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Tax Update

New rules governing exchange differences on related party loans

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Exchange differences on loans and other exchange items are generally taken into account for tax purposes on an unrealised basis in terms of section 24I of the Income Tax Act. This treatment is similar to the IFRS treatment of these exchange differences.

Section 24I(10) contains an exception to this rule for exchange items between connected persons. The main policy reasons for the exception is that these items usually have longer maturity periods than other exchange items, which could place pressure on the cash flow of the parties to the exchange item if the exchange differences are taxed every year while they may only realise in cash in the distant future date. Section 24I(10) therefore states that any exchange difference on the following exchange items should only be taken into account when determining taxable income when the item is realised:

- Exchange item between a **resident** and **non-resident connected company** or a **controlled foreign company** in relation to that person or a company that forms part of the same group of companies as the resident company; or
- A forward exchange contracts or foreign currency option contract to hedge the above item.

Section 24I(10) has however resulted in a number of mismatches and practical difficulties and is therefore replaced by section 24I(10A). This section states that no exchange difference must be taken into account in respect of the following exchange items *if at the end of the year*:

(a) The person and the other party to the item are part of the same group of companies or connected to each other; and

(b) The exchange item is not:
- A current asset or liability for purposes of IFRS; or
- Not directly or indirectly funded by an external party; and

(c) No forward exchange contracts or foreign currency option contract has been entered into to hedge that item.

It is clear that the scope of section 24I(10A) is narrower than that of section 24I(10). Some connected person loans may therefore no longer qualify for the exception to section 24I. The transitional provisions from section 24I(10) to section 24I(10A) are rather complex.

The transitional provisions basically come down to it that any exchange difference on an item that was within the scope of section 24I(10) and is still within the scope of section 24I(10A) will only be taken into account when the item realises. If an item no longer qualifies to be within the scope of section 24I(10A), it will be deemed to have realised if it still outstanding on the last day of the year of assessment that ends before the year of assessment commencing on or after 1 January 2014.

An initial comment on the new provision is that it seems to be worded in such a way that the exception to section 24I will cease to apply one year before the item is realised, as the item will be classified as a current asset or liability as that date. It is uncertain whether this was the intention of the legislature.

As this new section may affect any company with loans to or from connected persons that are denominated in a foreign currency it will be wise to consider its impact sooner rather than later to take this into account for budgeting and planning purposes.
