Introduction

The number of commercial transactions that are now denominated in foreign easily convertible currencies, especially the United States Dollars, astronomically increased in the last decade, mostly due to the benefit of retaining earnings in US Dollars, as opposed to the Naira, which is the national currency in Nigeria.

The fall in crude oil prices, which resulted in recession and in the devaluation of the Naira, has however adversely affected US Dollar based transactions most of which are/were sourced and are required to be retired at higher parallel market exchange rates.

Businesses with transactions denominated in foreign currency must therefore familiarise themselves with the minimum tax principles which will impact on such transactions; and in the process, manage the associated Foreign Exchange (?FX?) risks arising thereform.

Taxation of FX Profits

Elementarily, it is the profits of a company, from all its trade or business, and not its revenue or turnover, that is taxed on a preceding year basis. And tax assessments and payments must be in the currency of the transaction. To earn a profit, a company must deplore resources and incur expenses. However, only the expenses of a company which are wholly, exclusively, necessarily and reasonable incurred in the production or acquisition of such profits enjoy a tax deduction from the company?s revenue before the profits of such a company are taxed. Examples of such expenses include business loans and interest paid on such business loans, business premises rent, office maintenance and repairs, plants and machineries, bad and doubtful debts, salaries wages and emoluments, pensions, research and developments, charitable donations, etc.

Advance earnings however suffer or bear an advance withholding tax at the tax rate of ten per cent (?10%?) for corporate entities; and five per cent (?5%?) for individuals. Receipts or certificates obtained after such withheld tax are usually subsequently used by the earning party to net-off its final tax at the end of the subject financial year of tax assessment.

FX Taxation

The taxation of profits accruing from foreign exchange denominated transactions is usually not contentious as can be deciphered from the above. The same cannot be said of FX losses where the tax authority traditionally and cautionarily is quick to discourage a tax deduction for FX related losses, which losses usually arise from FX rates fluctuations.

A good example of such a contentious situation can be found in the Supreme Court decision in Shell Petroleum Development Company v. Federal Board of Inland Revenue (Shell v. FBIR), which decision was delivered on 27th September 1996. The Supreme Court held in this case that the FX losses that the Appellant suffered were equitably, and following the doctrine of Accord and Satisfaction, tax deductible expenses which were wholly, necessarily and incidentally incurred in the cause of the Appellant abiding with the Agreements it entered into with the Federal Government of Nigeria (?FGN?) in order for the Appellant to continue to undertake its petroleum operations in Nigeria. The Supreme Court observed in Shell v. FBIR that if the Petroleum Profits Tax (?PPT?) due were paid by the Appellant in Naira, as the Petroleum Profits Tax Act applicable at the time required, the Appellant would not have incurred any foreign exchange losses. The latter would have also occurred if the Respondent?s principal, who is the FGN, had received the PPT in Naira only to suffer FX losses when converting the Naira to British Pounds Sterling.

Accounting Treatment of FX

The International Financial Reporting Standards (?IFRS?) IAS 21 requires a foreign currency transaction to be recorded, on its initial recognition, in the functional or national currency of the concerned company, applying the spot FX rate at the date of the transaction.

IFRS IAS 20 goes further to require that at the end of each reporting accounting year-end, the foreign currency monetary items are required to be converted into the functional or national currency using the closing FX rate for the currency of the transaction.

Any resulting exchange rate difference ? the FX rate at the date of the transaction and the FX rate at the closing of the transaction - whether a profit or a loss, are required to be recognised in the Accounting Books of the company at the date when they each arise. Where the transaction is a continuing one, IFRS requires such investment to be initially recognised under Other Comprehensive Income and reclassified to a profit or loss position on the disposal or completion of the transaction or investment.

In summary, assets and liabilities are required to be translated and booked at the FX rate, at the end of the accounting period of each transaction. Income and expenses are required to be translated at the FX rate existing on the dates of each of these events. And lastly, FX rate differences are recognised under Other Comprehensive Income and subsequently reclassified to the Profit and Loss Account on the disposal or completion of the FX related transaction.

Conclusion

In an article by Jenny Bourne Wahl, published in the National Tax Journal, this writer while considering the United States of America Tax Reform Act 1986, was of the opinion that the timing of the recognition of FX gains and losses directly influence the effective tax rate that will apply to foreign assets and liabilities. This writer concluded that legislation which allows FX gains or losses to be taxed on the realisation of the gain or loss, as opposed to when the loss or gain accrues, or comes into existence, is a much stronger tax incentive to promoting transactions in the FX market.

The opinion of the above writer is tandem with IFRS IAS 21 as summarised above for your compliance.