

University of Cape Town



The treatment of section 24J instruments denominated in a foreign currency

**with regard to the categorisation as fixed or variable rate instruments and the
interaction between section 24J, section 25D (foreign currency translation rules) and
section 24I (gains and losses on foreign exchange transactions)**

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ABSTRACT

Section 24J is regarded to be one of the most complex provisions in the Income Tax Act No. 58 of 1962. This study specifically focuses on the income tax treatment of section 24J instruments denominated in a foreign currency, specifically with regards to whether such instruments are fixed or variable rate instruments for purposes of section 24J and the interaction between section 24J, section 25D (foreign currency translation rules) and section 24I (gains and losses on foreign exchange transactions).

The basic concepts surrounding the incurral and accrual of interest for income tax purposes, as well as of some of the general issues faced when section 24J is practically applied are discussed. Importantly it is found that although the definition of 'instrument' includes all debt instruments, regardless of whether such instruments are interest-bearing, the application of section 24J would have no impact on the issuer or holder of an instrument that is a non-interest bearing debt instrument. Also, the section 24J definition of 'interest' is wider than the common law meaning of the same term. However, as 'interest' is defined with reference to itself, the common law meaning is still very relevant.

It is confirmed that section 24J poses various interpretational uncertainties which are especially highlighted when some of the key provisions of section 24J are applied in determining the interest accrual amounts based on the yield to maturity method.

Applying the rules of statutory interpretation and with the aid of hypothetical examples, it is argued that foreign exchange rates would fall within the definition of a variable rate for purposes of section 24J. However, an instrument denominated in a foreign currency would be regarded as a fixed rate instrument to the extent that the amounts payable are fixed amounts specified in the applicable foreign currency or the calculation of the amount payable in the applicable foreign currency does not involve the application of a 'variable rate' (as defined).

Further is it argued that section 24J merely provides for a single accrual or incurral event during each year of assessment in relation to each instrument. Therefore, where accrual amounts be denominated in a foreign currency it should be translated at the spot rate on the last day of the year of assessment (or on the date of redemption/transfer in the instance

where the instrument was transferred/redeemed during the year of assessment) for purposes of determining the sum of the accrual amounts to be included in taxable income. It is also argued that the timing of the accrual and incurral of interest amounts in terms of section 24J is applied in establishing the 'transaction date' of the interest amount owing for purposes of determining 'exchange differences' at the end of any year of assessment in terms of section 24I.

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Chapter 1: Introduction

1.1 Background

The concept of earning and incurring interest plays an essential role in modern day business, finance and the economy at large. Although ‘interest’ has been defined in various ways, the basic idea behind the concept seems to be that a lender is to be compensated for the time period that he is deprived of the use of the money so lent.¹

Prior to the introduction of section 24J of the Income Tax Act No. 58 of 1962 (further referred to as ‘the Act’)², the income tax treatment of interest accrued or incurred was a highly debated topic. As no specific legislation relating to the taxation of interest was included in the Act, the general provisions of the ‘gross income’ definition in section 1 and the general deduction formula contained in section 11(a) had to be considered. Various South African (further referred to as ‘SA’) court cases dealt with and had conflicting views regarding the timing of the incurral or accrual of interest. In **ITC 1485** and **ITC 1496** Melamet J. observed that interest is inherently characterised by it being incurred and accruing on a day to day basis.³ However, it was held in **ITC 1588** by Van Zyl J. that a fixed amount of interest payable in terms of a 5 year loan arrangement constituted an unconditional obligation or liability on day one and is therefore expenditure actually incurred on that day.⁴ Similarly it was found in **ITC 1587** that discount charges (i.e. interest) were expenses incurred on the day of the acquisition of the loan and were therefore deductible in terms of section 11(a) on day one of the loan.⁵ In 1996 the Supreme Court of Appeal reached a decision in the case of **Cactus**

¹ Brincker, T.E. 2011. *Taxation Principles of Interest and Other Financing Transactions*. Durban, South Africa: LexisNexis. Available at: [http://za-zatlxn001:8090/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://za-zatlxn001:8090/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu). [2013, August 29]. (Referred to as ‘**Brincker**’). Part III – Interest, Chapter V.2 The nature of interest.

² **I Income Tax Act, No. 58 of 1962**, as amended. 2012. Juta’s Compendium of Tax Legislation, Claremont: Juta Law. All references to ‘section’ in this document are to sections of ‘**the Act**’.

³ **Income Tax Case No 1485**, 1990 52 SATC at 337 (refer to as ‘**ITC 1485**’) and **Income Tax Case No 1496**, 1991 53 SATC at 229.

⁴ **Income Tax Case No 1588**, 1994 57 SATC at 148.

⁵ **Income Tax Case No 1587**, 1994 57 SATC at 97.

Investments⁶ that interest would be incurred and accrued on day one of a loan arrangement. The court held that the right to the interest accrues to the lender immediately (i.e. when the loan is entered into).⁷

In the 1995 Budget speech the Minister of Finance (Mr Chris Liebenberg) announced that the Act would be amended and that interest would be accrued and incurred over the term of the instrument (i.e. the so-called ‘yield to maturity basis’ (further referred to as ‘YTM’)) for SA income tax (further referred to as ‘income tax’) purposes. The proposed amendments were specifically geared to address the uncertainty regarding the timing of interest deductions and accruals for income tax purposes and to reflect the economic reality of interest bearing instruments.⁸ The budget announcement was brought into effect by the introduction of section 24J as inserted into the Act by clause 21(1) of Act No. 21 of 1995 and generally applies to all financial instruments issued after 15 March 1995 (note that section 24J also applies to instruments issued on or before 15 March 1995 and transferred on or after 19 July 1995, or issued on or before 15 March 1995 and unredeemed by the holder on 14 March 1996).

Section 24J is regarded to be one of the most complex provisions in the Act and various amendments have been made to the section since its introduction in 1995. Understanding the concepts of section 24J and how this section interacts with other sections in the Act remains a very relevant topic.

⁶ **Cactus Investments (Pty) Limited v Commissioner for Inland Revenue**, 1999 (1) All SA 345 (A) (referred to as ‘Cactus Investments’) at 350.

⁷ *Ibid.*

⁸ South Africa, Department of Finance. 1995. *Budget Review*. 15 March 1995. Cape Town: Department of Finance.at 5.3.2.6.

1.2 Objectives and approach

With the ever increasing trend towards international trade and globalisation, the tax consequences relating to section 24J instruments (e.g. interest bearing debt arrangements) denominated in a foreign currency is considered highly relevant. This study focusses on *the income tax treatment of section 24J instruments denominated in a foreign currency with regards to whether such instruments are categorised as fixed or variable rate instruments for purposes of section 24J and the interaction between section 24J, section 25D (foreign currency translation rules) and section 24I (gains and losses on foreign exchange transactions)*. Note that the purpose of this study is *not* to provide a comprehensive analysis of section 24J in its entirety. Due to the many complexities and various interpretational uncertainties surrounding section 24J it is practically impossible to cover all the aspects of section 24J within the parameters of this paper.

That said, it is however necessary to establish a fundamental understanding of section 24J by discussing some of the defined terms and ‘basic’ principles of section 24J (i.e. the concepts surrounding the incurral and accrual of interest for income tax purposes) as well as some of the general issues taxpayers face when section 24J is practically applied, in order to perform the above study. In this regard the following terms defined in section 24J are specifically considered: ‘Instrument’, ‘income instrument’, ‘interest’, ‘accrual amount’, ‘accrual period’, ‘adjusted initial amount’, ‘yield to maturity’, ‘fixed rate instrument’, ‘variable rate instrument’ and ‘variable rate’. In addition to these defined terms, the provisions of section 24J(2), section 24J(3) and section 24J(5) are also focused on for purposes of this study (referred to as ‘**the relevant provisions of section 24J**’).

Although some of the other defined terms in section 24J are in some instances briefly mentioned / discussed, these terms are not analysed in detail for purposes of this study. Section 24J(3A), section 24J(4), section 24J(6), section 24J(7), section 24J(8), section 24J(9), section 24J(10) and section 24J(12) are also not considered in detail for purposes of this

study. Further it should also be noted that section 24I and section 25D are not considered the main focus areas of this study. These provisions are only discussed to the extent that interaction occurs between ‘the relevant provisions of section 24J’ in respect of the income tax treatment of instruments denominated in a foreign currency.

The ‘relevant provisions of section 24J’ are therefore considered in detail and the practicality of the application of these provisions is tested. As will be shown, the interpretation of several of ‘the relevant provisions of section 24J’ and the interaction between these provisions could result in unintended tax consequences and anomalies compared to the economic position of the taxpayer. The study will consider the actual wording of the Act compared to the supposed intention of the legislation. The study will also explore to what extent the taxpayer could benefit depending on the assumed interpretation of the law and to what extent clarity is required in this regard.

The methodology to be applied is the rules of statutory interpretation as it is applied in the context of fiscal legislation, as well as commentaries contained in judicial and other sources of literature. Although the purpose of the study is *not* to establish the correct or incorrect manner in which to interpret legislation, there are various instances throughout this paper where it is necessary to consider the true intention of the legislation due to the use of ambiguous or unclear wording in the Act. In this regard the following interpretational method is applied: Firstly, it is noted that there is no difference between the rules of interpretation applied to fiscal legislation and other statutes (for example, the Act).⁹ Also, it is a well-established principle that words should be given their ordinary grammatical and literal meaning in establishing the intention of the legislator (referred to as ‘the golden rule’ of statutory interpretation).¹⁰ However, in some instances the difficulty arises that, no matter how carefully words are chosen, when applied under certain circumstances the original

⁹ **Glen Anil Development Corporation Limited v Secretary for Inland Revenue**, 1975 (4) All SA 620 (A) at 626.

¹⁰ **Venter v Rex**, 1907 TS 910 at 913 (referred to as ‘**Venter v Rex**’), **Adampol (Pty) Limited v Administrator**, 1989 (4) All SA 776 (AD) at 778.

intention of the writer is not conveyed correctly.¹¹ It was therefore established that only in the instance where the ordinary meaning of the words in question lead to an *absurdity so glaring that it could never have been contemplated by the Legislature*, the golden rule could be deviated from.¹² In such instances further aids would have to be relied on, leading to various approaches to statutory interpretation being applied and conflicting judgements in this regard. In the recent Supreme Court of Appeal case of **Natal Joint Municipal Pension Fund v Endumeni Municipality**, judge Wallis JA stated that “*ascertaining the intention of the legislature*” is a misnomer as it “*involves an enquiry into the mind of the Legislature*”.¹³ Judge Wallis JA then established the following approach to interpretation:¹⁴

“Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. ... The “inevitable point of departure is the language of the provision itself”, read in context and having regard to the purpose of the

¹¹ *Supra Venter v Rex* at 913.

¹² *Shenker v The Master and another*, 1936 AD 136 at 142 (referred to as ‘*Shenker v The Master*’); *Supra Venter v Rex* at 913; *Barkett v SA Mutual Trust and Assurance Company Limited*, 1951 (2) All SA 462 at 468 (referred to ‘*Barkett v SA Mutual Trust*’) and *Savage v CIR*, 1951 (4) All SA 249 (A) at 254 (referred to as ‘*Savage v CIR*’).

¹³ *Natal Joint Municipal Pension Fund v Endumeni Municipality*, 2012 (2) All SA 262 (SCA) (referred to as ‘*Natal v E*’) at paragraph 20.

¹⁴ *Supra Natal v E* at paragraph 18. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction chapter (Chapter 1) to this paper.

provision and the background to the preparation and production of the document.” (own emphasis)

The clarified approach to statutory interpretation, as laid out by judge Wallis JA above, will be applied where necessary throughout this study, i.e. considering the language and the context together.¹⁵

Hypothetical, practical examples will also be used throughout the study to aid in the illustration of the section 24J interest calculations and different outcomes depending on the application of the law.

¹⁵ Note that the purpose of this study is not to consider the correct or incorrect method of interpreting legislation. The precedent established in the latest Supreme Court of Appeal case in this regard is therefore accepted.

Chapter 2: The ambit of section 24J

2.1 Introduction

Section 24J includes a total of 31 defined terms.¹⁶ The understanding and interpretation of many of these terms impact significantly on the timing and calculation of the amount of interest accrued or incurred. Before these key concepts are further considered (as per Chapter 3 of this study), it is necessary to first reflect on the circumstances in which the provisions of section 24J will find application. The definitions of ‘instrument’, ‘interest’, ‘issuer’ and ‘holder’ are of particular importance in this regard.

2.2 Instrument

Section 24J applies where a person is the issuer of an ‘*instrument*’ or the holder of any ‘*income instrument*’ during a year of assessment.¹⁷ The application of section 24J is therefore founded on the definition of ‘instrument’.¹⁸ This definition has been amended since its introduction into the Act and as of 1 January 2013 ‘instrument’ means the following:¹⁹

- “any form of *interest-bearing arrangement* or any *debt*;
- any acquisition or disposal of any *right to receive interest* or an *obligation to pay interest*, as the case may be, in terms of any other interest-bearing arrangement; or

¹⁶ See definitions in section 24J(1).

¹⁷ See section 24J(2) and (3).

¹⁸ Davids, D., Olivier, L. & Urquhart, G. 2013. *Commentary on Income Tax*, Claremont, South Africa: Juta Law. Available at: <http://ipproducts.jutalaw.co.za/nxt/gateway.dll?f=templates&fn=default.htm&vid=Publish:10.1048/Enu>. [2013 August 29]. Chapter II The taxes (ss 5 - 64C), PART I Normal Tax (ss 5 -37H), 24J Incurral and accrual of interest, RS 18, 2013 JUTA'S INCOME TAX 24J. (Referred to as ‘**Commentary on Income Tax**’) -16.

¹⁹ See definition of ‘instrument’ in section 24J(1) (‘referred to as ‘**definition of instrument**’).

- *any repurchase agreements or resale agreement.”*

Note that the definition of ‘instrument’ where an ‘instrument’ was issued after 15 March 1995, or issued on or before that 15 March 1995 and transferred on or after 19 July 1995, or issued on or before that 15 March 1995 and unredeemed by the holder on 14 March 1996. ‘Lease agreements’ are specifically excluded from the definition of ‘instrument’.²⁰ Further note that in the case of a company the term ‘income instrument’ is synonymous with ‘instrument’. In the case where the holder is a person other than a company, section 24J will only apply if the expected term of instrument exceeds one year and the instrument is issued/acquired at a discount or premium or bears deferred interest.²¹

As per the 2012 Taxation Laws Amendment Act the words preceding the specific inclusions (as listed above) in the definition of ‘instrument’ are deleted.²² Previously the preceding words, “*instrument means any form of interest-bearing arrangement, whether in writing or not, including-*” specifically limited the ambit of section 24J only to interest-bearing arrangements. To the extent that this requirement was not satisfied, section 24J did not have to be considered any further. However, with the deletion of this umbrella requirement from the current definition of ‘instrument’ each specifically listed inclusion and exclusion to the definition should be considered to determine whether or not section 24J applies.

- It is arguable that the essence of the definition of ‘instrument’ now rests in the phrase “*any interest-bearing arrangement or any debt*”, although the other inclusions (i.e. an acquisition/disposal of a right to receive/obligation to pay interest in terms of an interest-bearing arrangement or repurchase/resale agreements) should still be considered separately. Firstly, ‘interest-bearing arrangement’ should be read with the wider meaning of ‘interest’ as defined for purposes of section 24J and would include

²⁰ *Ibid*, read with the definitions of ‘repurchase agreement’ and ‘resale agreement’ also in section 24J(1).

²¹ See definition of ‘income instrument’ in section 24J(1).

²² *Taxation Laws Amendment Act, No. 22. of 2012*. 2013. Government gazette. 36122. 1 February. Government notice no. 71. Cape Town: Government Printer. (referred to as ‘**2012 TLAA**’) at clause 54.

any form of arrangement where there is a *debtor/creditor relationship* and an *amount is payable as compensation to the lender for the use of money for a period of time*. (Refer to detailed discussion on ‘interest’ at sub-heading 2.3 below.) Whether or not the principal amount is required to be repaid by the borrower does not seem to have any bearing on the classification as an ‘interest-bearing arrangement’. Although case law has established that the interest payable should *relate to the principal amount concerned*²³ there is no precedent that the incurral or accrual of interest is dependent on the *repayment of the principal amount*. The normal meaning of ‘arrangement’ is very wide and includes, amongst others, a conception, course of action, ground plan, layout, master plan, method, outline, program of action, schema, scheme, system, agreement, compact, compromise, contract, mutual agreement, mutual assent, mutual promise, mutual undertaking, pact.²⁴ An arrangement could therefore include any agreement between parties on any terms, including an agreement that requires the payment of interest without the repayment of the principal amount.

Secondly the term ‘debt’ should be considered. Prior to 1 January 2013 the definition of ‘instrument’ included references to various forms of debt (for example, bonds, debentures, bills, promissory note etc.).²⁵ However, as per the 2012 Taxation Laws Amendments Act all these cumbersome terminologies were replaced throughout the Act with the word ‘debt’.²⁶ ‘Debt’ is not defined for income tax purposes and should therefore be interpreted based on the statutory interpretation rules. “*Consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its*

²³ Refer to comments on ‘interest – the common law meaning’ at sub-heading 2.3.1 and the various case law cited in this regard.

²⁴ Free Dictionary. 2013. Huntingdon Valley, PA: Farlex.Inc. Available at: <http://legaldictionary.thefreedictionary.com> [2013, August 31]. (referred to as ‘FreeDictionary’).

²⁵ See the definition of ‘instrument’ in section 24J prior to the amendments of *supra* 2012 TLAA, specifically subsections (a), (b) and (c).

²⁶ *Supra* 2012 TLAA.

production”.²⁷ As per the Oxford Dictionary ‘debt’ is “a sum of money that is owed or due”.²⁸ As per the 2012 Explanatory memorandum to the tax amendments:

*“debt encompasses a sum owed by one party (the debtor) to another party (the creditor). Typically, a debt is created when the creditor lends a sum of money to a debtor. The debt is granted with expected repayments that may (or may not) include interest for the use of the sums loaned. Debt can come in many forms, including a personal loan, an advance (e.g. on salary), a note, a bond, a debenture, a bank deposit or any other claim of money requiring repayment. Debt may be held privately or publicly traded.”*²⁹

From the ordinary meaning of ‘debt’ it is clear that an ‘interest’ component is not an inherent requirement. Debt is regarded as a monetary obligation between two parties, regardless of whether interest will or will not be charged. It is interesting to note that although the purpose of section 24J is to determine the income tax treatment of interest accrued or incurred, on the strict interpretation of the Act (as it currently reads), it also applies to non-interest bearing arrangements that still fall within the ambit of ‘debt’.

The section 24J definitions of ‘holder’ and ‘issuer’ also offer no further limitations with regard to the ambit of section 24J. An ‘issuer’ being a person entitled to any interest receivable or amount in terms of an instrument and ‘holder’ a person who has incurred any interest or is obligated to repay an amount in terms of an income instrument.³⁰ It is arguable that the reference to ‘amount’ in the above two definitions would include a repayment of the principal amount in terms of the instrument. Therefore where persons enter into, for example,

²⁷ *Supra Natal v E* at paragraph 18.

²⁸ *Oxforddictionaries.com*. 2013. Oxford: Oxford University Press. Available at: www.oxforddictionaries.com/defintion/english. [2013, August 29] (referred to as ‘**Oxford Dictionary**’).

²⁹ South Africa. National Treasury. 2012. *Explanatory memorandum on the Taxation Laws Amendment Bill, 2012*. Pretoria: National Treasury. (referred to as ‘**2012 Explanatory Memo**’) at 31.

³⁰ See definition of ‘holder’ and ‘issuer’ in section 24J(1).

a loan agreement that only requires the repayment of the nominal amount these persons would still be considered an issuer or holder of an instrument for purposes of section 24J.

Although section 24J would have no impact on the issuer or holder of an instrument that is a non-interest bearing debt (as there is no interest to be spread over the term of the instrument), there is still an onus on the taxpayer to apply section 24J to each and every instrument (including all debt instruments) and *prove* that there is no impact on his or her taxable income. Considering the definition of ‘instrument’ in the *context of section 24J as a whole and the circumstances attendant upon its coming into existence*, it is doubtful that it was ever intended for the ambit of section 24J to be this wide.³¹

2.3 Interest

As mentioned above, the definition of ‘instrument’ is the foundation of section 24J, however the primary purpose of the section is to determine the amount of interest incurred or accrued during a specific year of assessment in relation to every instrument held or issued.³² The definition of ‘interest’ is therefore a critical component to the application of section 24J.

The section 24J definition of ‘interest’ is not exhaustive and includes the gross amount of any *interest or related finance charges, discount or premium* payable or receivable in terms of or in respect of a financial arrangement (further referred to as ‘the first part of the definition of interest’).³³ Note that the definition of ‘interest’ also includes an amount (or portion thereof) payable by a borrower to a lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement,

³¹ *Supra Natal v E*. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction chapter (Chapter 1) to this paper.

³² See section 24J(2).

³³ See definition of ‘interest’ in section 24J(1).

have been entitled; as well as the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement (referred to as the ‘second part of the interest definition’).³⁴

Professor Brincker makes the following two observations in his book “Taxation Principles of Interest and Other Financing Transactions”:³⁵

- This first part of the definition of interest can be classified into two elements, namely; (1) *interest or related finance charges* and (2) *any discount or premium* payable or receivable in respect of a financial arrangement. Based on this classification it would seem that the concept of interest and related finance charges is self-standing, and that it is defined without reference to a financial arrangement; and
- The section 24J definition of interest is wider than the common law meaning of the same term. However, as interest is defined with reference to itself, the common law meaning is still regarded as important.

2.3.1 *Interest – the common law meaning*

The term ‘interest’ has been the subject matter of various judgments:

In **Riches v Westminster Bank Limited** it was said that: “... *the essence of interest is that it is payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had had use of the*

³⁴ *Ibid.*

³⁵ *Supra* Brincker, Part III – Interest, Chapter V.2 The nature of interest.

money or conversely the loss he suffered because he had not had that use. The general idea is that he is entitled to compensation for the deprivation.” (own emphasis added)³⁶

In **CIR v Lever Bros** the Court said: “*In the case of a loan of money, the lender gives the money to the borrower, and in return incurs an obligation to pay the same amount of money at some future time and, if the loan is one which bears interest, he also incurs an obligation to pay that interest. As a rule, the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and this supply of credit is a service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently, this provision of credit is the originating cause or source of the interest received by the lender. Although, colloquially, one speaks of a debt carrying interest, or interest on a debt, as though interest were a sort of growth sprouting from the debt, the language used means no more than that the borrower pays interest, if that is the agreement between the borrower and the lender, as consideration for the benefits allowed to him by the lender.*” (own emphasis)³⁷

Interest was described in **ITC 1485** as “*an expense to compensate a lender for the time period during which money is lent to a second party.*” (own emphasis)³⁸

In the Australian case of **FCOT v Myer Emporium Limited** it was said that: “*Interest is regarded as flowing from the principal sum ... and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum.*” (own emphasis)³⁹

In **CIR v Cactus Investments (Pty) Limited**⁴⁰, a wider definition was attached to the meaning of interest. It was said that interest is *not necessarily compensation for the use of*

³⁶ **Riches v Westminster Bank Limited**, 1947 1 All ER 469 (HL) at 472.

³⁷ **Commissioner for Inland Revenue v Lever Bros**, 1946 AD 441.

³⁸ *Supra* **ITC 1485** at 342.

³⁹ **Federal Commissioner of Taxation v Myer Emporium Ltd**, 1987 (18) ATR 693 (HCA) (referred to as **FCOT v Myer Emporium**).

⁴⁰ *Supra* **Cactus Investments** as paraphrased by Professor Brincker. See *Supra* **Brincker**, Part III – Interest, Chapter V.2 The nature of interest.

money, but it is the stipulated return which a lender would require if he lends money to a borrower.

The Oxford Dictionary defines interest as “*money paid regularly at a particular rate for the use of money lent, or for delaying the repayment of a debt*”.⁴¹

Professor Brincker summarises the general common law definition of ‘interest’ based on the various findings of the courts as follows:⁴²

“Generally, it seems that an amount will constitute interest if there is a debtor/creditor relationship; it is calculated with reference to a sum of money; it is payable for the use of money; and it accrues over time.”

It is noted that Professor Brincker’s summary does not seem to take into account the wider meaning of interest as confirmed in the **Cactus Investments (Pty) Limited** case (refer to foot note 40). The general meaning of interest (based on the various findings of the courts) should therefore rather be summarised as follows:

An amount will constitute interest if there is a lender / borrower relationship, and an amount is payable for the use of the money or an amount is stipulated by the lender as the return which he requires for lending money to the borrower. Such an amount could be calculated with reference to a sum of money; and it accrues over time.

⁴¹ *Supra* Oxford Dictionary.

⁴² *Supra* Brincker, Part III – Interest, Chapter V.2 The nature of interest.

2.3.2 Related finance charges

The term ‘related finance charges’ is not defined in the Act or in other current SA statutes, for example the National Credit Act.⁴³ The Investor Dictionary includes the following definition of ‘finance charges’; “*all charges that the borrower pays for the use of funds including interest, fees and other charges paid directly for the use of credit, or indirectly as a condition for the extension of credit*” (own emphasis).⁴⁴ As per ‘**Commentary on Income Tax**’, the normal meaning of ‘related finance charges’ is the following: “*any kind of charge levied, irrespective of name, with the intention, and having the effect, or raising the effective interest burden on the transaction as a whole. The charge must be related to the amount concerned, and the time period or which interest will be paid.*”(own emphasis).⁴⁵

The evident similarities between the general common law meaning of ‘interest’ and the normal meaning of ‘finance charges’, are that both ‘charges’ are considered *compensation for the use of funds* and *relate to the principal amount concerned*. It therefore seems that with the inclusion of this concept of ‘related finance charges’ it was intended for the ambit of the provision to include all *such* charges regardless of what it is called or when it is incurred (e.g. over the period of the arrangement or on initiation of the agreement). The fact that finance charges are a fixed amount that is *not* determined as a percentage of the principal amount has no bearing on whether or not it is considered ‘interest’ for purposes of section 24J. Similar to interest, such finance charges would simply be considered a portion of the required return stipulated by the lender, i.e. interest. It is therefore probable that costs that generally relate to the raising of credit, such as initiation fees (defined in the National Credit Act as “*a fee in respect of costs of initiating a credit agreement, and charged to the consumer by the credit provider; or paid to the credit provider by the consumer upon entering into the credit*”

⁴³ National Credit Act No. 34 of 2005, as amended. 2008 Available: <http://discover.sabinet.co.za/document/NTL10433> [2014, August 8] (referred to as the ‘**National Credit Act**’).

⁴⁴ *Investor Dictionary*. 2013. InvestorDictionary.com. Available at: www.investordictionary.com [2013, August 30].

⁴⁵ *Supra Commentary on Income Tax* -16A.

agreement”⁴⁶⁾, raising fees and funding costs could fall within the section 24J definition of ‘interest’. The various cost relating to each arrangement should however be carefully considered on its own merit to determine whether it is considered a ‘related finance charge’ for purposes of section 24J, further consideration in this regard is however beyond the scope and purposes of this study.

2.3.3 *Discounts and premiums in respect of financial arrangements*

Where an instrument is issued or transferred⁴⁷ for an amount less than or more than the nominal value of that instrument, a discount or premium will be applicable. As mentioned above, the inclusion of discount and premiums in the definition of ‘interest’ in section 24J is only in respect of *financial arrangements*. Again, the term ‘financial arrangement’ is not defined for purposes of the Act and takes on its normal meaning of a contractual arrangement involving finance or credit of some kind.⁴⁸ Professor Brincker makes the notable observation that it is necessary to distinguish between a premium and discount payable in respect of a financial arrangement, compared to a commercial arrangement. For example, a cash discount would not be seen to be a discount payable in respect of a financial arrangement, but rather in respect of a commercial arrangement.⁴⁹

Silke makes the following relevant observation: “*By treating premiums and discounts as ‘interest’, although undoubtedly part of the overall yield on the instrument, section 24J is premised on the notion that all amounts, both payable and receivable, are taxed to the extent that they form part of the overall yield. This principle therefore overrides the general capital*

⁴⁶ *Supra National Credit Act*, see definition of ‘initiation fee’.

⁴⁷ “Transfer’ is defined for purposes of section 24J (see definition of ‘transfer’ in section 24J(1)) and includes any transfer, sale, assignment or disposal.

⁴⁸ *Supra Commentary on Income Tax* -16A.

⁴⁹ *Supra Brincker*, Part III – Interest, Chapter V.2 The nature of interest.

*versus revenue principle which advocates that discounts and premiums constitute amounts of a capital nature in certain circumstances and not interest.*⁵⁰

The inclusion of discounts and premiums in the definition of interest is particularly relevant in the instance where zero coupon debt instruments are issued. Although no cash payments are made to the holder over the period of the instrument, the return or profit to the lender usually lies in the premium at which the instrument is redeemed (e.g. R50 is made available by the lender to the borrower, and the borrower then repays the lender R160 two years later). The only benefit that the borrower has obtained from the arrangement is the use of the lenders money for a period of time. The borrower therefore compensates the lender for this benefit by paying a premium at the end of the arrangement as stipulated by the lender. Similar to the other components included in the definition of interest, a premium is payable as *compensation to the lender for being kept out of the use and enjoyment of the principal sum*.

⁵⁰ De Koker, A.P. & Williams, R.C. 2013. *Silke on South African Income Tax*. Durban, South Africa: LexisNexis. Available at: [http://za-zatlxn001:8090/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://za-zatlxn001:8090/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu). [2013, September 1]. (Referred to as '**Silke**'). Chapter 17 Special provisions § 17.63 Accrual and incurral of interest - definitions and interpretations.

Chapter 3: A discussion of the main defined terms contained in section 24J

3.1 Introduction

The concepts of ‘interest’ and ‘instrument’ as defined for purposes of section 24J were discussed in detail in Chapter 2. However, section 24J contains various other defined terms that are essential to the understanding section 24J and performing the required YTM calculations for purposes of section 24J.

Before the further relevant terms defined in section 24J are discussed, it is important to first establish the ‘bigger picture’ of section 24J:

To the extent that any person is considered the issuer in *relation to an instrument* or a holder in relation to an income instrument during a year of assessment⁵¹, such a person is *deemed to have incurred or accrued an amount of interest* as determined in accordance with the provisions of section 24J.⁵² Such an amount of interest is equal to:⁵³

- “(a) *the sum of all accrual amounts, in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or*
- (b) *an amount determined in accordance with an alternative method in relation to such a year of assessment in respect of such an instrument*”

To determine ‘the sum of all accrual amounts’ as required in (a) above, section 24J requires each accrual amount to be determined by performing a *YTM calculation*. Note the conditions surrounding the selection of an ‘alternative method’ (refer to (b) above) of calculating an

⁵¹ Refer to Chapter 2 of this paper for considerations in this regard.

⁵² See section 24J(2) and (3).

⁵³ See section 24J(2)(a) and (b) as well as section 24J(3)(a) and (b).

amount of interest are stringent and, amongst others, includes a requirement that the method achieves a result, in so far as the timing of the accrual and incurrance of interest is concerned, that does not differ significantly from the results of the YTM calculation as per (a) above.⁵⁴ It is arguable that even if an alternative method is selected a YTM calculation in accordance with the requirements of section 24J (a so-called ‘section 24J calculation’) still has to be performed to evidence that the results are similar.

Performing a YTM calculation in terms of section 24J to determine the amount of interest incurred or accrued can prove complicated, specifically in the instance where the instrument is not a straight forward fixed rate instrument. Mr Feinstein comments in his article **The interest conundrum**, that “*Section 24J is a very long and complex section in the Income Tax Act and unfortunately applies across the board, i.e., to companies, trusts and natural persons who have invested in financial instruments as defined*”.⁵⁵ He further states that before the introduction of section 24J “*The taxpayer was not obliged to perform complicated calculations but would be taxed only on the interest actually received within the tax year.*”⁵⁶ As an editorial comment to the article it is noted that “*SAICAs Taxation Committee has recommended to the Commissioner that, in view of the difficulty experienced by ‘ordinary’ individual taxpayers, consideration be given to the introduction of a ‘de minimus’ exclusion into section 24J.*”⁵⁷

Although many of the terms used in section 24J are specifically defined, the section remains unclear in some instances. The most important terms for purposes of this study and the relevant uncertainties are further considered below.

⁵⁴ See the definition of ‘alternative method’ in section 24J(1).

⁵⁵ Feinstein, K. 1997. The interest conundrum. *Integritax, South African Institute of Chartered Accountants*. December 1997, Issue No. 501. Available at: http://www.saica.co.za/integritax/1997/501_The_interest_conundrum.htm [2013, September 1]. (Referred to as ‘**The interest conundrum**’).

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

3.2 *Determining an accrual amount*

The accrual amount (i.e. the deemed amount of interest accrued or incurred) should be calculated for *each accrual period* by multiplying the ‘*adjusted initial amount*’ with the ‘*YTM*’ applicable to *that ‘accrual period’*.⁵⁸ Should the end of the year of assessment fall within an accrual period or the instrument be transferred other than at the end of an accrual period, the accrual amount should be apportioned on a day-to-day basis to determine the portion of the amount of interest that accrues within that year of assessment.⁵⁹

Determining an accrual amount therefore essentially relies on integrated application of the following three terms; (1) *accrual period*, (2) *adjusted initial amount*, and (3) *YTM*.

3.2.1 *Accrual period*

The accrual period of an instrument determines the frequency at which the interest accrued or incurred will be compounded (i.e. added to the outstanding capital portion of the instrument).⁶⁰ Determining the accrual period is essential as both the adjusted initial amount and the YTM (and thereby the accrual amount) are determined with regard to a particular accrual period.⁶¹

Where an instrument includes regular payments to be made at intervals that are equal in length (referred to as ‘coupon payments’) and the interval *between* such payments is less than

⁵⁸ See definition of ‘accrual amount’ in section 24J(1).

⁵⁹ See proviso (i) and (ii) of the definition of ‘accrual amount’ in section 24J(1).

⁶⁰ South Africa. National Treasury. 1995. *Explanatory Memorandum on the Income Tax Bill, 1995*. Pretoria: National Treasury. (referred to ‘**Explanatory Memo 1995**’) at page 8.

⁶¹ See definition of ‘adjusted initial amount’ in section 24J(1), (referred to as ‘**AIA definition**’) and ‘definition of ‘yield to maturity’ in section 24J(1), referred to as ‘**YTM definition**’)

12 months, each such interval *may* be considered an accrual period.⁶² The reference to “*the interval between such payments*” is problematic as it is unclear whether the coupon payment occurs at the end or the beginning of an accrual period. ‘Between’ is normally considered to mean “*in the middle*”⁶³, therefore not including the starting point or the end point, only everything in between. Based on the literal language of the statute, the event of the coupon payment will never fall into any accrual period. However, applying this literal meaning leads to an “... *absurdity so glaring that it could never have been contemplated by the Legislature*”,⁶⁴ as the section 24J calculation will not reflect the economic reality of the arrangement to the extent that the coupon payments are not taken into consideration in any accrual period.⁶⁵ Applying the interpretational approach established in **Natal v E**, regard should be given to the context in which the definition of ‘accrual period’ is used by reading the particular provision in the light of the whole document (i.e. section 24J as a whole) and the circumstances attendant upon its coming into existence. Further consideration must be given to the ordinary rules of grammar and syntax and the apparent purpose of the wording.⁶⁶ Taking all these interpretational factors into account it is probable that the intention of the legislation was that each accrual period will include the coupon payment *at the end* of that interval and the subsequent accrual period will commence immediately after that coupon payment. This interpretation is based on the consideration of the following:

- Proviso (iii) included in the definition of ‘accrual amount’ in section 24J(1) requires that ‘accrual amount’ be specifically adjusted by taking into account any amounts received or paid “*other than at the end of an accrual period*”. This requirement only makes sense to the extent that the calculation of the accrual amount already takes the

⁶² See definition of ‘accrual period’ in section 24J(1), (referred to as “**accrual period’ definition**”), proviso (a).

⁶³ *Supra* **FreeDictionary**.

⁶⁴ *Supra* **Shenker v The Master** at 143. *Supra* **Rex v Venter** at 913. *Supra* **Barkett v SA Mutual Trust** at 468; and *Supra* **Savage v CIR** at 254.

⁶⁵ The coupon payments are included in the calculation of the ‘adjusted initial amount’ in each accrual period. Refer to the detailed discussion on ‘adjusted initial amount’ in this regard (sub-heading 3.2.2).

⁶⁶ *Supra* **Natal v E** at paragraph 18. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction to this paper.

coupon payment at the end of the accrual period into account and therefore does not require an additional adjustment. The *normal* coupon payments are therefore considered to occur at the end of the accrual period as oppose to the beginning;

- The examples of section 24J calculations included in the Explanatory Memorandum to the tax amendments⁶⁷, also regards the coupon payments to occur at the end of the accrual periods; and
- Including the coupon payment at the beginning of the accrual period instead of at the end of the accrual period results in the final coupon payment falling into its ‘own’ accrual period (i.e. the last accrual period will only include the ‘day’ of the coupon payment). When performing a YTM calculation on this basis, the last coupon payment is effectively only spread over that one day, resulting in the accrual or incurral of a ‘catch up charge’ on the last coupon payment day. Again, the purpose of section 24J is that interest should be spread over the entire period of the instrument. A lump sum catch up interest accrual or incurral at the end of the term of the instrument is therefore not in line with the overall intention of the section.

Section 24J also allows for the taxpayer to elect any other period that is less than 12 months as the accrual period of an instrument (i.e. monthly, daily etc.).⁶⁸ As pointed out by Professor Brincker, “*it appears that the period chosen by the holder can be different from the period chosen by the issuer*”.⁶⁹ A more frequent accrual period results in a larger accrual amount earlier in the term of an instrument in comparison to a longer accrual period.⁷⁰ In the instance of long term investments, it is more beneficial from the holders perspective to select a longer (e.g. 12 month) accrual period instead of a shorter (e.g. daily) accrual period as the interest

⁶⁷ *Supra Explanatory Memo 1995* at page 13.

⁶⁸ *Supra ‘accrual period’ definition*, see proviso (b).

⁶⁹ *Supra Brincker*, Part III – Interest, Chapter V.2 The nature of interest.

⁷⁰ Pine Grove Software. 2013. *Compound Interest Calculator*. Available at: <http://www.pine-grove.com/online-calculators/compound-interest-calculator.htm> [2013, September 2].

accrual amount will be slightly deferred (i.e. the income tax payable is slightly deferred). The opposite is true in the instance of the issuer.

Once an accrual period is selected for a specific instrument, that accrual period must be applied consistently throughout the term of that instrument (i.e. the taxpayer does not have the option to change the originally selected accrual period).⁷¹

3.2.2 *Adjusted initial amount*

On interpretation of definition of ‘adjusted initial amount’ it is evident that the ‘adjusted initial amount’ should be calculated at the *beginning of each accrual period* (the South African Revenue Service (further referred to as ‘SARS’) also issued a ruling in this regard confirming that the accrual amount should be calculated with reference to the adjusted initial amount at the *beginning* of each accrual period).⁷² It should also be calculated *immediately before there is a change in the instrument that requires a redetermination of the YTM*.⁷³ Such changes would include a variation in the applicable variable rate, any terms and conditions that will affect the YTM or where the rights / obligations in respect of amounts receivable / payable by the holder or issuer change. In general, the adjusted initial amount is calculated as follows:⁷⁴

⁷¹ *Supra* ‘accrual period’ definition.

⁷² South African Revenue Service. 2007. *Binding Private Ruling No. 002*. Available: <http://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BPR-2012-02%20-%20Method%20Determination%20Interest%20Amount%20Collection%20Distressed%20Debtors%20Book.pdf> [2013, September 10], at heading 6 ‘Specific ruling’.

⁷³ Refer to discussion on ‘YTM - Variable rate instruments’ at paragraph 3.2.3.1, as well as ‘YTM - Variations in the terms, conditions, rights and obligations’ at sub-heading 3.2.3.2.

⁷⁴ *Supra* ‘AIA’ definition.

- the market value of the consideration payable or receivable on the acquisition or issue of an instrument;⁷⁵
- plus all accrual amounts accrued or incurred in previous accrual periods relating to the instrument;
- less all cash flows received or paid in previous accrual periods in terms of that instrument.

The definition of ‘adjusted initial amount’ includes a specific anti-avoidance proviso that is aimed at structured finance schemes where compulsory convertible debt instruments are used that result in the circular flow of funds through a number of related and unrelated companies and the borrowing of an inflated amount by the party claiming interest for tax purposes. In this regard section 24J refers to any ‘transaction, operation or scheme’.⁷⁶ **Silke** comments that “*The expression ‘transaction, operation or scheme’ is the same as that used in s 103(1) (section 103(1) contains the general anti-avoidance provisions of the Act). It is submitted that the same criteria be used as for s 103(1) to ascertain whether a transaction, operation or scheme exists.*”⁷⁷ SARS is of the view that these schemes are entered into to generate a tax benefit for the group of companies entering into the scheme. SARS states that the benefit created for the group of companies is “*the deduction of interest on the principal amount of a loan on an accrual basis and the creation of a deferred capital gain which in essence results in the deduction of interest and capital of the actual financing needs of the borrower.*”⁷⁸ Although the proviso is not very well written, it basically requires where payments are made pursuant to a specific transaction with the direct or indirect purpose of making payment to the holder or connected person to the holder, such payments must to be taken into account for

⁷⁵ See definition of ‘initial amount’ with reference to the definitions of ‘issue date’ and ‘transfer date’ in section 24J(1).

⁷⁶ Supra ‘**AIA**’ definition, see the proviso.

⁷⁷ Supra **Silke**, Chapter 17 Special provisions § 17.63 Accrual and incurral of interest - yield to maturity.

⁷⁸ South Africa. National Treasury. 2004. *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004*. Pretoria: National Treasury. (referred to ‘**Explanatory Memo 2004**’) at page 20.

purposes of determining the ‘adjusted initial amount’. To this extent, “*a circular flow of funds would then reduce the amount of interest claimed by a group company.*”⁷⁹ Similar provisos are included in the definition of YTM for purposes of calculating the rate of compounded interest.⁸⁰ Various commentators are however of the view the provisos do not achieve the desired objectives.⁸¹ The section 24J implications relating to such structure finance schemes are not considered a focus area for this study and are therefore not considered in further detail.

3.2.3 Yield to Maturity

Before the wording of the definition of YTM as per the Act is considered, it is useful to have a brief look at the general commercial understanding of the term YTM:

*“Yield to maturity (YTM) is the rate of return expected on a bond which is held till maturity. It is essentially the internal rate of return on a bond and it equates the present value of bond future cash flows to its current market price.”(own emphasis).*⁸²

*“The percentage rate of return paid on a bond, note, or other fixed income security if the investor buys and holds it to its maturity date. The calculation for YTM is based on the coupon rate, length of time to maturity, and market price. It assumes that coupon interest paid over the life of the bond will be reinvested at the same rate.”*⁸³

⁷⁹ *Supra Explanatory Memo 2004* at page 21.

⁸⁰ *Supra* ‘YTM’ definition, see proviso (a) and (b).

⁸¹ South Africa. National Treasury and South African Revenue Service. 2005. *Responses to written representations by organisations to the Portfolio Committee on Finance and Select Committee on Finance on the Taxation Laws Amendment Bill, 2005*. Pretoria: South African Revenue Service. As well as *Supra Brincker*, Part III – Interest, Chapter V.5 The mechanism to be used to understand the workings of section 24J of the Act, at paragraph 5.9.1.

⁸² Obaidullah, J. *Accounting Explained, Yield to Maturity*. Available at: <http://accountingexplained.com/misc/corporate-finance/yield-to-maturity>. [2013, September 2].

⁸³ *Supra FreeDictionary*.

Silke also includes the comment that YTM calculated for tax purposes essentially amounts to the internal rate of return of the instrument.⁸⁴ The first part of the section 24J definition of YTM is in line with the above commercial understanding and essentially comprises of the following:

- calculating *the rate of compound interest* per accrual period,
- at which the *present value of all amounts payable or receivable* in terms of that instrument *equals the 'initial amount'*.⁸⁵

The explanatory memorandum to the tax amendments⁸⁶ explains that to facilitate the spreading of interest, *a rate* should be calculated that, when *applied to the adjusted initial amount in relation to each accrual period*, will ultimately result in an adjusted initial amount equal to the redemption payment if the instrument is held until the date of redemption (this rate is referred to as the YTM). In other words, the adjusted initial amount should be nil if calculated immediately after the final redemption payment.

Calculating the YTM in the instance of a fixed rate instrument⁸⁷ (where there are no alternations or variations in the rights, term or conditions) is relatively simple. Although the Act requires that YTM should be calculated per accrual period, the YTM will remain constant throughout the term of such an instrument.

⁸⁴ *Supra Silke*, Chapter 17 Special provisions § 17.63 Accrual and incurral of interest - definitions and interpretations.

⁸⁵ See definition of 'initial amount' with reference to the definitions of 'issue date' and 'transfer date' in section 24J(1).

⁸⁶ *Supra Explanatory Memo 1995* at page 9.

⁸⁷ See discussion on fixed vs. variable rate instruments, refer to paragraph 4.2.

3.2.3.1 YTM – Variable rate instruments

In the instance of a variable rate instrument the coupon amounts receivable or payable (and in some instances also the redemption amount) will be linked to an indexation rate (e.g. the Consumer Price Index ('CPI')) or another interest rate (e.g. the Johannesburg interbank agreed rate ('Jibar')) or some other factor that causes the coupon amounts to vary.⁸⁸

The calculation of accrual amounts in the instance of a variable rate instrument is a daunting task for the ordinary taxpayer and the wording used in the Act with regards to determining the YTM in this regard, unfortunately, creates further confusion.

Section 24J determines that the YTM relating to a variable rate instrument should be initially calculated or redetermined (should the variable rate change) with reference to the *variable rate applicable on the date such YTM is to be calculated or redetermined*.⁸⁹ Two questions arise in this regard:

- Exactly when (i.e. what exact date) should the YTM be calculated or redetermined; and
- What is the variable rate applicable at that date?

To practically illustrate the consideration of the two questions highlighted above, the following example (further referred to as 'Example A'⁹⁰) is discussed below. Taxpayer A, that has a year of assessment ending on 31 December annually, holds an instrument with a nominal value of R1,000. Coupon payments are received semi-annually (i.e. 30 June and 31 December) and are subject to the variable rate applicable at these dates (i.e. 10% on 30 June 2013 and 11.5% on 31 December 2013). The instrument is redeemed at its nominal

⁸⁸ *Ibid.*

⁸⁹ *Supra* 'YTM' definition, see sub-paragraph (a) and (b).

⁹⁰ Example A.

value on 31 December 2013. The taxpayer elected its accrual periods for purposes of section 24J to end on the date of each coupon payment.

Taking a step back, it has been established that the ‘adjusted initial amount’ should be calculated at the beginning of an accrual period.⁹¹ Further, it has also been established that YTM and ‘accrual amount’ should be determined per accrual period, however it is unclear *when* these calculations should be done in relation to each accrual period. With reference to ‘Example A’, should the YTM calculation to determine the accrual amounts be performed on 30 June and 31 December, only on 31 December or is another date also suitable?

The definition of ‘accrual amount’, requires *a calculation at the end of the year of assessment* to determine the accrual amounts that are to be included in that year.⁹² Similarly, the charging provisions require the determination of all accrual amounts that fall within a specific year of assessment.⁹³ As the calculation of an ‘accrual amount’ requires a YTM input, it is then also necessary to perform a calculation of YTM at year end. The Explanatory Memorandum to the tax amendments⁹⁴ includes the following statement:

“Where a taxpayer does not calculate the accrual amounts in relation to an instrument on an ongoing basis during a year of assessment, the yield to maturity rate may be calculated at the end of a year of assessment for application thereof during such year of assessment in relation to such instrument.”(own emphasis)

It is therefore arguable that the taxpayer can determine the accrual amount in relation an accrual period at any time during the year of assessment (to the extent that the required information is available at such a time), but *at the latest* needs to determine these amounts on

⁹¹ Refer to the discussion on ‘adjusted initial amount’ in Chapter 3, see paragraph 3.2.2.

⁹² Refer to the discussion on ‘accrual amount’ in Chapter 3, see paragraph 3.2.

⁹³ See section 24J(2) and (3).

⁹⁴ *Supra Explanatory Memo 1995* at page 9.

the last day of the year of assessment. Within this parameter, the “*date such YTM is to be calculated or redetermined*” is therefore determinable by each taxpayer. In ‘Example A’, the taxpayer could therefore decide to perform the YTM calculations on 30 June and 31 December (i.e. at the end of each accrual period) or only perform the YTM calculations for both accrual periods at 31 December (i.e. the end of the year of assessment).

In establishing the variable rate that should be used in the calculation of the YTM, the choice of wording in the Act is rather confusing, i.e. “*variable rate applicable on the date such YTM is to be calculated or redetermined*”(own emphasis).⁹⁵ For example, to the extent that the taxpayer decides to calculate all accrual amounts falling within a year of assessment on the last day of that year, based on the literal interpretation of the wording of the Act, the variable rate applicable on the last day of the year should be used in calculating *all* the relevant YTM. Considering ‘Example A’, based on this interpretation, the taxpayer would have to apply the variable rate of 11.5% as at 31 December 2013 to both the accrual periods ending on 30 June 2013 and 31 December 2013 respectively. For income tax purposes the taxpayer would then include an interest accrual of R115 [calculated at an effective interest rate of 11.5%, applied to the AIA as at 30 June 2013 and 31 December 2013 respectively] in his 2013 taxable income; however the economic reality is that the taxpayer only earned R108 [calculated as the coupon payment on 30 June 2013 of R50 (10% effective interest rate) plus the coupon payment on 31 December 2013 of R58 (11.5% effective interest rate)] interest on his investment. As suggested in ‘**Commentary on Income Tax**’⁹⁶, this clearly gives rise to incorrect results. It is clear that this literal interpretation of the wording leads to an “... *absurdity so glaring that it could never have been contemplated by the Legislature*”.⁹⁷ Again the interpretational approach established in **Natal v E** is therefore applied, having regard to the context in which the wording is used by reading the particular provision in the light of the whole document (i.e. section 24J as a whole) and the circumstances attendant upon its coming

⁹⁵ *Supra* ‘YTM’ definition, see sub-paragraph (a).

⁹⁶ *Supra* **Commentary on Income Tax** -16.

⁹⁷ *Supra* **Shenker v The Master** 143. *Supra* **Rex v Venter** at 013. *Supra* **Barkett v SA Mutual Trust** at 468.

into existence. Further consideration must be given to the ordinary rules of grammar and syntax and the apparent purpose of the wording.⁹⁸

In the Explanatory Memorandum to the tax amendments the circumstances upon the coming into existence of the phrase ‘applicable variable rate’ in the context of section 24J is explained as follows; in reference to YTM, “*a rate must be calculated, which rate, when applied to the adjusted initial amount in relation to each accrual period, will ultimately result in an amount equal to the redemption payment*”.⁹⁹ (Note that, as discussed by Sonnenberg “*Statements made in Explanatory Memoranda have historically been inadmissible as evidence of legislative intent. However there is recent authority that one may in certain circumstances have regard to Explanatory Memoranda*”).¹⁰⁰ Keeping in mind that the YTM calculated for each accrual period is assumed to apply to all amounts receivable or payable over the remaining term of the instrument¹⁰¹ and that the YTM is applied to the appropriate ‘adjusted initial amount’, it is clear that the *applicable variable rate* could only mean the following:

- Where the taxpayer elects the accrual period of a variable rate instrument as the period between the coupon payments, *the rate at which the coupon is to be calculated* (i.e. at the end of the accrual period) will be the variable rate applicable to *that* accrual period; In ‘Example A’ (refer to page 27), an effective interest rate of 10% will therefore apply to the accrual period ending on 30 June 2013 and an effective rate of 11.5% to the accrual period ending on 31 December 2013 (regardless of when the YTM calculation is performed).

⁹⁸ *Supra Natal v E* at paragraph 18. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction chapter (Chapter 1) to this paper.

⁹⁹ *Supra Explanatory Memo 1995* at page 9.

¹⁰⁰ Sonnenberg, EN. 2011. The law of unintended consequences – section 24J. *Integritax, South African Institute of Chartered Accountants, February 2011*, Issue No.138. Available at: http://www.saica.co.za/integritax/Archive/Integritax_February_2011_Issue_138.pdf [2013, September 1]. With reference to Chaskalson CJ's judgment in the **Minister of Health and Another No v New Clicks South Africa (Pty) Limited and Others (Treatment Action Campaign and Another as AMICI CURIAE)**, 2006 (2) SA 311 at 391.

¹⁰¹ *Supra Explanatory Memo 1995* at page 10.

- Where the taxpayer elects an alternative accrual period (e.g. daily) the applicable variable rate will be the *rate at which the next coupon payment will be calculated*. To the extent that different rates apply to the various coupon payments over the term of the instrument, *the change in the variable rate occurs immediately after each coupon payment is made* and a new YTM will apply to all accrual periods going forward. For example, assuming that the taxpayer elected a daily accrual period in ‘Example A’ (as oppose to the period between the coupon payments), an effective interest rate of 10% will apply to all accrual periods (i.e. each day) until the first coupon is received on 30 June 2013. An effective interest rate of 11.5% will then apply to all accrual periods immediately after the first coupon payments until the date of redemption (31 December 2013). Note that there is essentially no difference between the variable rates applied where the taxpayer elected an accrual period between the coupon payments and where an alternative (e.g. daily) accrual period was selected.

It should be noted that fluctuations in the variable rate that do not affect the actual returns (i.e. coupon payments or redemption amount) of a specific instrument have no bearing on the calculation of the accrual amounts of that instrument. For example, if it is assumed that the taxpayer in Example A (refer to page 27) elected quarterly accrual periods (instead of semi-annual accrual periods) and the variable interest rate was 9% and 10.5% on 31 March 2013 and 30 September 2013 (remembering that the semi-annual coupon payments are linked to the variable rate applicable to 30 June 2013 and 31 December 2013 of 10% and 11.5%). The variable rate *applicable* to determine the accrual amounts for the accrual periods ending on 31 March 2013 and 30 September 2013 is a rate of 10% and 11.5% respectively (i.e. the rate at which the *next* coupon payment is calculated). Although the variable rate was 9% on 31 March 2013 and 10.5% on 30 September 2013 these rates have no bearing on the instrument and are effectively ignored for purposes of calculating the accrual amounts. In other words, the variations in the variable rate during the year, other than the variations that

influence the coupon payments, have no effect on the return of the instrument and it is *therefore not considered a variation in the rate applicable to this instrument*.

If the variable rates of 9% and 10.5% was used as the applicable variable rate to determine the YTM on 31 March 2013 and 30 September 2013 respectively, these YTM's (when applied to the adjusted initial amount) will not result in an amount equal to the redemption payment. In 'Example A', the result of using the incorrect variable rates will be that instead of spreading the actual interest earned / incurred of R108 over the term of the instrument, the taxpayer will only include a total amount of R104 in its taxable income over the term of the instrument.¹⁰² In this regard Professor Brincker is also of the view that the total of the section 24J accrual amounts should equal the total actual interest amount on redemption date, stating that "Should an instrument or income instrument be held until its envisaged redemption date, there will not be a gain or loss on the ultimate redemption, as those amounts would have been factored into the calculation of the yield-to-maturity of the instrument or income instrument."¹⁰³

In many instances the variable rate applicable to the next coupon payment will be available at year end as these payments are often linked to a 'lag period' (e.g. the coupon is determined with reference to the variable rate 3 month prior to the actual payment). However, to the extent that the applicable variable rate is not known at the end of the year of assessment it could be difficult to perform an accurate tax calculation for provisional tax purposes. From a practical perspective it is arguable that a best estimate of the applicable variable rate be assumed for purposes of performing such a calculation. For example, considering the variable rate at year end and the expected market trends until the time of the next coupon payment. For purposes of the study it is sufficient to note that in terms of paragraph 20(2) of the Fourth Schedule to the Act, which is to be read in conjunction with Chapter 15 of the Tax

¹⁰² Note that this incorrect treatment will also affect the calculation of the adjusted gain / loss on transfer or redemption of an instrument.

¹⁰³ *Supra* Brincker, Part III – Interest, Chapter V.8 Adjusted gain or loss on the transfer or redemption of an instrument, at introductory paragraph.

Administration Act¹⁰⁴, SARS has a discretion to remit any penalty in the case of an under-estimation of provisional taxation, if SARS is satisfied that the amount of any estimate referred to “*was seriously calculated with due regard to factors having a bearing thereon and was not deliberately or negligently understated*”. To the extent that an underestimation of provisional tax occurs due to change in the variable rate after year end and a detailed section 24J calculation was performed using the best estimate available at the time of making the estimate, it is probable that SARS will be of the view that provisional tax amount was seriously calculated and not deliberately misstated.

3.2.3.2 YTM – Variations in terms, conditions, rights and obligations

The Act also requires that the YTM be redetermined in the instance where an instrument is affected by changes in; any terms and conditions that will change the YTM¹⁰⁵, the rights / interest in respect of amounts receivable by the holder, or obligations in respect of amounts payable by the issuer. This variation does not give rise to a change in rate, but involves some other change that nevertheless affects the YTM.¹⁰⁶ Such change can therefore occur in either variable rate or fixed rate instruments. In these instances the YTM is recalculated with reference to either the applicable fixed rate or the variable rate (depending on the type of instrument) (refer to the discussion on the timing of the YTM calculation and rate to be used at sub-heading 3.2.3.1 above). This rate is applied to the adjusted initial amount immediately before such a change.

It is interesting to note that in the case of a change in the rights (of the holder) /obligations (of the issuer) in respect of amount receivable or payable, the Act requires a redetermination of

¹⁰⁴ *Tax Administration Act, No. 28 of 2011*, as amended. 2012. Juta’s Compendium of Tax Legislation, Claremont: Juta Law.

¹⁰⁵ *Supra* ‘YTM’ definition, see paragraph (c).

¹⁰⁶ *Supra* Commentary on Income Tax -18.

the YTM irrespective of whether the change in rights / obligations will result in a variation of the YTM (whereas in the instance of a change in terms and conditions, a redetermination is only required if the YTM will change). Further, the amount receivable or payable is not limited to interest amounts only.¹⁰⁷ Also changes in rights and obligations that relate to amounts that are conditional on some future event (i.e. conditional amounts) will not be regarded as a 'change' for purposes of section 24J as the words 'payable' and 'receivable' refers to future payments that are free of all conditions.¹⁰⁸

3.2.3.2.1 *Variation in the term of an instrument*

The most prevalent change in terms and conditions is probably a change in the term of an instrument over which the YTM is calculated. 'Term' is defined for purposes of section 24J¹⁰⁹ as the period relating to an instrument commencing on the 'issue' or 'transfer date' and ending on the 'date of redemption' of the instrument. The 'term' of an instrument could therefore vary to the extent that the redemption date (i.e. the date on which all liability to pay all amounts in terms of that instrument) *is not specified or subject change* (e.g. where such a date is determinable by the holder).¹¹⁰ For example, where a debenture instrument is issued to a holder and as per the terms of the instrument the holder has the option to redeem the debenture at the end of either a 3 year or 5 year term (referred to as 'Example B'). In the instance of a variable redemption date, the Act determines that the YTM calculation of these instruments be based on the date that all liabilities will, *on a balance of probabilities*, most likely be paid. In Example B, the holder will therefore have to assess whether he is more likely to redeem the instrument at the end of 3 years or 5 years to establish which redemption

¹⁰⁷ *Supra Explanatory Memo 2004*, at page 22.

¹⁰⁸ *Supra Commentary on Income Tax -17*.

¹⁰⁹ See the definition of 'term' in section 24J(1).

¹¹⁰ 'Date of redemption' is specifically defined for purposes of section 24J and differentiates between instruments where such a date is subject to change and where such a date is fixed.

date should be used for purposes of his section 24J calculations. The issuer of the debenture instrument will also have to make a similar assessment in determining when the holder is most likely to exercise his redemption right. Prior to the 2011 amendments¹¹¹ to section 24J, various commentators were of the view that debt instruments with no maturity date could not be subjected to the provisions of section 24J as a YTM calculation could not be performed without such a date.¹¹² This view is no longer plausible based on the current interpretation of the Act.

Practically speaking, the determination of a redemption date in the instance of a loan where there is no specified maturity date (e.g. shareholders loans) is problematic. For example, shareholder loans are often acquired at a discount and have no pre-determined redemption dates. The discount is regarded as interest for purposes of section 24J and should therefore be accrued for on a YTM basis for income tax purposes. National Treasury / SARS have not provided any guidance on what is meant by “*a balance of probabilities*” and how such a date should be determined. Again the rules of statutory interpretation therefore need to be applied taking into account the language used in the light of the ordinary rules of grammar and syntax, the context in which the phrase appears and the apparent purpose to which it is directed.¹¹³

The ordinary meaning of ‘on balance’ is “*taking everything into consideration*” and the meaning of ‘probable / probability’ is “*likely to happen or to be true*”, “*very likely*”.¹¹⁴ Therefore, it could be read that the redemption date should be calculated by *taking everything into consideration that is very likely to happen or be true*. Remote or incidental contingencies should therefore not be taken into account when determining this redemption date. (Interestingly other countries (such as the USA) require that such contingent factors be taken

¹¹¹ *Taxation Laws Amendment Act, No. 24 of 2011*. 2012. Government gazette. 34927. 10 January. Government notice no. 16. Cape Town: Government Printer..

¹¹² *Supra Brincker*, Part III – Interest, Chapter V.5 The mechanism to be used to understand the workings of section 24J of the Act, at paragraph 5.9.7.

¹¹³ *Supra Natal V E* at paragraph 18. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction chapter (Chapter 1) to this paper.

¹¹⁴ *Supra FreeDictionary*.

into account when such a redemption date is calculated).¹¹⁵ ‘Balance of probabilities’ is also a term commonly used in civil law and generally means the more likely scenario/outcome *having regard to all evidence*.¹¹⁶ ‘Balance of probability’ does not mean proving beyond all reasonable doubt.¹¹⁷ Beckert is of the view that in the case of shareholder loans one could take into account factors such as “*the purposes of the loan, creditworthiness of the company, the company’s history of repayment terms, the industry in which the company operates, whether the loans are subordinated, the operational performance of the company, the cash flows of the company and the company’s ability to obtain other third party funding.*”¹¹⁸

Based on the strict interpretation of the Act a redetermination of the YTM is required every time this ‘balance of probabilities’ fluctuates. However, determining the most probable redemption date based on all the various factors could prove to be a rather time consuming exercise. From a practical perspective, it could prove beneficial to perform a detailed analysis of variations in the factors influencing the probable redemption date of an instrument on an annual basis at the end of the year of assessment (instead of performing various calculations during the year).¹¹⁹ However, if the assessment of the redemption date is only done at year end, it should be remembered that a separate YTM calculation is still required for each accrual period within that year of assessment. Where, for example, there were 4 accrual periods during the year of assessment, the probable redemption date should be determined for each accrual period. With reference to Example B, if there the debenture instrument has semi-annual accrual periods, an assessment will be done at the end of each year, considering all the available information, to determine when the debentures will most likely be redeemed (i.e. at the end of 3 years and 5 years). The assessment will also include determining whether there

¹¹⁵ Hochberg, J. & Klein, J. 2010. Report on Ambiguities and Uncertainties in the Original Issue Discount Regulations. *New York State Bar Association Tax Section*. Report No. 1212. Available at: <http://www.sullcrom.com/siteFiles/Publications/Hochberg-Klein-NYSBA-Tax-Section-Report-05-2010.pdf> [2013, September 6].

¹¹⁶ **Kalil v Decotex (Pty) Limited and another**, 1998 (2) All SA 159 (A) at 180 – 183.

¹¹⁷ Goldswain, G. 2010. Reverse onus of proof – IV. *Tax Planning: Corporate and Personal*. Volume 24 No. 5.: 13 – 15.

¹¹⁸ Beckert, T. 2013. The treatment of interest and loans in complying with tax legislation: tax law. *Tax Professional*. 2013 No. Quarter 3: 22 – 23.

¹¹⁹ As discussed above, although the Act requires a redetermination of the ‘YTM’ on various occasions, the taxpayer can determine when he would like to perform these calculations during the year of assessment. Refer to the detailed discussion in this regard at paragraph 3.2.3.1.

was a change in this ‘estimate’ during the year (i.e. where any factors changed between the first and second accrual periods within the year of assessment that would result in a different redemption date being used for the two accrual periods).

In the instance where the redemption date is subject to change, there is no provision in section 24J that requires that the holder and the issuer to use the same term/redemption date for purposes of the section 24J calculations. Therefore, it is practically possible for the holder and issuer to accept different redemption dates based on their assessment of the balance of probabilities. For example, at the end of year 2 the holder in Example B has financial difficulties and decides to redeem the debentures at the end of the 3 year instead of year 5, he will use the end of year 3 as his redemption date. However, if the issuer is unaware of the holder’s financial difficulties and based on all other factors he assesses that the holder will only redeem at the instrument at the end of the 5th year, he will use the end of year 5 as his redemption date. The interest incurred by the issuer in year 2 could therefore differ to the interest accrued by the holder in year 2 for purposes of section 24J. Only when the issuer becomes aware of the intentions of the holder to redeem at the end of year 3 will *his assessment* on the balance of probabilities of the redemption date change.

Chapter 4: Fixed rate instruments vs. Variable rate instruments

4.1 *Introduction*

Determining whether an instrument is a ‘fixed rate instrument’ or a ‘variable rate instrument’ for purposes of section 24J is of some importance. Firstly, the section 24J YTM calculations relating to a fixed rate instrument are in most instances straightforward and regarded as ‘do-able’ by taxpayers (in stark contrast to that of variable rate instruments). Secondly, there are a few uncertainties surrounding aspects of variable rate instruments, these are considered in further detail below.

4.2 *Fixed rate instrument and variable rate instrument defined*

The concepts of a ‘fixed rate instrument’ and ‘variable rate instrument’ are specifically defined for purposes of section 24J. A ‘variable rate instrument’ is an instrument which is *not a fixed rate instrument*.¹²⁰ A ‘fixed rate instrument’ in turn means an instrument of which the amounts payable or receivable consists of:¹²¹

- i) specified amounts;
- ii) amounts calculated on a method does not involve the application of a *variable rate*; or
- iii) any combination of (i) and (ii) above.

¹²⁰ See the definition of ‘variable rate instrument’ in section 24J(1), (referred to as ‘**variable rate definition**’).

¹²¹ See the definition of ‘fixed rate instrument’ in section 24J(1), (referred to as ‘**fixed rate instrument definition**’).

As noted in the **Commentary on Income Tax**,¹²² in considering the definition of ‘fixed rate instrument’ as a whole, it is likely that the reference to ‘specified amounts’ (point (i) above) in this context is referring to an actual, stated amount rather than an amount designated by reference to a formula or some other method of calculation. The latter type is referred to in the second part of the definition (point (ii) above). Professor Brincker makes the observation that “*a fixed rate instrument is really defined in the negative, as it will be an instrument to the extent that it does not involve the use of a variable rate.*” (own emphasis)¹²³ The crux of the differentiation between fixed rate and variable rate instruments therefore lies in the definition of the term ‘variable rate’.

‘Variable rate’ is specifically defined as a rate determined with reference to an:¹²⁴

- interest rate;
- indexation rate; or
- other similar factor

that varies or may vary or may vary during the term of the instrument.

Note that, based on the strict interpretation of the definition of ‘variable rate’, should a rate other than a variable rate (as defined) be applied, that somehow *results in variations in the amount receivable or payable*, such an instrument would theoretically be considered a fixed rate instrument for purposes of section 24J.¹²⁵ For example, where the interest rate charged by the lender is dependent on another type of variable factor (i.e. not an interest, indexation or other similar factor) such as in the case of a student loan, the student’s results during each

¹²² *Supra Commentary on Income Tax* -15.

¹²³ *Supra Brincker*, Part III – Interest, Chapter V.5 The mechanism to be used to understand the workings of section 24J of the Act, at paragraph 5.9.3.

¹²⁴ *Supra ‘variable rate’ definition.*

¹²⁵ *Supra Commentary on Income Tax* -15.

semester. That said, it is however important to determine the exact ambit of the meaning of ‘variable rate’ considering the relevant wording of the Act in detail.

As a prerequisite, the applicable rate/factor should be subject to a degree of variation to fall within the definition of ‘variable rate’. However, it is arguable that this requirement is satisfied even if there is only a slight chance that the rate/factor ‘may vary’ during the term of the instrument. In **ITC 1034**¹²⁶ judge Watermeyer J draws a useful distinction between the use of the word ‘may’ as oppose to ‘shall’ in a case dealing with obligations under a lease agreement. In this case, Watermeyer J. determines that the use of the word ‘may’ instead of ‘shall’ in the lease agreements implies that there is no obligation on the lessee to make certain leasehold improvements, but that permission was simply granted to make the improvements if the lessee wished to do so. Similarly, the use of the word ‘may vary’ in the definition of variable rate instrument implies that the rate/factor does not have to change, but there could be a possibility for the rate/factor to change. The ordinary meaning of ‘may’ is “a choice to act or not, or a promise of a possibility, as distinguished from ‘shall’ which makes it imperative”.¹²⁷ The scope of ‘variable rate’ is therefore not limited by the degree of variation in the rate/factor, but rather to the extent such variation relates to an “*interest rate, indexation rate or other similar factor*”.

4.2.1 ‘Interest rate’

As established in Chapter 2, the common law meaning of ‘interest’ can be summarised as an *amount calculated with reference to a sum of money; it is payable for the use of money; where there is a debtor/creditor relationship; and it accrues over time.* The ordinary meaning of ‘interest rate’ (or rate of interest) is very much in line with this understanding of ‘interest’, i.e.

¹²⁶ **Income Tax Case No 1034**, 1963 26 SATC 78(C) at 80.

¹²⁷ *Supra* **FreeDictionary**.

“the percentage of a sum of money charged for its use”.¹²⁸ The South African Reserve Bank (‘SARB’) further explains interest rates as:

*“prices for loanable funds – prices of funds invested, lent out or borrowed for various periods. The supplier or lender of funds normally wants to earn an income and the user or borrower will generally be prepared to pay for the right to use the accumulated funds.”*¹²⁹

Therefore, where *the percentage charged by the lender for the use of the principal amount by the borrower* (i.e. the interest rate) is *subject to any change (or even just able to change)*, such an *interest rate* will be considered a *variable rate*.

Variable rates instruments are commonly linked to interest rates that are determined by underlying market forces (e.g. demand and supply of funds and inflation rates). An example of such an interest rate is the SA prime interest rate (*“the interest rate charged by banks to their largest, most secure, and most creditworthy customers on short term loans”*).¹³⁰

4.2.2 ‘Indexation rate’

‘Indexation rate’ is not defined for income tax purposes, but ‘indexation’ is a commonly used term in general economics meaning the *“linking of a quantity to the rate of change in another quantity or factor, as measured through an index”*. As per the Business Dictionary an ‘index’ means a:

“statistical device which summarizes a collection of data (usually related to the price or quantity of a ‘basket’ of goods and services) in a single base figure. This composite figure serves as a benchmark for measuring changes in the price or quantity data over a period

¹²⁸ *Ibid.*

¹²⁹ South African Reserve Bank. 2012. *Interest rates and how they work (Fact Sheet 8)*. Pretoria: South African Reserve Bank. Available at: <http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblast=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=5000>. [2013, September 15].

¹³⁰ *Business Dictionary.com*. 2013. Washington, D.C.: WebFinance, Inc. Available at: <http://www.businessdictionary.com/definition/prime-lending-rate>. [2013, September 15].

(month, quarter, year). Usually, the base is assigned an arbitrary value of 100 and all subsequent data is expressed in relation to this base....Indexes (indices) also measure up and down movement of industrial production, and of the market prices of bonds, commodities, shares, etc.”¹³¹

An ‘indexation rate’ is therefore by definition variable in nature and will always constitute a ‘variable rate’. In SA government bonds are commonly linked to the SA Consumer Price Index (‘CPI’), a measure of the general level of prices based on the cost of a typical basket of consumer goods and services.¹³²

As a side remark, it is interesting to note that the CPI (as with most indexes) does not have a floor value of zero, the index could therefore reflect a negative value in the instance of constant downward movements (i.e. deflation). This could theoretically result in a negative amount. Professor Brincker however notes that “*it is an inherent fundamental of interest that it can only be a positive figure*”.¹³³ As SA has not experienced deflation (i.e. a negative CPI) since the introduction of section 24J in 1996 the impact of such a scenario on the calculation of YTM for purposes of section 24J has not really been tested (and probably not fully contemplated by the legislator).

4.2.3 ‘Other similar factor’

No guidance is provided as to what the legislator means when reference is made to ‘other similar factor’ in the definition of ‘variable rate’. In ‘**Commentary on income tax**’¹³⁴ it is

¹³¹ *Ibid.* Refer specifically to the definition of ‘indexation’ and ‘index’. Accessed [7 September 2013].

¹³² South African Reserve Bank. 2012. *Introduction to the South African Reserve Bank (Fact Sheet 1)*. Pretoria: South African Reserve Bank. Available at: <http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblast=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=4995>. [2013, September 15].

¹³³ *Supra Brincker*, Part III – Interest, Chapter V.5 The mechanism to be used to understand the workings of section 24J of the Act, at paragraph 5.9.4.

¹³⁴ *Supra Commentary on Income Tax* -17.

said that the logical meaning of this ‘other similar factor’ appears to be any financially based factor (i.e. as both interest rates and indexation rates are financial factors). Based on the wording of the Act this ‘other factor’ should be *similar to an interest rate or indexation rate that varies over the term of the instrument (i.e. the other factor will qualify as a variable rate if it is similar to either a variable interest rate or indexation rate, it does not have to be similar to both these factors)*. As mentioned above the ordinary meaning of ‘interest rate’ is simply “*the percentage of a sum of money charged for its use*”.¹³⁵ Therefore considering, for example, where the annual amount payable as a return on a shareholders loan is determined as *a percentage of the company’s net profit*. The *rate charged for the use of the shareholder’s funds* is linked to a *financial factor* that is inherently variable (i.e. as the net profit is dependent on the company’s future performance) this rate would therefore be considered a variable rate and the instrument would be subject to the variable instruments ‘rules’ of section 24J. The meaning of ‘variable rate’ is therefore considerably widened by the inclusion of the words of ‘other similar factor’.

Further considering the meaning of ‘other similar factor’ in the light of the understanding of variable interest rate and indexation rate (as discussed above) there is a common thread that these factors are often linked to market conditions and are financial indicators of current economic conditions. This raises the question whether *foreign exchange rates* are regarded as a ‘similar factor’ and therefore a variable rate. Foreign exchange rates are explicitly given as an example of an ‘other similar factor’ in ‘**Commentary on Income Tax**’.¹³⁶ Foreign exchange rates are ever changing and significantly influenced by market conditions. SARB indicates that the strength of the Rand is mainly dependent upon the balance-of-payments position of SA, the inflation differential between SA and its main trading partners/competitors and the expected changes in transactions with the rest of the world. The mechanism behind determining a foreign exchange rate is arguably very similar in nature to that of an

¹³⁵ *Supra FreeDictionary.*

¹³⁶ *Supra Commentary on Income Tax -17.*

inflationary indexation rate or a prime lending rate and would more likely than not be considered a 'other similar factor' and therefore *considered a variable rate for purposes of section 24J.*

Chapter 5: Instruments denominated in a foreign currency

5.1 *Introduction*

Having established in Chapter 4 that *foreign exchange rates* would more likely than not be considered *variable rates* for purposes of section 24J is notable as this beckons the question whether instruments in terms of which the amounts payable / receivable are denominated in a foreign currency would be considered *fixed or variable rate instruments*. At first glance it would seem that even in the instance of a very straightforward instrument that requires the application of a foreign exchange rate (i.e. a variable rate) to calculate the amounts payable / receivable would fall within the definition of a ‘variable rate instrument’ for purposes of section 24J. However, as discussed in detail below, once the wording of section 24J is carefully considered it would seem that this is not the case.

The income tax treatment of ‘foreign denominated instruments’ are therefore considered in further detail below, specifically with regards to whether such instruments should be regarded as *fixed or variable rate instruments* for purposes of section 24J, the *interaction* between section 24J, section 25D (foreign currency translation rules) and section 24I (gains and losses on foreign exchange transactions) and the impact of my findings on the taxpayer.

5.2 *Instrument type classification of ‘foreign denominated instruments’*

Firstly, the reference to a ‘foreign denominated instrument’ for purposes of this study should be clarified. The term is used as reference to an ‘instrument’ (as defined in section 24J) where the ‘initial amount’ and all other amounts payable or receivable (including the redemption payment) is quoted in a currency other than SA Rand (further referred to as ‘Rand’). For example, where a SA resident lends \$100 000 to a non-resident company and

receives monthly payments of \$1 000 from the company for the use of the capital amount before redeeming the debt within 5 years at \$100 000 (referred to as ‘Example C’¹³⁷).

At firstly glance the debt arrangement in ‘Example C’ looks relatively straightforward. The arrangement is definitely interest-bearing as there are fixed monthly coupon payments of \$1 000 on top of the nominal amount redemption payment. Section 24J should therefore be applied to determine the interest amounts accrued by the SA resident for each year of assessment. However, the question arises whether this instrument is truly an uncomplicated fixed rate instrument for purposes of performing the section 24J YTM calculation. The SA resident carries foreign exchange rate exposure on the coupon and redemption amounts receivable. From the SA resident’s point of view the actual Rand amounts that he would end up receiving will differ from month to month and be dependent on the ruling exchange rate between the Rand and the United States (‘US’) Dollar. It should therefore be considered whether the amounts receivable by the SA resident are not essentially calculated with reference to a variable rate (i.e. a foreign exchange rate) and the instrument thereby considered a variable rate instrument for purposes of section 24J.

In order to establish the nature of the instrument (i.e. fixed vs. variable) in ‘Example C’ it is necessary to revisit the definition of ‘fixed rate instrument’ (previously discussed at sub-heading 4.3 above):

A ‘fixed rate instrument’ is *an instrument in terms of which the amounts payable consists of specified amounts or amounts that are not calculated by applying a variable rate or any combination thereof.*¹³⁸

The meaning of ‘amount payable’ in the above definition is crucial in establishing whether an instrument is a variable or fixed rate instrument. For example in the context of ‘Example C’,

¹³⁷ Example C.

¹³⁸ *Supra* ‘fixed rate instrument’ definition.

if ‘amount payable’ is referring to the *Rand denominated amount* that the SA resident will receive the ‘amount payable’ is calculated by *applying the applicable foreign exchange rate*. It would therefore be considered a variable rate instrument¹³⁹ and a separate YTM calculation will have to be done every time there is a change in the applicable foreign exchange rate.¹⁴⁰ The effect would be that the Rand denominated interest amounts receivable will be spread over the term of the instrument. On the other hand, if ‘amount payable’ refers to *specified amounts receivable denominated in US Dollar* the instrument would meet the definition of a ‘fixed rate instrument’ for purposes of section 24J. The YTM would then have to be calculated with reference to the present value of the US Dollar amounts receivable, resulting in US Dollar dominated interest accrual amounts (i.e. the US Dollar amounts receivable will be spread over the term of the instrument). However, over the term of the instrument the SA resident needs to include a Rand amount in its taxable income, the US Dollar interest accrual amounts would therefore have to be translated to Rand amounts. As section 24J does not contain any specific translation provisions, the interaction between the general translation provisions of section 25D and section 24J would have to be considered (refer to sub-heading 5.3).

The terms ‘amount’, ‘payable’ and/or ‘amount payable’ are not defined for purposes of the Act. It should therefore be interpreted by considering the language used in the light of the ordinary rules of grammar and syntax, the context in which the phrase appears and the apparent purpose to which it is directed.¹⁴¹ Also “*where more than one meaning is possible each possibility must be weighed in the light of all these factors*”.¹⁴² Considering the ordinary meaning of ‘payable’ it includes “*to be paid*”, “*liable to be paid*”, from a legal perspective it means “*imposing an immediate obligation on the debtor*”.¹⁴³ However, in **CIR v Janke**¹⁴⁴

¹³⁹ See discussion on ‘other similar factors’ at paragraph 4.2. A foreign exchange rate falls within the definition of variable rate for purposes of section 24J.

¹⁴⁰ *Supra* ‘YTM’ definition, see par (c).

¹⁴¹ *Supra Natal v E* at paragraph 18.

¹⁴² *Ibid.*

¹⁴³ *Supra FreeDictionary.*

judge De Villiers, C.J. stated that “*the Act makes a difference between the meaning of ‘due’ and ‘payable’ ... the word payable is not always used consistently in contracts and statutes. The ordinary meaning of payable is not ‘payable presently’.*”

The term ‘payable’ could therefore in my view include amounts that are immediately payable and/or amounts that are determined, but will only become payable in future. If one considers the context in which the word ‘payable’ is used in the definition ‘fixed rate instrument’ it is referring to all amounts payable, now and in future, in terms of the instrument. It is therefore used in the general sense of the word and could be rephrased as *the amounts that a person is obligated to pay at any time during the term of the instrument.*

Although there is case law dealing with the meaning of the word ‘amount’, it has not been considered in the context of section 24J. Judge Watermeyer, J. found in the case of **Lategan v CIR**¹⁴⁵ that the meaning of the word ‘amount’ as used in the ‘gross income’ definition should be given a *wider meaning* and must *include not only money*, but the value of every form of property earned by the taxpayer whether corporeal or incorporeal which had a money value. In 2010 the SARS issued an Interpretation Note,¹⁴⁶ dealing with their interpretation of the judgment in the **Brummeria** case, where it was again noted that the word ‘amount’ should be interpreted widely.¹⁴⁷

Further, the phrase ‘amount payable’ is used with specific reference to “*the amounts in terms of the instrument*” in the definition of a ‘fixed rate instrument’.¹⁴⁸ The phrase ‘in terms of the instrument’ infers that one should consider the actual, stated amounts, as per the contractual agreement. A ‘foreign denominated instrument’ would more often than not include amounts

¹⁴⁴ **Commissioner for Inland Revenue v Janke**, 1930 AD 474 at 476, also see **Stafford v Registrar of Deeds**, 1913 CPD 379, C.P.D at 379.

¹⁴⁵ **Lategan v Commissioner for Inland Revenue**, 1926 CPD 203 at 208, also see **Commissioner for Inland Revenue v People’s Stores (Walvis Bay) (Pty) Limited**, 1990 (2) SA 353 (A).

¹⁴⁶ South African Revenue Service. 2012. *Interpretation Note 58*. Available: <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-58%20%20Brummeria%20Case%20Right%20Use%20Loan%20Capital%20Interest%20Free.pdf> [2013, September 10].

¹⁴⁷ **Commissioner for the South African Revenue Service v Brummeria Renaissance (Pty) Limited and others**, 2007 (4) All SA 1338 (SCA). (Referred to as ‘**Brummeria**’)

¹⁴⁸ *Supra* ‘fixed rate instrument’ definition

payable or receivable quoted in a foreign currency. In ‘Example C’ (refer to page 46), the terms of the instrument require monthly payments of \$1 000 regardless of the bearing of the applicable exchange rate. The **Caltex Oil**¹⁴⁹ case dealt with the deductibility of amounts incurred in a foreign currency to purchase trading stock for purposes of section 11(a). It was held that it would be correct for a taxpayer, who had *incurred a liability for payment in another currency*, to convert the amount of that liability at the exchange rate prevailing on the date the liability had been incurred for purposes of reflecting a Rand amount in its accounting records.¹⁵⁰ It was further held that *the amount actually incurred and deductible in terms of section 11(a) was the amount in Rands which it actually cost the taxpayer to make this payment.*¹⁵¹

It is important to note that **Caltex Oil**¹⁵² confirms that a taxpayer firstly incurs a foreign currency amount and only then is the amount so incurred converted into Rands. This is in line with section 25D (which was added subsequent to the judgment in **Caltex Oil**¹⁵³) where a foreign currency amount should first be incurred or have accrued before the foreign currency translation rules apply.

Therefore, to the extent that foreign currency amounts are payable / receivable in relation to an instrument as per the terms of the agreement (now or in future) it would be regarded as an ‘amount payable’ for purposes of the definition of ‘fixed rate instrument’ in section 24J on the premise that:

¹⁴⁹ **Caltex oil (SA) Limited v Secretary for Inland Revenue**, 1975 (2) All SA 222 (A) (referred to as ‘Caltex Oil’).

¹⁵⁰ *Supra Caltex Oil* at 231. Note that this case was heard before the introduction of section 25D that currently governs the conversion of foreign amounts incurred and section 24I that deals with the treatment of foreign exchange differences.

¹⁵¹ *Ibid.*

¹⁵² *Supra Caltex Oil* at 227.

¹⁵³ *Ibid.*

- the word ‘amount’ as used in the Act should be widely interpreted and includes ‘money’ given its ordinary meaning of a medium that can be exchanged for goods and services¹⁵⁴ (therefore not only Rand amounts); and
- applying the same reasoning used in the **Caltex Oil** case, that a taxpayer can be considered liable (or become liable) for amounts payable expressed in foreign currency.

Importantly it should be noted that although foreign exchange rates are considered variable rates for purposes of section 24J, a ‘foreign denominated instrument’ would still be regarded as a fixed rate instrument to the extent that the amounts payable are *specified foreign currency amounts* or the *calculation of the foreign currency amount payable does not involve the application of a variable rate (e.g. an index or interest rate or a combination of the two)*. Although this conclusion could seem contradictory at first glance, it is not the case. Essentially, what is found in this study is that a foreign exchange rate is indeed a ‘variable rate’ for purposes of interpreting section 24J. However, when establishing whether or not a ‘foreign denominated instrument’ is a fixed or variable rate instrument, one needs to look at how the foreign amounts payable / receivable in terms of the instrument are determined. In other words, before the amounts are converted by applying a foreign exchange rate. The application of the foreign exchange rate for currency conversion purposes is therefore only done after the fact, i.e. after the instrument has been classified as either a fixed or variable rate instrument. The subsequent application of a ‘variable rate’ (i.e. a foreign exchange rate) for conversion purposes has no bearing on the classification of the instrument for purposes of section 24J.

For example, in ‘Example C’ the variable foreign exchange rate is not applied in determining the specified amount payable of \$1 000. It is applied after the fact (i.e. after the instrument has

¹⁵⁴ *Supra* FreeDictionary.

been classified as a fixed rate instrument) for purposes of determining the taxpayer's taxable income.

Note that there could be instances where the terms of the instrument require that the amounts payable be determined by applying the specific exchange rate. For example, if a SA resident lends \$100 000 to a non-resident company and is entitled to receive the Rand equivalent of \$1 000 at the end of each month by applying the Rand to US Dollar exchange rate on the 25th of that same month. This instrument would fall within the ambit of a variable rate instrument for purposes of section 24J.

That being said, it should be kept in mind that the 'amounts payable or receivable' in terms of an instrument will be used in the YTM' calculation to determine the interest accrual amounts for purposes of section 24J.¹⁵⁵ To the extent that these amounts payable or receivable are foreign currency amounts (and based on the interpretation above that 'amounts payable' include foreign currency amounts), the 'YTM' calculation will result in foreign currency accrual amounts.

The further question is therefore whether section 24J allows or caters for the calculation of the interest accrual amounts in a foreign currency amount or whether the accrual amounts have to be determined as Rand amounts within section 24J. In the instance that section 24J only allows for the calculation of the interest accrual amounts denominated in Rand, the reference to 'amounts payable or receivable' throughout the section (including the definition of 'fixed rate instrument') will be limited in its application to Rand denominated amounts only. 'Foreign denominated instruments' would (following such an interpretation) always fall outside the ambit of 'fixed rate instruments'.

In this regard the wording of section 24J(2) and (3) need to be considered carefully, in terms of which a taxpayer is deemed to have incurred or accrued an amount of interest during a year

¹⁵⁵ *Supra* 'YTM' definition.

of assessment *equal to the sum of all such accrual amounts relating to accrual periods that fall (in whole or in part) within that year of assessment. The taxpayer as the issuer must deduct an amount of interest equal to the sum of all these interest accrual amounts from his income* (derived from carrying on a trade, if that amount is incurred in the production of income) *and the taxpayer as the holder of the instrument must include the sum of all these interest accrual amounts* (regardless of whether or not the amounts are capital or revenue in nature) *in its gross income.*¹⁵⁶

Section 24J therefore requires a calculation of the sum of all applicable interest accruals for purposes of determining a taxpayer's taxable income for each year of assessment. To the extent that taxpayer has both interest accrual amounts calculated in Rand amounts and foreign currency amounts, it is not possible to obtain a logical mathematical answer by using the aggregate of the amounts denominated in the various currencies.

Section 24J is very specific in requiring that the sum of the interest accrual amounts of the holder "must be included in gross income" (own emphasis) and that of the issuer "must be deducted from the income" (own emphasis).¹⁵⁷ The question is therefore whether these specific requirements should be as narrowly interpreted as meaning the interest accrual amounts, exactly as calculated in terms of section 24J, should be summed and included (as is) in gross income or deducted from income. In other words, because of the very specific provisions in section 24J to include / deduct the sum of the calculated accrual amounts in gross income / income, the taxpayer is potentially not given the option to first translate any foreign currency accrual amounts. Section 24J therefore essentially side-steps the general translation mechanism included in the Act (i.e. section 25D). If this narrow interpretation is correct, the YTM calculation could only be based in Rand amounts payable or receivable (and

¹⁵⁶ See section 24J(2) and (3).

¹⁵⁷ *Ibid.*

the reference to ‘amounts payable’ in the definition of ‘fixed rate instrument’ could then only be referring to the amounts reflected in Rand).

To establish whether section 24J allows for the translation of foreign currency accrual amounts for purposes of including such amounts in gross income (or deducting such amounts from income), it is useful to consider the translation ‘rules’ established by case law as well as the workings of other sections in the Act and how these sections compare and interact with section 24J.

It was noted in the **Caltex Oil** case that:

*“for the purposes of the Republic’s taxation laws it was necessary for the appellant to reflect in its books of account its trading operations with Caltex Services Limited and Caltex(UK) Limited in South African currency”.*¹⁵⁸

The corner stone of taxable income (that needs to be reflected as a Rand amount) is essentially *gross income less income exempt from normal tax* (i.e. income¹⁵⁹) and *amounts deductible* from such income. Gross income (as the starting point of determining taxable income) is the *total amount*, in cash or otherwise, received or accrued to in favour of a resident (excluding receipts or accruals of a capital nature).¹⁶⁰ Again, amounts can only be totalled in a logical manner to the extent that such amounts are reflected in the same currency. It is therefore an inherent requirement of the gross income definition for amounts received or accrued to be translated into Rand amounts before such amounts are summed to determine the *total amount of gross income*. In turn, amounts are exempted or need to be deducted from gross income for purposes of calculating taxable income also needs to be in the same currency to logically determine the taxable income amount.

¹⁵⁸ *Supra Caltex Oil* at 229.

¹⁵⁹ See definition of ‘income’ in section 1.

¹⁶⁰ See definition of ‘gross income’ in section 1.

It is arguable that the translation of foreign currency amounts is merely an ancillary step to practically account for and report taxable income. The translation of an amount does not influence the timing of accrual, receipt or incurral of the foreign currency amount. The wording of section 25D¹⁶¹ (which establishes a general rule for the translation of amounts denominated in foreign currency to the currency of the Republic (i.e. Rands), while certain specific rules can be found in other provisions of the Act¹⁶²) is in line with this view, in that it requires (subject to certain exceptions) *any amount received by or accrued to, or expenditure or loss incurred in any currency other than Rand to be translated by applying the spot rate on the date on which the amount was so received, accrued or incurred*. Section 25D therefore only determines the method of translation to be applied to foreign currency amounts that have *already been received, accrued or incurred* for purposes of determining taxable income.

Further, there are various other instances in the Act where a taxpayer is required to include a specific amount in the determination of his taxable income. For example, section 23L¹⁶³ (subject to certain exclusions) requires that the aggregate of all policy benefits received or accrued in terms of an investment policy ‘*must be included in gross income*’. The Second Schedule to the Act also includes, for example, that a taxpayer must include lump sums derived in consequence of certain events in its gross income.¹⁶⁴ In both these examples it is possible for the amounts to be denominated in a foreign currency and no specific translation rules are included in these sections to facilitate the inclusion in gross income. The requirement that a taxpayer *must* include an amount in his taxable income is therefore not unique to section 24J.

Section 9G deals with taxable income in respect of foreign equity instruments held as trading stock and serves as an example of a provision in the Act that contains specific translation rules. In terms of section 9G *the amount to be included in the gross income* of a person “*shall*

¹⁶¹ See section 25D(1).

¹⁶² *Supra Silke*, Chapter 17 Special provisions § 17.7 - Determination of taxable income in foreign currency.

¹⁶³ See the definition of ‘premium’ in section 23L(1).

¹⁶⁴ See paragraph 2(1)(a) of the Second Schedule of the Act.

be the amount received or accrued in any currency other than currency of the Republic in respect of that disposal translated into the currency of the Republic at the average exchange rate for the year of assessment during which that foreign equity instrument is disposed of”. (own emphasis)¹⁶⁵

In section 9G, it is evident that the legislator recognises that foreign currency amounts require translation before such amounts could be included in gross income. Where the legislator requires such amounts to be translated in a specific manner, translation rules are included in the specific section (for example section 9G). Where amounts must be included in gross income / deducted from income, in the absence of specific translation rules, it is arguable that there is an inherent requirement within the Act to apply the general translation rules (regardless of the wording of the specific section). In the instance of foreign currency amounts, the wording ‘*must be included in gross income / must be deducted from income*’ should therefore be read as ‘foreign currency amounts, subject to translation of such amounts into Rand amounts, *must be included in gross income/ must be deducted from income for purpose of the Act*’.

Section 24J should therefore not be as narrowly interpreted as to exclude the translation of accrual amounts for purposes of determining the sum of the accrual amounts. Considering the purpose of the requirement in section 24J(2) and (3), *to calculate the sum of the interest accrual amounts*, it is clear that this calculation is only done for purposes of determining the amount to be included in *taxable income* (either as an inclusion in gross income or a deduction from income). The general translation rules of section 25D should therefore be applied to accrual amounts denominated in a foreign currency. In other words, the amount to be included in gross income (as determined by section 24J) *include interest accrual amount received or accrued in any currency other than Rand, translated as per the general translation rules of section 25D*.

¹⁶⁵ See section 9G(2).

5.3 *The interaction between section 25D and section 24J*

The interaction between section 25D and section 24J is not specifically dealt with anywhere in the Act. Section 25D provides for the translation of any expenditure or loss incurred (or amount received or accrued) in a foreign currency to Rand at the ‘spot rate’ *on the date on which the amount was so received or accrued*. (Note that section 25D includes specific provisions in the instance of amounts attributable to a foreign permanent establishment of a resident, a natural person or non-trading trusts.)¹⁶⁶ ‘Spot rate’ is defined as “*the appropriate quoted exchange rate at a specific time by any authorised dealer in foreign exchange for the delivery of currency*”.¹⁶⁷ Although the deeming provisions of section 24J that determine an amount of interest to be incurred or accrued during a specific year of assessment applies for the purposes of the entire Act,¹⁶⁸ there is uncertainty as to the *exact date* that section 24J interest accrual amounts are incurred or accrue.

As discussed in Chapter 3,¹⁶⁹ an accrual amount needs to be determined for each accrual period. At first glance, it could therefore appear that the spot rate at the end of each accrual period should be applied to translate the applicable accrual amount. To the extent that the accrual period is elected as the period between coupon payments, the ‘spot rate’ used for the conversion of the section 24J accrual amount on the last day of the accrual period will then co-inside with the date of the actual receipt of a coupon payment.¹⁷⁰ Alternatively, considering the general purposes behind section 24J to essentially spread interest over the

¹⁶⁶ See section 25D(1).

¹⁶⁷ See definition of ‘spot rate’ in section 1.

¹⁶⁸ Refer to the wording ‘shall for the purposes of this Act’ in section 24J(2) and (3).

¹⁶⁹ Refer to paragraph 0.

¹⁷⁰ Note however that the section 24J foreign currency accrual amount will in most instances differ from the foreign currency actual coupon payment.

term of the instrument, it is also plausible that a section 25D currency translation should be done on a daily basis.

However, the wording of section 24J should be carefully considered in this regard. Section 24J(2) and (3) determine that, in relation to an instrument, a person shall be deemed to have incurred or accrued an *amount of interest* respectively *equal to* the sum of all accrual amounts in relation to all accrual periods falling, whether in part or in whole within such year of assessment. It is clear that section 24J(2) and (3), as the charging provisions of section 24J, merely provides for a *single* accrual or incurral event during each year of assessment in relation to each instrument. It does not provide for a deemed accrual of each accrual amount determined for each accrual period or part therefore falling within the relevant year of assessment. It also does not provide for a deemed daily accrual.

In the case of a 'foreign denominated instrument', the various requirements of section 24J are applied to determine a *foreign accrual amount* per accrual period using the YTM method. However, these foreign accrual amounts are not considered to be incurred or accrued by the taxpayer until the provisions of section 24J(2) or (3) are applied (i.e. although these amounts could be calculated at various instances throughout the year of assessment, it has no bearing on the taxpayer until section 24J(2) or (3) is applied). These charging sections require that the accrual amounts, in relation to each instrument, first be summed and then a single deemed accrued / incurred interest amount is determined for the year of assessment that should be included in taxable income. The 'order of events' is thus, in relation to each instrument, to (1) determine the accrual amounts, (2) determine the sum of the accrual amounts. The sum (a single amount) of the accrual amounts is then (3) deemed incurred / accrued and (4) included in taxable income.

Section 25D can clearly only be applied to any amount that has been *received by or accrued to, or expenditure or loss incurred by*, a person during any year of assessment in any currency

other than the currency of the Republic.¹⁷¹ With reference to the ‘order of events’ listed above, section 25D can therefore only be applied to the deemed accrual / incurral interest amount (i.e. only at the time that there is an accrual / incurral) for purposes of including a Rand amount in taxable income (i.e. between steps (3) and (4)). As each foreign accrual amount determined per accrual period is not deemed to be incurred or accrued separately, the translation rules cannot be applied to these individual amounts have not accrued (i.e. it cannot be applied between step (1) and (2) as per the ‘order of events’ listed above). It is also necessary to mention that one also cannot have regard to when the actual cash flows occur, as these are ignored for the purposes of gross income (in the case of the holder) and not deductible in terms of section 11(a) (in the case of the issuer).¹⁷² As mentioned before, the deeming provisions of section 24J applies for purposes of the entire Act.¹⁷³ The foreign accrual amounts are therefore only deemed incurred / accrued as a portion of the single deemed interest amount incurred / accrued determined for the specific year of assessment.

That being said, although it is established above that section 24J only allows for a single interest accrual / incurral amount per year of assessment, the actual date of this deemed accrual / incurral is still unclear. Specifically as section 24J(2) and (3) only makes reference to an amount accrued / incurred ‘during’ that year of assessment as oppose to ‘at the end’ of the year of assessment. Based on the wording of section 24J it is not possible to meaningfully ask exactly ‘when’ these amounts are deemed to accrue, it can only be said that it falls within a specific year of assessment. It would therefore seem that the only option is to revert to common law principles in determining the actual date of accrual / incurral under section 24J, for purposes of section 25D.

In the case of **Caltex Oil** it was determined that it is only *at the end of the relevant year of assessment* that the amounts incurred / received / accrued *must be determined, in order to*

¹⁷¹ See section 25D(1).

¹⁷² See section 24J(5).

¹⁷³ See introductory paragraph in section 24J(2) and (3).

determine the taxable income of a taxpayer.¹⁷⁴ Judge Botha, JA. also cited the case of **Port Elizabeth Electric Tramway Co**¹⁷⁵ and **Delfos**¹⁷⁶ stating that “*it is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment*”. Although in the instance of the **Caltex Oil** case the court applied this principle in the context of determining actual expenditure incurred, it specifically confirmed that the principle *will equally apply where amounts are received or accrued have to be determined*.¹⁷⁷ It is therefore arguable that, in respect of each instrument, it is only necessary to determine the single deemed interest accrual or incurral amount to be included in taxable income *at the end of each year of assessment*. The date that the amount is therefore deemed as accrued or incurred would be the *last day of the year of assessment*. Meaning that *all section 24J accrual amounts falling within a specific year of assessment should be translated at the spot rate prevailing on the last day of the year of assessment* to determine the total deemed accrual or incurral interest amount to be included in taxable income.

It should be noted that a single deemed interest accrual / incurral amount should be calculated *in respect of each instrument*.¹⁷⁸ Although the interpretation above submits that the single accrual / incurral interest amount would be considered incurred / accrued on the *last day of the year of assessment*, there is, in my opinion, an exception to this rule. To the extent that the instrument is ‘transferred’ or ‘redeemed’ during the year of assessment, it is my opinion that, the sum of the accrual amounts falling within the year of assessment relating to such instrument will be deemed to be accrued / incurred *on the redemption or transfer date* of such instrument.

¹⁷⁴ *Supra Caltex Oil* at 11.

¹⁷⁵ **Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue** 1936 CPD 241 at 244.

¹⁷⁶ **Commissioner for Inland Revenue v Delfos**, 1933 AD 242 at 257.

¹⁷⁷ *Supra Caltex Oil* at 11.

¹⁷⁸ See section 24J(2) and 24J(3).

Based on interpretational rules established in **Natal v E**¹⁷⁹, it is noted that, among the other factors to consider, one must have regard to the context in which the wording is used in light of the whole document. In the discussions to follow below the interaction between section 24J, section 25D and section 24I is considered. Based on the findings of these further discussions, it is evident that the date of incurral / accrual of the single interest accrual / incurral amount in the instance of an instrument that was redeemed or transferred during the year can only be the date of redemption or transfer. To the extent that the single interest accrual / incurral amount is deemed to be the last day of the year of assessment, the interaction between section 24J, section 25D and section 24I results in bizarre and obviously unintended tax consequences (refer to detail discussion at sub-heading 5.4.1.1 below), specifically when one is required to determine foreign exchange gains or losses in terms of section 24I.

5.3.1 The practical implication on a taxpayer of the interaction between section 24J and section 25D

Based on the interpretation above of the treatment of a ‘foreign denominated instrument’ and the interaction between section 24J and section 25D, the practical implications on the taxpayer should be considered.

In summary, the following is expected from the taxpayer in relation to a ‘foreign denominated instrument’: Firstly, the taxpayer will be required to perform a YTM calculation determining the accrual amounts in the foreign currency.¹⁸⁰ The taxpayer will then be required to determine the sum of all accrual amounts and the sum of all incurral amounts falling within

¹⁷⁹ *Supra Natal v E* at paragraph 18. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction to this paper.

¹⁸⁰ See sub-heading 5.3 ‘The interaction between section 24J and section 25D’ above.

the year of assessment to determine the deemed accrual or incurral amount to be included in its taxable income. Any foreign currency accrual amounts should be translated at the *spot rate on the last day of the year of assessment* (or the spot rate on the date of redemption/transfer in the instance where the instrument was redeemed/transferred during the year of assessment) for purposes of calculating these sum amounts.¹⁸¹

The implication of the above treatment is that the *foreign currency interest amounts* in terms of the instrument are subject to the provisions of section 24J and are *spread over the term of the instrument*. However, the Rand amount included in the taxpayers taxable income could differ significantly year on year as the underlying ‘evenly spread’ foreign accrual amount is translated at spot rate that (would most probably) differs at the end of every year. The foreign exchange risk related to the interest accrual amounts is therefore not spread over the term of the instrument.

Further, the total Rand amount of interest included in taxable income over the term of the instrument could also differ significantly from the actual Rand amount of interest received or paid in terms of the instrument. The reason being that *the actual cash flows* (e.g. coupon payments) paid or received will be the Rand amount as translated at the *spot rate on the date as determined in the terms of the instrument* (e.g. the spot rate on the day that the coupon amount becomes receivable / payable), whereas for tax purposes *all accrual amounts* falling within that year of assessment will be translated at *the spot rate at the end of the year of assessment* (or the spot rate on the date of redemption/transfer in the instance where the instrument was redeemed/transferred during the year of assessment). To the extent that there is substantial volatility in the exchange rate the spot rates used for the conversion of the actual coupon payments could differ significantly from the spot rate at the end of the respective years of assessment. The question is then whether, at the time of redemption or transfer of the

¹⁸¹ See paragraph 5.4 ‘The interaction between section 24J and section 24I’ above.

instrument, the taxpayer could find himself in a position where he paid tax on Rand amounts that he never received or deducted Rand amounts that it never paid.

The general mechanism included in section 24J to deal with scenario where the section 24J interest differs from the actual interest at the time of the redemption of an instrument is included in the concepts of an ‘adjusted gain on transfer or redemption of an instrument’ and ‘adjusted loss on transfer or redemption of an instrument’ as defined, (referred to as the ‘adjusted gain / loss mechanism’).¹⁸² The purpose of the ‘adjusted gain / loss mechanism’ is to essentially calculate the difference between the amount of the net actual payments / receipts in terms of an instrument and the total accrual amounts included in taxable income at the time of redemption or transfer.¹⁸³ Section 24J(4) then essentially allows for a ‘catch-up’ amount to be deemed incurred or accrued by the taxpayer in the year of assessment when the instrument is redeemed or transferred.

That being said, there are concerns that ‘adjusted gain / loss mechanism’ does not apply or have the intended effect in all scenarios. Firstly, as explained by **Silke**¹⁸⁴, section 24J(4) only deems the adjusted gain / loss on transfer or redemption as accrued or incurred in a specific year of assessment. In contrast to the normal charging provisions in section 24J(2) and (3) it does not specifically state that such amounts should be included in gross income or deducted from income. It would therefore seem that the normal requirements of the Act for including an amount in gross income or deducting an amount in terms of section 11(a) should be satisfied, including the test whether the amount is of a capital or revenue nature. It is therefore arguable that any adjustment resulting from the ‘adjusted gain / loss mechanism’ will only be included in gross income or deducted from income in the instance where the instrument is held on revenue account by the taxpayer. To the extent that the instrument is held on capital

¹⁸² See definition of ‘adjusted gain / loss on transfer or redemption of an instrument’ in section 24J(1).

¹⁸³ *Supra Silke*, Chapter 17 Special provisions § 17. 70 Accrual and incurrence of interest — gains and losses on transfers or redemption and incurrence of interest.

¹⁸⁴ *Ibid.*

account the rules of the Eighth Schedule to the Act will apply in determining the gain or loss on disposal of the instrument.

Secondly, where the translated Rand accrual amounts differ to the actual translated Rand amounts received / paid due the changes in the spot rate in the instance of a 'foreign denominated instrument' (as explained in detail above) the 'adjusted gain / loss mechanism' is of no benefit to the taxpayer. This due to the adjusted gain or loss on transfer being calculated with reference to the accrual amounts and the payments and receipts in terms of the instrument, i.e. *the foreign currency amounts*. Therefore, the 'adjusted gain / loss mechanism' will only determine the difference between the foreign amounts accrued and the foreign amounts received / paid at the time of redemption or transfer of the instrument. The Rand amount difference caused by the translation of these amounts is not considered in this calculation. The taxpayer could therefore find himself in a scenario where he pays income tax on a higher Rand amount accrued / incurred than the actual Rand amount received / paid (or vice versa).

5.4 *The interaction between section 24J and section 24I*

As considered in detail above, any foreign denominated section 24J interest amounts accrued or incurred are *translated* in terms of section 25D. However, the interaction between section 24J and section 24I, which determines the gains or losses on foreign exchange transactions should also be considered, specifically whether the timing of the accrual / incurral of interest rules in terms of section 24J impacts on the application of section 24I.

Section 24I is applicable where a realisation of an ‘exchange item’ occurs or where an ‘exchange item’ is held at the end of the year of assessment.¹⁸⁵ The interaction between section 24J and section 24I therefore becomes relevant where an ‘instrument’ as defined for purposes of section 24J is also an ‘exchange item’ as defined for purposes of section 24I.

As a starting point, it is important to note that section 24I only applies to companies / trusts that carry on a trade and natural persons who hold foreign currency or debt (owing / receivable) as trading stock.¹⁸⁶ Any interaction between section 24I and section 24J discussed below is therefore limited to these types of taxpayers. Further, section 24I also does not apply to non-residents other than controlled foreign companies, unless the exchange item is attributable to a permanent establishment in South Africa.¹⁸⁷

Fundamentally, section 24I determines that, subject to certain exclusions, any ‘exchange difference’ in respect of an ‘exchange item’ should be included in or deducted from a taxpayer’s income.¹⁸⁸ The corner stones of section 24I are therefore found in the definitions of ‘exchange difference’ and ‘exchange item’. For purposes of this study emphasis is placed on the following aspects of these two relevant terms:

Exchange item:

- An ‘exchange item’ includes “an amount in a foreign currency ... owing by or to that person in respect of a debt incurred by or payable to such person”¹⁸⁹ (referred to as a ‘foreign currency debt’ for purposes of this paper).

¹⁸⁵ Supra **Commentary on Income Tax**, PART I Normal Tax (ss 5-37H), 24I Gains or losses on foreign exchange transactions, RS 18.

¹⁸⁶ See section 24I(2).

¹⁸⁷ See the proviso to section 24I(2).

¹⁸⁸ See section 24I(3). Note that section 24I(3) is subject to the specific provisions of section 24I(10) and section 24I(10A) that deals with exchange items relating to connected persons, group companies and controlled foreign companies.

¹⁸⁹ See proviso (b) to the definition of ‘exchange item’ in section 24I(1).

Exchange difference:

- An ‘exchange difference’ means a foreign exchange gain or loss *in respect of an ‘exchange item’*.
- To calculate an ‘exchange difference’ relating to a ‘*foreign currency debt*’ the ‘foreign currency debt’ amount is multiplied by the difference between:¹⁹⁰
 - The spot rate on ‘transaction date’¹⁹¹, of the ‘foreign currency debt’; and
 - The spot rate on the day the ‘foreign currency debt’ is realised or if still on hand at year end, the spot rate at the end of the year of assessment; **or**
 - If the ‘foreign currency debt’ was on hand at the end of the immediately preceding year of assessment, the difference between the spot rate at the end of the year of assessment or when the foreign current debt is realised; and
 - the spot rate at the end of the immediately preceding year of assessment.

Although section 24I in itself is not the main focus of this study, it is useful to briefly consider the general purposes of section 24I before the interaction between section 24J and section 24I is considered further.

Section 24I was introduced into the Act in 1993, and the relevant Explanatory Memorandum¹⁹² to the amendment act explains the objectives for including this section, amongst others, is to treat all gains made and losses incurred in respect of foreign exchange transactions in a manner which takes into account as far as possible the principles of *fairness and economic reality*. It is also stated that as per section 24I all gains and losses relating to

¹⁹⁰ See the definition of ‘exchange difference’ read with the definition of ‘ruling exchange rate’ in section 24I(1).

¹⁹¹ In relation to a debt owing by a person, the ‘transaction date’ is considered the date on which the debt is actually incurred. Refer to subparagraph (b) in the definition of ‘transaction date’ in section 24I(1).

¹⁹² South Africa. National Treasury. 1993. *Explanatory Memorandum on the Income Tax Bill, 1993*. Pretoria: National Treasury.

foreign exchange transactions have to be brought into account for tax purposes at the end of the year of assessment irrespective of whether they have been realised or not. In other words, for income tax purposes section 24I requires a taxpayer to recognise any foreign exchange gains and losses as and when it occurs, instead of recognising the entire gain or loss only when the exchange item is realised.

For example, if a \$100 debt is incurred when the exchange rate is R10:\$1 and is settled 2 years later when the exchange rate is R13:\$1, a total foreign exchange loss of R300 [calculated as $(R13 - R10) \times \$100$] is realised. However, assuming the exchange rate was R12:\$1 at the end of year 1, an exchange difference of R200 [calculated as $(R12 - R10) \times \$100$] should be deducted against income at the end of year 1, and an exchange difference of R100 [calculated as $[(R13 - R12) \times \$100]$] should then be deducted in year 2. *Note however, that the aggregate of the foreign exchange losses (i.e. R200 + R100) recognised over the period of the debt arrangement is equal to the total actual foreign exchange loss of R300. The purpose of section 24I is not to create / recognise manufactured foreign exchange losses or gains, but to reflect the actual economic reality of the transaction.*

5.4.1 *The overlap between section 24J ‘instruments’ and section 24I ‘exchange items’*

As considered in detail in chapter 2 (refer to sub-heading 2.2) an ‘instrument’ as defined in section 24J includes ‘any debt’¹⁹³ and the general meaning of ‘debt’ is ‘*an amount owed by one party to another party*’.¹⁹⁴ To the extent that a *foreign currency amount is then owed by one party to another* it will fall within the ambit of the definition of an ‘instrument’ for purposes of section 24J and could also be considered an ‘*exchange item*’ (specifically with reference to the aspect of this definition highlighted above) for purposes of section 24I.

¹⁹³ *Supra* definition of ‘instrument’.

¹⁹⁴ Refer to footnote 28 and 29 above regarding the ordinary meaning of ‘debt’.

Considering a basic interest-bearing debt arrangement, it typically consists of; (1) an amount that is borrowed by one party to another that is repayable after a period of time lapses and (2) interest payments over the term of the loan as compensation to the lender for the use of the money (or the required return as stipulated by the lender for lending the money to the borrower). Two ‘types’ of amounts can therefore be *owed* by the lender to the borrower in terms of an interest-bearing debt arrangement; (1) *the principal capital amount that is repayable on redemption of the loan* and (2) *the interest payments* (e.g. coupon payments) could be owing to the extent that it has accrued to the lender in terms of the debt agreement, but remains unpaid by the borrower.

For purposes of the discussion below the following example (referred to as ‘Example D’) will be referred to:¹⁹⁵ A SA resident borrows an amount of \$1 000 on 1 June 2012 from an unconnected non-resident lender. The capital amount of \$1 000 is repayable after a period of 2 years on 31 May 2014. Interest is payable annually on 31 May at an effective annual interest rate of 12%. Although the interest becomes due and payable to the lender on the 31st of May annually, no actual interest payments are made to the lender until the loan is settled after 2 years (i.e. the interest payments and capital amount will be repaid at the end of the 2 year period). The SA resident borrower has a December year end. The hypothetical applicable Rand: US Dollar exchange rates are as follows:

1 June 2012	31 Dec 2012	31 May 2013	31 Dec 2013	31 May 2014
R10:\$1	R10.5:\$1	R10.6:\$1	R10.8:\$1	R11:\$1

For purpose of this discussion, it should be kept in mind that the purpose of section 24J is to determine the timing and amount of *interest* incurred or accrued by spreading the interest (as defined in section 24J) in terms of an arrangement over the term of the instrument. It is therefore evident that section 24J has no relevance to the treatment of the capital or principal

¹⁹⁵ Example D

loan amount owing by the borrower to the lender (i.e. the \$1 000 borrowed by the SA resident). As this paper focuses on the interaction between section 24J and section 24I, the treatment of the principal amount owing for purposes of section 24I is not discussed in much detail.

Briefly, any ‘exchange difference’ in respect of the capital amount owing will simply be calculated using the spot rate at the end of the relevant year of assessment (or if realised, the spot rate on the realisation date) less the spot rate on the date the debt was incurred (or if on hand in the immediately preceding year end, the spot rate at the end of the preceding year). With reference to ‘Example D’, if only the \$1 000 capital amount owing is considered, the borrower should deduct an exchange difference of R500 from his income¹⁹⁶ at the end of year 1. [The exchange difference is calculated as: \$10.5 - \$10 (applicable exchange rate at the end of year 1, less the exchange rate on the day the debt was incurred, 1 June 2012) x \$1 000 (multiplied with the capital amount owing)].

5.4.1.1 Where interest payments are owed to the lender

As established above *interest payments* in respect of a foreign currency debt arrangement that remain *owing* to a lender could fall within the ambit of an ‘exchange item’ for purposes of section 24I. The question then arises whether there is any interaction between section 24J dealing with interest accrued / incurred for income tax purposes and foreign interest payments *owing* in terms of section 24I.

Firstly, careful consideration is required of the word ‘owing’ as used in the definition of ‘exchange item’ (refer to the definition on page 62 above) . Again the rules of interpretation as established in **Natal v E** should be applied to determine the meaning of this undefined term. The language used in the light of the ordinary rules of grammar and syntax, the context

¹⁹⁶ See section 24I(3)(a).

in which the phrase appears and the apparent purpose to which it is directed should therefore be considered.¹⁹⁷ Also ‘*where more than one meaning is possible each possibility must be weighed in the light of all these factors*’.¹⁹⁸

In the case of **Rhodesian Newspapers Company** it was considered that the word ‘due’ is capable of two interpretations, it could mean ‘payable’ or it could mean ‘owing’ irrespective of whether the amount is immediately payable.¹⁹⁹ Also in the case of **Lekhari v Johannesburg City Council**²⁰⁰ it was considered that the word ‘owing’ generally means “*owing but not payable*” and not necessarily due and payable. As per the Oxford dictionary²⁰¹ ‘owing’ means an amount of money “*yet to be paid*”. In the context of the definition of ‘exchange item’ it is also apparent that the word ‘owing’ means *indebted, but not necessarily immediately payable*. For example, in ‘Example D’ (refer to page 67) , although the annual interest of \$120 [calculated at an annual effective interest rate of 12% x \$1000 (capital amount borrowed)] is only payable on 1 May every year, \$60 [calculated as the annual interest amount of \$120, apportioned over the applicable number of months (i.e. 6 / 12 months)] *is already owing* to the lender at year end (31 December 2012) *regardless of the fact that the amount is not payable at this date*.

However, to qualify as an ‘exchange item’ for purposes of section 24I the definition of the same term does not only require ‘an amount in a foreign currency *owing* by or to a person’, it also has a secondary requirement in that such an amount owing should be ‘in respect of a debt *incurred by or payable to* such person’.²⁰² As considered above, ‘debt’ is not defined for purposes of the Act and its ordinary meaning of as ‘*an amount owed by one party to another party*’ is rather wide.²⁰³ Therefore where *interest* denominated in a foreign currency *is owed*

¹⁹⁷ *Supra Natal v E* at paragraph 18.

¹⁹⁸ *Ibid.*

¹⁹⁹ **Rhodesian Newspapers Company Limited v Allison**, 1934 SR 60 at 65.

²⁰⁰ **Lekhari v Johannesburg City Council**, 1956 (2) All SA 12 (A) at 27.

²⁰¹ *Supra Oxford Dictionary*.

²⁰² See definition of ‘exchange item’ in section 24I(1).

²⁰³ Refer to footnote 28 and 29 above regarding the ordinary meaning of ‘debt’.

by one person to another, that *interest owing in itself is regarded as a debt*. In respect of such interest amounts owing the ‘exchange item’ definition can then essentially be interpreted as an *amount of interest denominated in a foreign currency owing by or to a person to the extent that such an amount of interest (i.e. the debt) is incurred by or payable by such person*.

With reference to ‘Example D’, it was previously said that \$60 is already *owing* to the lender at 31 December 2012, although the interest *amount is only payable on 1 May 2013*. It would therefore seem that one could argue that there is no ‘exchange item’ at 31 December 2012 as the \$60 *owing is not payable*. However, the requirement in terms of the ‘exchange item’ definition refers to ‘incurred by or payable’. It should therefore also be considered, although the \$60 is not payable at 31 December 2013, whether or not the interest amount owing has been *incurred* by the taxpayer as at 31 December 2013.

It should be remembered that section 24J is essentially a ‘taxing mechanism’, in other words, section 24J would have no bearing on the *actual amount of interest owing* by the borrower to the lender in terms of the debt agreement. However, where a person is the holder / issuer of an interest-bearing debt arrangement, *interest amounts relating to such debt arrangement is incurred / accrued as per the deeming provisions of section 24J for purposes of the entire Act*.²⁰⁴ The general rules relating to the incurral of expenses in terms of section 11(a) and the accrual of income in terms of the ‘gross income’ definition in section 1 does not apply to interest amounts relating to such debt arrangements.²⁰⁵ In relation to a debt arrangement (as illustrated in ‘Example D’), the requirement in the definition of ‘exchange item’ to consider whether the *interest amount owing* has been *incurred*, therefore automatically requires *the consideration of the timing of the incurral / accrual of interest in terms of section 24J* as the interest cannot be incurred / accrued in terms of any other section in the Act.

²⁰⁴ Refer to section 24J(2) and 24J(3). Note that the section 24J deemed interest incurral / accrual rules do not apply in the instance where a company deals in instruments and has elected out of section 24J in terms of section 24J(9), note that section 24J(9) does not apply to years of assessments commencing on or after 1 January 2014).

²⁰⁵ See section 24J(5).

For example, in ‘Example D’ (refer to page to 67), if it is assumed that the *section 24J interest accrual amount* in respect of the \$1 000 debt arrangement for the 2013 year of assessment is also \$60, the \$60 interest amount *owing* to the lender at 31 December 2012 would be *incurred* by the borrower and considered an ‘exchange item’ at the end of the that year of assessment regardless of the fact that it is not payable at such time.

The problem that arises in this regard is that, as established above, section 24J has no bearing on the actual *interest amounts owing* in terms of a debt arrangement. Section 24J only determines the timing of incurral / accrual of the *interest accrual amounts* for income tax purposes. A disconnect therefore seems to result from trying to determine whether or not the *interest amount owing has been incurred* by considering the *timing of accrual of the interest accrual amounts*. To the extent that the sum of the interest accrual amounts determined for purposes of section 24J does not differ from the actual interest amount owing at the end of that year of assessment (as assumed in ‘Example D’ in the paragraph above), *it is arguable that a direct correlation can be drawn between the two amounts and that the section 24J timing of accrual / incurral can be attributed to the interest amount owing*.

However, where the interest amount owing is less or more than the section 24J interest accrual amounts the interaction between section 24J and section 24I becomes rather blurred. For example, in a hypothetical scenario where interest amounts of \$120 is owing, but the interest accrual amount is only \$100, it is arguable that the ‘exchange item’ *could be limited to the amount of \$100 incurred of for purposes of section 24J* (i.e. the amount owing is only considered an ‘exchange item’ to the extent that it has been incurred). This is however again based on the assumption that a direct correlation can be drawn between the interest amount owing and the interest accrual amounts. In other words, it is assumed that the \$100 incurred *is a portion* of the \$120 owing. As discussed before, section 24J is a taxing mechanism and its purpose is to spread the interest in relation to an instrument evenly over the term of the instrument. Section 24J has no bearing on the interest amount owing. The opposite is also true, in that the interest amounts owing has no bearing on the YTM calculation to determine

the interest accrual amounts (note that only interest amounts actually received or paid in taken into account in the AIA for purposes of the YTM calculation).²⁰⁶ In other words, the \$100 interest accrual amount could technically relate to interest amounts that *are not yet considered owing* at the end of that year of assessment (i.e. it could relate to interest amounts that will only be considered owing in terms of the debt arrangement at a later stage). *It is therefore impractical and probably nearly impossible to determine what portion of the specific interest amount owing has in fact been incurred in terms of section 24J.*

In my view a practical approach should be followed where the sum of the interest accrual amounts differ to the interest amount owing during any year of assessment, whereby the economic reality of the taxpayer should be reflected. In other words, any resulting ‘exchange difference’ (discussed in detail below) determined in respect of any ‘exchange item’ should result in the *actual* economic foreign exchange gain / loss ensued or suffered by the taxpayer from a tax perspective. To the extent that an interpretation of ‘exchange item’ is adapted (due to of a specific interpretation of the Act) that results in the calculation of exchange gains or losses that deter from the economic reality of the taxpayer, such an interpretation should be reconsidered. It is also further recommended that the legislation be clarified in this regard.

Once it is established that an ‘exchange item’ exists for purposes of section 24I, the next step is to calculate the ‘exchange differences’ relating to this ‘exchange item’. For purposes of determining these exchange differences the ‘transaction date’ in respect of the ‘exchange item’ is required.²⁰⁷ The ‘transaction date’ in respect of a debt owing is the date on which the debt is *actually incurred*.²⁰⁸ As discussed above, section 24J determines the timing of *interest amounts* accrued / incurred for purposes of the Act,²⁰⁹ section 24J could therefore again impact on the ‘transaction date’ of *interest amount owing* considered to be ‘exchange items’ for purposes of section 24I.

²⁰⁶ *Supra* ‘AIA’ definition’.

²⁰⁷ See sub-paragraph (a) to the definition of ‘exchange difference’ in section 24I(1).

²⁰⁸ See definition of ‘transaction date’ in section 24I(1).

²⁰⁹ Refer to section 24J(2) and 24J(3).

As discussed in detail under heading 5.3 above, for purposes of section 24J it is only necessary to determine the single deemed interest accrual or incurral amount to be included in taxable income *at the end of each year of assessment*. The date that the interest amount (i.e. the sum of the accrual amounts falling within that year of assessment) is therefore deemed as accrued or incurred would be the *last day of the year of assessment*.²¹⁰ Therefore, to the extent that the *date of accrual / incurral* of an interest amount owing in respect of a foreign debt arrangement needs to be determined with reference to the timing of incurral / accrual rules as per section 24J the date of incurral / accrual will be the last day of the year of assessment. Again the problem that arises in this regard is that, as established above, the *interest amounts owing* for purposes of section 24I has no relation to the *interest accrual amounts* determined for purposes of section 24J, and section 24J only determines the *timing* of incurral / accrual of the interest accrual amounts.

SARS issued Practice Note 4 of 1999 ('PN 4') to provide additional guidance on the treatment of gains and losses on foreign exchange transactions in terms of section 24I. Before PN 4 is considered further, it should be noted the definition of 'transaction date' was amended in terms of the **2012 TLAA**.²¹¹ However, as per the Explanatory Memorandum to the 2012 Taxation Laws Amendment Bill the amendment was simply made as part of a process to unify the various concepts utilising the term 'debt' within one single term.²¹² In other words where 'transactions date' previously referred to loans or advances owing / payable, it now simply refers to 'debt' owing.²¹³ Although it is arguable whether or not the amendment really had no effect of the meaning of 'transaction date' based on the literal interpretation of the wording used, the intent behind the amendment was not to alter the original meaning of the defined term. Therefore, although PN 4 was originally issued in 1999, the examples and application of the term 'transaction date' is still relevant today and can be used to as an aid of interpretation.

²¹⁰ Note timing of incurral / accrual will differ in the instance where the instrument is transferred or redeemed during the year of assessment.

²¹¹ *Supra* **2012 TLAA**.

²¹² *Supra* **2012 Explanatory Memo** at 32.

²¹³ See definition of 'transaction date' before and after the amendments as per *supra* **2012 TLAA**.

Although no direct guidance is provided on the ‘transaction date’ relating to interest amounts owing in respect of foreign debt arrangements, PN 4 does include two illustrative examples²¹⁴ where interest amounts are owing at the end of the year of assessment. In both these examples the ‘transaction date’ of the interest amounts owing is considered to be *the last day of the relevant year of assessment*. In Example 16²¹⁵ a capital amount of \$100 000 is owed as of 1 July 1997, and interest is incurred from this date. The relevant taxpayer’s year of assessment ends on 31 August 1997. For purposes of calculating the exchange difference relating to this debt arrangement at 31 August 1997, the ‘transaction date’ of the \$100 000 debt amount incurred is 1 July 1997, *but the ‘transaction date’ of the interest amount owing at year end is 31 August 1997 (i.e. the last day of the year of assessment)*. In this example it is specifically noted that “*although interest accrues from 1-07-1997, the transaction date is assumed to be 31-08-1997*”.²¹⁶ No further reason for this assumed ‘transaction date’ is however provided.

From the two relevant examples in PN 4, it would seem that the *timing* of the accrual and incurral of interest amounts in terms of section 24J is indeed applied when the ‘transaction date’ of the interest amount owing is determined. In other words, the ‘transaction date’ of the interest amounts owing in respect of foreign debt arrangement could in all instances *only be the last day of the year of assessment*.

For example, in ‘Example D’ (refer to page 67) the interest amount owing (although not yet payable) as at 31 December 2012 is \$60. It is assumed that the interest deemed to be incurred for purposes of section 24J is also \$60. The interest amount owing is therefore *equal* to the deemed interest accrual amount incurred. As the interest is *deemed to be incurred on the last day of the year of assessment* for purposes of section 24J, the *same date of incurral* is used for

²¹⁴ South African Revenue Service. 1999. *Practice Note 4 of 1999*. Available: <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-PrN-2012-08%20-%20Income%20Tax%20Practice%20Note%204%20of%201999.pdf> [2013, August 8]. (referred to as ‘PN 4’), Annexure C, Example 10 and Example 16.

²¹⁵ *Supra* PN 4, Annexure C, Example 16.

²¹⁶ *Supra* PN 4, refer to the ‘Note:’ under ‘YEAR END 31-08-1997’, Annexure C, Example 16.

purposes of determining the ‘transaction date’ of the *interest amount owing* for purposes of section 24I.

It should be remembered that for income tax purposes all foreign interest accrual amounts in relation to an instrument will be included in taxable income *at the spot rate on the last day of the year of assessment*²¹⁷ (refer to the discussion at sub-heading 5.3.1). Bearing in mind the general purpose of section 24I, as discussed at heading 5.4 above, is to include *actual* foreign exchange gains and losses in taxable income as and when such gains / losses occur, *to reflect the actual economic reality of the transaction*. It would be expected that an ‘exchange difference’ could only occur to the extent that a change occurs in the spot rate *after* the date on which the interest amounts were included in taxable income.

For example, in ‘Example D’ (refer to page 67) although interest is owing from 1 June 2012, the interest accrual amount of \$60 in year 1 is only deemed to be incurred on the last day of year 1, 31 December 2012 as per section 24J. Section 25D is then applied on the date of incurral, and as the exchange rate of R10.5: \$1 applies on 31 December 2012; interest of R630 is deducted from income on the last of the year of assessment. As the interest amount remains owing on 31 December 2012, section 24I should be applied to calculate any exchange differences relating to this exchange item. The *economic reality from a tax perspective* is that interest of R630 is deducted from income in year 1, and only to the extent that the Rand amount of interest owing differs to the initial Rand amount deducted from income should any exchange differences be realised. *As the interest accrual amount of \$60 was translated using the spot rate on 31 December 2012, there should be no exchange difference recognised in this regard. The only manner in which the application of the section 24I could reflect this economic reality is to assume that the ‘transaction date’ for purposes of the interest amount owing is the last day of the year of assessment, in line with section 24J.*

²¹⁷ Except in the instance where the instrument was redeemed or transferred during the year of assessment.

However, as discussed under heading 5.3 above, interest is deemed to be incurred on the last day of the year of assessment for purposes of section 24J, *except* where the instrument was redeemed or transferred during the year of assessment. Where the instrument was redeemed / transferred any interest accrual amounts relating to that year of assessment in respect of that instrument is *deemed incurred / accrued on the transfer / redemption date*. One of the main reasons for adopting this view is that deeming the interest relating to a ‘foreign denominated instrument’ that was transferred / redeemed during the year of assessment to only be incurred / accrued on the last day of the year of assessment results in unintended tax consequences when exchange differences are calculated for purposes of section 24I.

For example, interest of \$100 relating to a foreign denominated debt arrangement is owing and payable on 1 January 2011. The loan and outstanding interest is settled on 30 June 2011 when the exchange rate is R12:\$1. The borrower’s year-end is 31 December 2011 when the exchange rate is R13.50:\$1. It is assumed that the section 24J interest accrual amount is also \$100. (Referred to as ‘Example E’)

If the general interpretation of timing of accrual in terms of section 24J is applied (i.e. that all interest accrual amounts are incurred /accrue on the last day of the year of assessment) to ‘Example E’, the ‘transaction date’ (date of incurral) of the \$100 interest amount owing for purposes of section 24I is considered the last day of the year of assessment. Applying the definition of ‘exchange difference’, the difference between the spot rate on the ‘transaction date’ and the realisation date should be determined.²¹⁸ The spot rate on ‘transaction date’ (i.e. 31 December 2011) is R13.50:\$1 and the spot rate of realisation date is R12:\$1. An exchange difference of R150 is therefore deductible from taxable income. The result of this calculation is absurd, as economically the borrower only incurred a cost of R1 200 (R12 x \$100) and not R1 350 (\$100 x R13.50) to settle the interest obligation. It is therefore highly unlikely that the

²¹⁸ See definition of ‘exchange difference’ in section 24I(1).

purpose of the legislation was to allow the borrower to deduct a total cost R1 350 from his taxable income when he only incurred R1 200.

In scenarios where the instrument was redeemed / transferred during the year of assessment, as illustrated in 'Example E' above, *the economic reality of the transaction can only be reflected if the 'transaction date' is regarded to be the date of realisation* (i.e. as no exchange difference will then arise). As the 'transaction date' in this regard is considered to be the date of incurral in terms of section 24J, the date of incurral / accrual in terms of section 24J should be the redemption / transfer date instead of the last day of the year of assessment in these instances.

As a general remark, determining the income tax treatment of foreign currency interest amounts owing is rather complicated when the interaction between section 24I, section 24J and section 25D is carefully considered. Due to the unclear wording of the legislation (or the lack therefore) and no further guidance being provided on the interaction between these sections, numerous uncertainties arise. The taxpayer is thereby placed in a position where various interpretational judgement calls are required to determine his income tax consequences. Incurring a foreign loan and owing interest to a lender in this regard is common practice in today's global economy. It is therefore not in only a few isolated instances that taxpayers that need to consider the tax implication of such transactions. I'm therefore of the view that these uncertainties can only be sufficiently addressed by a change in legislation whereby a fair, but practical approach to the calculation of 'exchange differences' in the instance of foreign interest amounts owing is included.

Conclusion

This study sought to clarify the income tax treatment of section 24J instruments denominated in a foreign currency, specifically with regards to whether such instruments are fixed or variable rate instruments for purposes of section 24J and the interaction between section 24J, section 25D (foreign currency translation rules) and section 24I (gains and losses on foreign exchange transactions).

With the purpose of establishing the necessary foundations in order to understand the workings of section 24J, the basic concepts surrounding the incurral and accrual of interest for income tax purposes, as well as some of the general issues faced when section 24J is practically applied were discussed in Chapter 2. Two of the more important findings established in Chapter 2 are, firstly, that although the definition of ‘instrument’ includes all debt instruments, regardless of whether such instruments are interest-bearing, the application of section 24J would have no impact on the issuer or holder of an instrument that is a non-interest bearing debt instrument. Secondly, the section 24J definition of ‘interest’ is wider than the common law meaning of the same term. However, as ‘interest’ is defined with reference to itself, the common law meaning is still very relevant.

It was found in Chapter 3 that section 24J poses various interpretational uncertainties which are especially highlighted when some of the key provisions of section 24J are practically applied in determining the interest accrual amounts based on the YTM method. Based on the rules of statutory interpretation as established in the common law and clarified in **Natal v E**²¹⁹, solutions were proposed in this regard. Importantly, it was concluded that where the ‘accrual period’, as defined, is regarded as the interval between coupon payments, each

²¹⁹ *Supra Natal v E* at paragraph 18. Also refer to the discussion on the method applied to the interpretation of statutes in the introduction chapter (Chapter 1) to this paper.

accrual period will include the coupon payment at the end of that interval and the subsequent accrual period will commence immediately after that coupon payment.

In Chapter 4, the nature of fixed rate instruments versus variable rate instruments was discussed. It was concluded that foreign exchange rates would fall within the definition of a 'variable rate' for purposes of section 24J.

In Chapter 5, the main focus area of this study was discussed: namely, determining the income tax treatment of instruments denominated in a foreign currency, specifically considering whether such instruments are regarded as fixed or variable rate instruments and the interaction between section 24J, section 25D and section 24I. It was concluded that section 24J allows for the calculation of foreign denominated 'accrual amounts' (i.e. there is no inherent requirement in section 24J that accrual amounts should be calculated in Rand denominated amounts). Further, a 'Foreign denominated instrument' would be regarded as a fixed rate instrument to the extent that the amounts payable are fixed amounts specified in the applicable foreign currency or the calculation of the amount payable in the applicable foreign currency does not involve the application of a 'variable rate' (as defined).

In respect of the interaction between section 24J and section 25D, it was concluded that 'accrual amounts' denominated in a foreign currency should be translated into Rand amounts by applying the general translation provisions of section 25D. Section 24J however merely provides for a single accrual or incurral event during each year of assessment in respect of each instrument. Any foreign currency accrual amounts should therefore be translated at the spot rate on the last day of the year of assessment (or on the date of redemption/transfer in the instance where the instrument was transferred/redeemed during the year of assessment) for purposes of calculating the single accrual / incurral amount to be included in gross income or deducted from income.

Considering the interaction between section 24J and section 24I in respect of 'foreign denominated instruments', it was importantly concluded that the timing of the accrual and

incurral of interest amounts in terms of section 24J should be applied in establishing the 'transaction date' of the interest amount owing for purposes of determining exchange differences at the end of any year of assessment in terms of section 24I. Due to the mechanisms of section 24J, the 'transaction date' of the interest amounts owing in respect of any foreign debt arrangement for purposes of section 24I, could only be the last day of a year of assessment (except in the instance where the instrument was transferred / redeemed during the year of assessment, where it would be the date of redemption / transfer).

Proposed further studies

Due to the many complexities and various interpretational uncertainties surrounding section 24J it was unfeasible to cover all the aspects of section 24J within the parameters of this paper. Further studies are therefore proposed to analyse and consider the following:

- The meaning of ‘adjusted gain on transfer or redemption of an instrument’, ‘adjusted loss on transfer or redemption of an instrument’, ‘alternative method’, ‘date of redemption’, ‘deferred interest’, ‘lending arrangement’, ‘redemption’, ‘repurchase agreement’, ‘resale agreement’, ‘short selling’ and ‘transfer’;
- The interpretation and practical application of section 24J(3A), section 24J(4), section 24J(6), section 24J(7), section 24J(8), section 24J(10) and section 24J(12); and
- The implications of the recently amended section 24J(9) and the newly inserted section 24JB.

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