



**FEDERAL INLAND REVENUE SERVICE
NIGERIA**

INFORMATION CIRCULAR

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SUBJECT: TAX TREATMENT OF FOREIGN EXCHANGE TRANSACTIONS

This circular is issued for the information and guidance of the general public, taxpayers, tax practitioners and tax officials on the appropriate tax treatment of foreign exchange transactions in line with the provisions of the relevant tax laws.

1.0 Introduction

The International Financial Reporting Standards (IFRS) prescribe the treatment of foreign currency transactions in the financial statements of an entity for accounting purposes. The Federal Inland Revenue Service ("the Service") notes that the treatment prescribed by the IFRS may be sufficient for accounting purposes. However, such treatments may not be in accordance with extant tax rules which would necessitate making relevant adjustments when computing tax payable.

The objective of this Information Circular is to clarify the relevant adjustments that may be required in order to determine the tax position from such transactions.

2.0 Legal Framework

Generally, only expenses that are wholly, exclusively, necessarily and reasonably incurred in the production of a taxable income may be deducted in order to ascertain the assessable profits for the relevant year of assessment, in line with 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)).

3.0 Foreign Exchange Difference

Foreign exchange difference arises where the foreign exchange rate used in booking a foreign-currency transaction differs from the rate used on a subsequent reporting or settlement date.

Illustration 1

Assume that Needy Ltd borrowed \$1m through a Nigerian bank on a date that the exchange rate was ₦500:\$1; and the loan must be repaid at the end of 24 months in the same currency.

The loan would be recorded in the books of Needy Ltd on the date of transaction as ₦500m (\$1m x 500). At the accounting year-end, if the exchange rate has moved to ₦600:\$1, the amount of loan due in naira would be ₦600m (\$1m x 600). A difference of ₦100m has arisen due to increase in exchange rate from ₦500:\$1 to ₦600:\$1.

Foreign exchange rates can rise or fall. Where the exchange rate rises i.e., goes up as in previous illustration, the resulting exchange difference is a loss to the paying party (Needy Ltd). On the other hand, if the exchange rate falls i.e., comes down, a gain accrues to the paying party.

Illustration 2

Using the Needy Ltd illustration, assume that on the date Needy Ltd repays the loan, the exchange rate fell to ₦560:\$1, it means that the bank will only debit its account with ₦560m (\$1m x 560). This will result in an exchange difference (gain) of ₦40m (₦600m – ₦560m) between the last booking date and the date of payment. Taking the transactions as a whole from the date the loan was granted to the date of loan repayment, there is a net exchange difference (loss) of ₦60m i.e., ₦500m (loan received) – ₦560m (repayment).

4.0 Classification of foreign exchange transactions

Exchange differences may be classified as follows:

- a. Revenue Differences: foreign exchange gains or losses arising from income-generating transactions, or
- b. Capital Differences: foreign exchange gains or losses arising from non-revenue generating transactions such as purchase of assets, borrowing, loan repayment, etc.)

As such, exchange differences are classified depending on the nature of the underlying transaction.

Revenue exchange differences will be accounted for in ascertaining assessable profits or income for income tax purposes. Capital exchange differences, on the other hand, will be reckoned with in ascertaining the amount of capital gains for Capital Gains Tax (CGT) purposes.

It should be noted that the nature of a taxpayer's ordinary business is a key factor in the classification of foreign exchange transactions. For example, while an exchange difference from a long-term loan granted by a bank to a customer to finance the purchase of new plant will be treated as revenue for the bank, the exchange difference on the same transaction will be classified as capital in the hand of the customer.

5.0 Realised and unrealised exchange differences

Foreign exchange differences are further classified as either "realised" or "unrealised".

Unrealised exchange differences occur when the revaluation of a foreign-currency transaction arose from mere accounting (reporting) purposes and does not result into payment or receipt of the revalued sum.

Using the illustration in paragraph 2, the ₦100m exchange difference occurring on the first reporting year was unrealised as it was only for reporting purpose.

Realised exchange differences occur when a foreign-currency transaction is closed at an exchange rate different from the booking rate, thereby resulting into payment or receipt of the revalued sum.

Going back to the illustration in paragraph 2, Needy Ltd liquidated the loan of \$1m at ₦560:\$1 compared to the receipt of \$1m loan at ₦500:\$1. While the company received ₦500m into its bank account upon the disbursement of the loan, it paid out ₦560m to liquidate the loan. This resulted into a net difference (loss) of ₦60m which is realised.

Unrealised exchange differences do not increase or decrease the tax liability as they must be ignored in the computation of the assessable profits. Where unrealised exchange loss is charged to statement of comprehensive income account (i.e., Profit and Loss Account), such unrealised losses are not tax deductible, while unrealised gain are equally not taxable income.

However, realised exchange differences would either increase (in the case of a gain) or decrease (in the event of a loss) tax due as they are included in the computation of the assessable profits.

6.0 Treatment of Capital Exchange Difference

Pursuant to the provision of Section 27 (a) of CITA, realised capital exchange loss, arising from non-current assets (fixed assets) is NOT deductible for tax purposes. However, the amounts can be added to the cost of the assets, in the year that the loss becomes realised, for the purpose of capital allowances. Capital exchange gains, on the other hand, will be subject to Capital Gains Tax at the prevailing CGT rate when the gain becomes realised.

Illustration 3

ABX Limited imported plant and equipment from its foreign supplier worth \$1 million in Jan 2023. Assume the exchange rate at the time of import was ₦120 per dollar. Payment was made by year end 2023, when the exchange rate was N150 per dollar.

The exchange loss arising from the imported capital item is a realised exchange loss of ₦30m (i.e. ₦150m- ₦120m). The loss crystallised when the payment was made. The loss is realised and will be treated as qualifying capital expenditure in the tax returns of the relevant year of assessment.

Illustration 4

Using illustration 3, assume that payment was made when the exchange rate at year end 2023, was N100 per dollar.

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The transaction resulted in a realised exchange gain of ₦20m at year end. The gain crystallised when payment was made and will be treated as disposal in the income tax returns of the company.

7.0 Monetary and non-monetary items

For monetary and non-monetary items, exchange differences will be treated as follows:

7.1 Exchange differences on the settlement or recovery of a monetary item is a realised exchange difference.

7.2 Exchange differences on foreign currency cash balances are unrealised upon conversion to another currency or another class of monetary or non-monetary item.

7.3 Exchange differences on any item which is monetary in nature is treated as taxable income or deductible expense for income tax purposes unless the underlying transaction represents the principal component of a capital item.

For instance, exchange difference on the sale of land denominated in a foreign currency by a non-property dealing company will be regarded as capital whereas the same transaction by a property dealing company will be treated as revenue item.

8.0 Hedging transactions

Foreign exchange differences arising from hedging transactions are not taxable income or deductible expense until the hedged item is realised. Upon realisation, the treatment either as revenue or capital will depend on the classification of the underlying item.

9.0 Tertiary Education Tax (TET)

The tax treatment of exchange currency transactions and translations also apply to TET. This means that exchange differences which are taxable income or deductible expenses for Companies Income Tax (CIT) purposes shall be similarly treated in arriving at assessable profits for TET purposes.

10.0 Other taxes

Unrealised exchange differences recognised for accounting purposes shall not be adjusted in computing the following taxes:

10.1 National Agency for Science and Engineering Infrastructure (NASENI) levy at 0.25% of the Profit Before Tax for eligible companies.

10.2 National Information Technology Development Agency (NITDA) Levy at 1% of Profit Before Tax payable by companies specified in the NITDA Act.

10.3 Minimum tax payable under section 33(2) of CITA at the rate of 0.5% of gross turnover as defined under section 105 of CITA (less franked investment income) where applicable.

11.0 Tax exempt items

Exchange differences arising from an item which is exempt from tax is not taxable in the case of a gain, and not deductible in the case of a loss. For instance, any exchange gain or loss on the disposal of Federal Government of Nigeria's (FGN) Eurobonds will not be a taxable income or deductible expense for income tax purposes regardless of the nature of the taxpayer's business.

Note that income and expenses relating to tax exempt items shall be disclosed in the tax computation statement or schedule, and shall be segregated by type. For example, expenses relating to FGN Naira Bonds and FGN Eurobonds shall be shown separately.

12.0 Documentation and returns

A company must keep detailed records of all foreign currency transactions stating the dates, amounts, counterparty, applicable exchange rates, and the basis of classification of items as either revenue or capital.

Furthermore, every company must provide a reconciliation of exchange differences recognised in the income statement, statement of comprehensive income or equity including associated deferred tax analysis.

13.0 Artificial transactions

Where the Service determines that a taxpayer is artificially realising or deferring the realisation of foreign exchange gains and losses with the

principal purpose of tax avoidance especially in a related party transaction, necessary adjustments shall be made to the tax due.

14.0 Other matters

- a. Commissions, fees and other charges associated with foreign exchange transactions including a split or second invoice (where applicable), foreign exchange hedging or the application of unofficial exchange rates shall be subject to the wholly, reasonably, exclusively and necessarily (WREN) test to determine tax deductibility.
- b. Any income earned; including consequential realised exchange gains shall be taxed irrespective of the circumstances unless the income is exempt from tax.
- c. Peer-to-peer exchange rates agreed for transactions between related parties shall be subject to transfer pricing rules.
- d. Offsetting of exchange gains or losses shall be segregated by line of business and by tax regimes. For instance, exchange gains arising from a taxable item or business operation shall not be offset against the loss from an item or a business operation that is exempt from tax.

15.0 Amendment or Revision of the Circular

The Service may, at any time, withdraw or replace this Circular or publish an amended or updated version.

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