in standards was to enhance transparency and reduce complexity.

Chapter 3 dealt with the interaction between section 24JB of the Act and the accounting treatment of financial instruments under IFRS 9 (and previously IAS 39). This chapter established a theoretical understanding of the taxation of financial instruments because section 24JB of the Act is following accounting principles when taxing financial instruments.

Chapter 4 discussed and examined the taxation of financial instruments in Australia, Canada and the United Kingdom. Major similarities and differences were mentioned.

In Chapter 5, an analysis was provided of the ways in which the accounting standard requirements may be interpreted and how this interpretation becomes part of the calculative realm to define the structure of what section 24JB of the Act intended. In addition, the chapter identified certain gaps between accounting principles and tax principles.

Chapter 6 summarised the research and the conclusions to be drawn and made recommendations for further research, where applicable.

The following section provides the summary of the contributions by this study and their implications. The contribution of the study is assessed using the previous chapters discussed. In addition, the following section discusses the problem areas of section 24JB of the Act and includes an overview of opportunities for further research.

6.4 SUMMARY OF CONTRIBUTIONS

This study aimed to provide the extent to which the tax principles embodied in section 24JB conform to IFRS 9 and the previous accounting standard, IAS 39. The summary of contributions of this study are highlighted below and include a discussion of the problem areas.

6.4.1 DISCUSSIONS OF DIVERGENT INTERPRETATIONS AND INAPPROPRIATE APPLICATIONS

As stated in Chapter 3.1.3, the rules of interpretation of statutes were laid down in the case of *Natal Joint Municipal Pension Fund v Endumeni Municipality (920/2010) [2012] ZASCA 13:*

a. The words used in the Act are to be given their ordinary grammatical meaning unless they are illogical.
b. Interpretation is the process of attributing meaning to the words used in legislation after having regard to the context provided by reading the section or sub-sections in the light of that section as a whole and the reasons for having that section.
c. Consideration must be given to the language used in the light of the ordinary rules of grammar and syntax.
d. Where more than one meaning is possible each possibility must be weighed in the light of all these factors.
e. An expression such as “the intention of the legislature” is to be avoided because it is a misnomer as it requires an enquiry into the mind of the legislature (see section 3.1.3).

However, it would be difficult to analyse the words in section 24JB of the Act in a case where there are no articles backing evidence to follow. In Chapter 3 (see section 3.4), it

was established that there are no articles that explain in part or in detail the inclusion of commodities in the taxation of financial instruments.

Chapter 5 highlighted some of the divergent practices relating to interpretations and inappropriate applications of section 24JB of the Act. The key problem identified was the interpretation of section 24JB of the Act as it specifically makes references to the specific accounting standards as basis for taxation and yet in certain instances as mentioned above, there is no clear guidance as to whether accounting principles should be followed or not. In addition, there is no clarity for the inclusion of commodities in the application of section 24JB of the Act. The following section will discuss the implications for existing theory.

6.4.2 IMPLICATIONS FOR EXISTING THEORY

In Chapter 1, the quote from Walter B. Wriston: "*All the Congress, all the accountants and tax lawyers, all the judges, and a convention of wizards all cannot tell for sure what the income tax law says*" (Yablon, 2013:1621) motivated the analysis performed in this study. The Wriston quote demonstrates the challenges experienced by professionals when interpreting the Act.

It was stated in Chapter 3.2.2 that section 24JB of the Act was introduced because the rules pertaining to financial instruments in respect of income tax and financial accounting have completely diverged. This divergence has proven to be a challenge for both taxpayers and the SARS alike. In addition, the sheer volume of financial transactions of large financial institutions requires expensive systems that require constant adjustment. As a result, tax deviations are often manually accounted for, thereby becoming prone to inaccuracies. From a SARS standpoint, the divergence between tax and accounting has become so profound that accounting is often no longer a useful benchmark for assessing risk *vis-à-vis* the accuracy of taxable income. It can therefore be deduced that the choice of following accounting principles in section 24JB of the Act to prevent the divergence between tax and accounting would require any person who utilise section 24JB of the Act

to be fully versed with accounting principles of financial instruments and general tax principles when needed.

The analyses in Chapter 2 and Chapter 3 have demonstrated some detail knowledge required and some challenges when using financial reporting rules for purposes of determining the financial liability for tax purposes. In the previous chapter (see chapter 5), the findings showed that the introduction of section 24JB of the Act could give rise to divergent practices and highlighted the challenges of interpreting this section.

The implications of the findings are significant as they will assist in bridging the gap between accounting principles and tax. This study will ensure that this reliance on accounting principles to determine the tax liability in the Act filters through to tax practitioners, who will need to have both accounting and tax knowledge as evidenced in a report by Oats and Tuck (2008:ix) (see Chapter 1.2.7). At the time of identifying the topic for research, this is the first study that evaluates, in detail, the interaction between accounting principles and section 24JB of the Act.

The following section highlights the contributions of this study that can be implemented in achieving an alignment between accounting and tax to limit divergent interpretations and inappropriate applications.

6.5 RECOMMENDATION FOR IMPLEMENTATION

The analyses in Chapter 2 and Chapter 3 have demonstrated some detail knowledge that is required and some challenges when using financial reporting rules for purposes of determining tax liability. In the previous chapter, the findings showed that the introduction of section 24JB of the Act could give rise to divergent practices and highlighted the challenges in interpreting this section. This study revealed that there are certain factors that need to be taken into account when applying section 24JB of the Act. Therefore, for effective application of section 24JB of the Act, emphasis should be placed on the importance of understanding the various gaps mentioned in chapter 5, such as:

i. To what degree are fundamental accounting principles covered by specific tax rules, when is the basic rule still used and is this basic rule connected to financial accounting, or not? (see section 5.3)
ii. Are gaps in tax legislation addressed taking IFRS principles into account or is there some guidance or interpretation note to address the gaps? (see section 5.5)

Understanding these factors will help the integration of accounting principles and tax. More-over it is interesting to note that section 22(1)(*b*) still contains the rules on how to determine the market value for purposes of financial instruments under section 24J(9) of the Act. Possibly, a technical correction is needed to delete this reference as obsolete as section 24J(9) was deleted.

This study also reveals that to ensure that SARS and taxpayers are not at odds with each other, users of section 24JB of the Act need to acquire knowledge of the accounting principles that underpins the tax computations in section 24JB of the Act.

Another practical contribution is that the study provided the framework for analysing section 24JB of the Act to gain an understanding of the interplay between the tax principles and accounting standard IFRS 9.

6.6 FUTURE RESEARCH

The main purpose of the study was to review the introduction of annual fair value taxation of financial instruments in respect of banks and brokers (defined as a “covered person” in section 24JB of the Act) that are taxed in accordance with accounting principles. However, future studies can be conducted on the alignment of the accounting and tax treatment of impairment allowances. Certain strides have been taken in the Act as two of the three stages of IFRS are allowed as a deduction when calculated using accounting principles. The research possibilities may include the following:

i. During the discussion on impairment losses (see Chapter 3.3.6) the last stage in calculating impairment losses does not follow IFRS 9, instead the criteria in paragraphs (a)(ii) to (vi) and (b) of the definition of 'default' as defined in Regulation 67 of the regulations issued in terms of section 90 of the Banks Act are followed. Central to further research is that future research should establish whether the criteria under these regulations are not subjective and may or may not create a further divergence from accounting. According to IFRS 9, stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime expected credit loss (ECL) is recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance). The IFRS 9 standard requires management, when determining whether the credit risk on a financial instrument has increased significantly, to consider reasonable and supportable information available, to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial instrument. It can be deduced from above that to get to stage three, a continuous process from stage two should be evaluated, but if a regulation criteria is followed, what "is this continuous process that should be established"?

ii. Pursuant to the Canadian case, should South Africa cater for a taxpayer that is not a financial institution to use mark-to-market accounting and in respect of which financial instruments?

iii. The qualitative characteristics of financial statements and its objective of ensuring that financial statements are of a high quality were discussed in chapter 2 (see Chapter 2.3). It was in this chapter where it was mentioned that a study by Barth et al (2012:70) found higher quality and increased comparability when comparing financial statements between companies due to the adoption of IFRS. A future study can investigate the accounting treatment of financial instruments under IFRS 9, with specific focus on the disclosure notes of these financial instruments across all the banks.

iv. On the impairment of financial assets as envisaged in sections 11(*j*) and 11(*j*A), does the introduction of accounting principles imply new provisions for tax purposes and should the concept of "significant increase in credit risk" be defined

to ensure consistent treatment across all companies? Another possible question that follows is whether this statistically estimated loan loss provision should be considered as incurred in terms of tax legislation?

6.7 CONCLUSION

In the article written by Freedman (2004:2), titled *"Aligning Taxable Profits and Accounting Profits: Accounting standards, legislators and judges"*, she questioned whether the accounting standard itself introduces questions of law. Freedman mentioned that at times accounting standards refer to legal concepts, or requires analysis of a legal document, in most cases it will be a contract. In this instance an accountant is giving an opinion on a legal concept or the proper construction of a contract. Furthermore, the article enquires whether, when a legal concept forms part of a standard, it would be interpreted according to legal principles. Therefore, if this scenario exists, it may lead to a complex interaction of accounting principles and legal principles. According to accounting principles, the definition of financial instruments also refers to agreements between two parties. Therefore, this study agrees with Freedman that, with the introduction of section 24JB of the Act it has brought some areas of complex interaction between accounting and tax principles, especially in instances where there is no clear guidance from the Act.

It is submitted in this study that without proper guidance, the adoption of accounting principles in section 24JB of the South African tax legislation could give rise to divergent interpretations and inappropriate applications. Even the definition of financial asset or financial liability in section 24JB of the Act refers to an accounting standard that still needs to be interpreted while Australia preferred to list what a financial instrument is even though the definition of a financial arrangement draws on, and closely corresponds with, the definitions of financial instruments in the accounting principles.

It is further concluded that, despite section 24JB of the Act being deemed to have come into operation for the first time on 1 January 2014, there is a possibility that there may

have been other issues that are not covered in this study coupled with inherent challenges of understanding the integration between tax and accounting. Broadly, there is no doubt that the adoption of accounting principles in section 24JB of the Act could bring divergent practices if there are still gaps that need to be clarified to bring clear alignment between tax and accounting. If these issues are not addressed, they may lead to a similar decision taken as in the Tax Court of Canada (TCC) in the judgment of *Kruger Inc. v. The Queen*, 2015 TCC 119. In this case, the question was whether "mark-to-market" accounting is an acceptable method of computing profit for tax purposes trading foreign currency option contracts. It was held that, the "mark-to-market" method is an administrative concession to financial institutions and other regulated entities rather than a reflection of the Minister's view of the correct application of income computation principles for income tax purposes to the trading of options.

That said, this study agrees that the introduction of section 24JB of the Act assisted the financial institutions (brokers and banks) to lessen the burden of having two systems of calculations, one for tax and another for accounting. In addition, the fact that under IFRS 9, financial assets could be classified as amortised cost or fair valued based on their contractual cash flow and business model as stated in Chapter 2. For these assets, it could be argued that the asset has remained part of a business model where the objective is to hold the assets for the long term and collect the contractual cash flows then a case can be made that the gains are on capital account and therefore not taxable. However, as a general matter, the question of whether financial instruments are capital or revenue in nature depend on the facts and circumstances of each case. Therefore, section 24JB of the Act introduced accounting principles into the Act and is a hybrid model as it seems to be halfway accounting and somehow brings in tax principles.

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