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

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Abstract

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

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

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

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