Derivatives: What are the critical tax considerations?

As most companies in the financial services industry in Nigeria are beginning to explore the opportunities of investing in the developing and lucrative derivatives markets, it is vital that investing parties understand the related tax implications in order to avoid conceding the benefits of derivatives due to poor or improper tax planning

Derivative markets are an integral part of the financial system. They play an increasingly important role in contemporary financial markets. According to Wikipedia, derivatives are defined as contracts whose returns are linked to, or derived from, the performance of some underlying asset, such as stocks, bonds, currencies, or commodities.

In their purest form, derivatives include forward contracts, futures, swaps, and options. In contrast with a stock issued by a company and purchased by an investor, a derivative contract is a private agreement between a buyer and a seller, which specifies how the value of the contract evolves over time.

In recent times, this form of financial instrument is becoming increasingly popular in the Nigerian financial market; hence, the need to understand the tax implications. There is a whole array of instruments called derivatives, but the majority constitutes variations on three basic instruments: forwards/futures, swaps and options. For tax purposes, it is essential to understand these derivatives and the underlying assets.

Forward contract: this is a derivative contract in which the terms are very similar to a cash-and-carry agreement, except that delivery and transfer of ownership of the underlying asset is in future. In a forward contract, the credit worthiness of both parties is critical to the performance of the contract.

Future contract: this is a contract under which one party agrees to deliver to another party on a specified date (the "maturity date") a specified asset at a price (the "strike price") agreed at the time of the contract and payable on the maturity date. A future contract is similar in intent to a forward contract but with few basic differences. A future contract has standard terms and it is usually traded on organised exchanges. It specifies trading a particular quantity of the underlying asset at a particular price and time. Although, the contract can be settled at expiration in the physical asset, it is more often settled in cash through the exchange.

A swap: this is a derivative in which two counterparties exchange cash flows of one party's financial instrument for those of the other party's financial instrument. The benefits in question depend on the type of financial instruments involved. For example, in the case of a swap involving two bonds, the benefits in question can be the periodic interest (coupon) payments associated with such bonds.

An option: this is a contract which gives the buyer (the owner) the right, but not the obligation, to buy or sell an underlying asset or instrument at a specified strike price on or before a specified date.

There are no specific rules for taxing derivative transactions in Nigeria, The general rules of taxation therefore becomes applicable. The first issue to deal with is a determination of whether there has been a gain, profit or losses which will be taxable under the Capital Gains Tax Act (CGTA) or Companies Income Tax Act (CITA). The general rule is that capital gains are ordinarily to be considered under the provisions of CGTA while trading profits or losses falls under the provisions of CITA.

Under CITA, where it can be established that a company is trading in the underlying assets of a derivative, such as shares, as its core business and income is derived from such transactions, then the company would be liable to company income tax (CIT) on the profits derived from the transaction. This aligns with the position of the Federal Inland Revenue (FIRS) as represented in the FIRS information circular on tax implication of the adoption of the International Financial Reporting Standards (IFRS) which provides that profits or losses from derivative contracts will be treated under CITA.

Under CGTA, gains arising from disposal of chargeable assets are subject to capital gains tax (CGT) at the rate of 10%. Chargeable assets have been defined as fixed assets, debts, options, incorporeal assets and currency other than the Nigerian currency.

The location of the underlying assets in a derivative contract has an impact on the taxation of the derivative transaction. However, CGTA gives indication to determine where some assets are located (e.g. land or tangible movable property) but did not provide for derivatives. Therefore, the logical test of location of a derivative could be where the rights and obligations relating to the sale of such derivative are attributed. Where the rights and obligations relating to the sale of a derivative are tied to Nigeria, it is arguable that the derivative is in Nigeria. The gains from the transactions will therefore be expected to be taxable in Nigeria. Where the rights and obligations relating to the sale are tied to a country outside Nigeria, it may be argued that the derivative is situated outside Nigeria. As a result, there will be no taxable gain arising from the sale of the derivative provided the proceeds from such sale are not brought into Nigeria.

Conversely, it may also be argued that the derivatives should take the status of the underlying assets. Where the sale of the underlying assets in a derivative is exempt from tax, the gain from the derivative transaction should also be exempted. For instance, under CGTA, gains realised from the disposal of Nigerian shares by a company is exempt from Nigerian tax except where such gain is brought into or received in Nigeria.

Therefore, where the underlying assets of a derivative contract are shares, any gain derived from the sale of the derivative instrument may be exempt from tax due to the tax exemption of the underlying asset under CGTA.

Also, there may be incidence of value added tax (VAT) where the derivative is considered to be goods or services. VAT is imposed on all supply of goods and services, other than items specifically exempt in the First Schedule to Value Added Tax Act (VATA). For instance, "options" are not considered to be "goods or service" but rather, an "incorporeal right", and as such would not be subject to VAT. Therefore, any premium paid by a company for the right in an option is not liable to VAT as there is no exchange of taxable goods or services.

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Oluseye Arowolo
Partner | Tax & Regulatory Services
oarowolo@deloitte.com

Yomi Olugbenro
Partner | Tax & Regulatory Services
yolugbenro@deloitte.com