STREN & BLAN PARTNERS TAX ALERT

FIRS ISSUES NEW GUIDELINES ON TAX TREATMENT OF FOREIGN EXCHANGE TRANSACTIONS

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INTRODUCTION

The Federal Inland Revenue Service (FIRS) issued an Information Circular on 14th June, 2024, to clarify the tax treatment of foreign exchange (forex) transactions ('the Circular'). The Circular aims to improve compliance and transparency among taxpayers by distinguishing between realized and unrealized exchange differences. It clarifies the differences between accounting practices under International Financial Reporting Standards (IFRS) and tax regulations on the tax treatment of these forex transactions. This article, therefore, comprehensively dissects the Circular; discussing its implications on the deductibility of expenses, classification of foreign exchange differences, and necessary documentation requirements to ensure accurate tax reporting.

WHAT DOES THE NEW CIRCULAR ENTAIL?

The new Information Circular provides essential guidance on the tax treatment of forex transactions, emphasizing the need for businesses to distinguish between accounting practices under IFRS and domestic tax regulations. The Circular categorizes the exchange differences arising from foreign exchange transactions into revenue exchange differences and capital exchange differences classifications, with distinct tax implications applying to each class. It further clarifies the treatment of realised and unrealised exchange differences, highlighting that only realised differences, resulting in cash flows, that would affect tax liabilities.

Additionally, the Circular provides specific criteria for deducting expenses related to forex transactions to ensure only legitimate costs are considered for tax deductions. It outlines record-keeping requirements, documentation standards, and compliance with tax laws. The systematic approach emphasizes the importance of adhering to both IFRS and local tax regulations for foreign currency dealings.

SPECIFIC PROVISIONS IN THE NEW CIRCULAR

Deductibility of Expenses: Only expenses that meet specific criteria can be deducted for tax purposes, aligning with sections of various tax Acts (Sections 24(1) & 27 of the Companies Income Tax Act (CITA), Sections 20 & 21 of the Personal Income Tax Act (PITA) and Sections 10 & 13 of the Petroleum Profits Tax Act {PPTA}). Hence, the Circular reemphasizes the law that expenses must be wholly, exclusively, reasonably and necessarily incurred in the production of a taxable income to be deducted in calculating the assessable profits of a company. This is to ensure that only legitimate and proportional expenses are considered for tax deductions.

Foreign Exchange Difference: Foreign exchange differences arise when the exchange rates used at the initiation of a transaction differ from the rates at the time of reporting or settling the transaction, thereby impacting financial statements. These differences are further classified into two, namely, Revenue Differences and Capital Differences. Revenue Differences are related to income-generating activities (e.g., sales), while Capital Differences relate to transactions that do not generate income directly (e.g., purchases, borrowing or loans).

Thus, the Circular assures that the nature of each transaction on whether it qualifies as revenue exchange differences and capital exchange differences will be taken into consideration in ascertaining assessable profits or income for income tax purposes, and the amount of capital gains for Capital Gains Tax (CGT) purposes, respectively. Hence, the significance of this differentiation is based on the FIRS' understanding that foreign exchange rates can rise or fall. Where the exchange rate goes up from the rates at the time of initiating a transaction, the resulting exchange difference is a loss to the paying party. Conversely, if the exchange rate falls i.e., comes down, a gain accrues to the paying party.

Realised and Unrealised Exchange Differences: Foreign exchange differences are further classified as either "realised" or "unrealised". Unrealised Exchange Differences entail changes in exchange rates that do not result in actual payment/receipt but are just noted for reporting purposes. Unrealised differences do not affect the tax liabilities of businesses, i.e., neither are unrealised losses tax-deductible, nor unrealised gains considered as taxable income. Conversely, realised exchange differences occur when there is a transaction that results in actual cash flow (payment or receipt) and affects tax liabilities, i.e., realised differences are considered in assessing taxable profits or deductible losses.

Treatment of Capital Exchange Differences: In line with the provisions of Section 27 (a) of CITA, realised Capital Exchange Losses arising from fixed assets are not deductible, but may be added to the cost of the assets for capital allowances. Realised Capital Gains on the other hand are subject to Capital Gains Tax (CGT).

Monetary and Non-Monetary Items: Monetary Items include cash and receivables. Therefore, exchange differences are treated as taxable income or deductible expenses unless related to capital items. On the other hand, non-monetary items such as fixed assets may be subjected to different treatments for exchange differences based on the nature of the transaction. For instance, forex realized from the sale of landed property by a real estate company will be treated as income for tax purposes, whilst forex realized from the sale of landed property by a non-property dealing company will be treated as capital for CGT purposes.

Hedging Transactions: The Circular provides that gains or losses from hedging are deferred until the hedged item is realised. This deferral affects how taxpayers plan their tax strategy around managed risk exposures.

Tertiary Education Tax (TET): The treatment of exchange difference for income tax also applies to TET, thereby ensuring consistency in taxation.

Other Taxes: Unrealised differences recognised for accounting purposes shall not be taken into consideration in computing the following taxes in the case of applicable companies:

- The National Agency for Science and Engineering Infrastructure (NASENI) levy (0.25% of taxable profit);
- The National Information Technology Development Agency (NITDA) Levy (1%); and
- Minimum tax to be paid under section 33(2) of CITA at the rate of 0.5% of a company's gross turnover as defined under section 105 of CITA.

Tax Exempt Items: Exchange differences arising from an item which is exempt from tax are not taxable in the case of a gain, and not deductible in the case of a loss. For example, transactions like government Eurobonds are explicitly not taxed. Therefore, businesses must segregate and disclose tax-exempt transactions in the reconciliation statement.

Documentation and Returns: A company must maintain comprehensive records of all forex transactions, including dates, amounts, counterparty details, exchange rates, and revenue or capital classification. Additionally, the company must provide a reconciliation of exchange differences in financial statements, along with deferred tax analysis.

Artificial Transactions: If the FIRS finds that a taxpayer is artificially realizing or deferring foreign exchange gains and losses to avoid paying taxes, especially in a related party transaction, the Service will make necessary adjustments to the tax due.

WHAT ARE THE IMPLICATIONS OF THE CIRCULAR?

Enhanced Clarity and Compliance: The Circular provides clear guidelines on the treatment of forex transactions for tax purposes, helping businesses understand their obligations, thereby reducing the risk of non-compliance and facilitating accurate tax reporting.

Improved Tax Deductibility Framework: By establishing specific criteria for the deductibility of expenses, the Circular ensures that only legitimate and reasonable expenses are deducted. This promotes fair taxation and helps prevent tax avoidance through inflated or non-justifiable deductions.

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CONCLUSION

The guidelines provided in the FIRS Circular on the treatment of foreign exchange transactions are essential to assist businesses in complying with tax obligations and accounting practices in international business. Business entities should enhance their understanding of the compliance requirements through training on foreign exchange treatment in tax computations and engage tax professionals to navigate these complexities. Importantly, maintaining meticulous records of foreign currency transactions is crucial for smooth compliance with FIRS regulations.

The FIRS could strengthen its efforts by conducting regular workshops and stakeholder consultations, simplifying documentation requirements, and fostering an environment of transparency and communication to improve compliance and minimize disputes.

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Stren & Blan Partners is a full-service commercial Law Firm that provides legal services to diverse local and multinational corporations. We have developed a clear vision for anticipating our client's business needs and surpassing their expectations, and we do this with an uncompromising commitment to Client service and legal excellence.

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