TAX TREATMENT OF DERIVATIVE INSTRUMENTS

Oluwaseun Viyon Ojo, Lagos State University
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By Oluwaseun Viyon Ojo*

The recent announcement of the projected upsurge in the trading of derivative instruments in the Nigerian financial market has attendant implications both for the traders in them as well as the regulators and the relevant tax authorities. 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. Also, it is vital that the relevant tax authority (RTA) know how to treat the instrument of derivatives for the purpose of imposition of relevant tax.

To start, a derivative is defined as a financial instrument whose value is linked in some way to the value of another instrument, underlying the transaction. The value is usually derived from a basic financial instrument. The underlying assets could be securities, commodities, currencies or indices. In contrast with a stock issued by 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. The variants of derivatives include options, forwards, futures, swaps and swaptions.

The result of a derivative transaction is a transfer or exchange of specified cash flows at defined future points in time. Financial derivatives provide for the purchase or sale of traditional financial instruments in the future at prices that are agreed upon on the day of the contract. Financial derivatives are mostly used as tools against hedging, speculation and arbitrage.

Derivative is a financial instrument forming an integral part of the derivatives market, which is playing an increasingly important role in contemporary financial markets. Nigeria being one of the emerging economies in the global financial market is an exploratory goldmine for derivative transactions. Presently, the derivatives market is relatively at its infancy and standardised regulatory framework for derivatives is yet to be fully developed, though recent market activities have been geared towards creating awareness and encouraging derivatives trading, with positive results.

It must be noted that the National Association of Securities Dealers (NASD) recently launched an Over-The-Counter (OTC) market for the trading of, among others, derivatives, options, futures, commodities and fixed income instruments. Also, the Financial Markets Dealers Quotation (FMDQ OTC Market also recently launched an OTC market to trade in money market and fixed income instruments. The Nigerian Stock Exchange(NSE) recently announced plans to create an options market that will trade stock options, bond options and indices by Q4 2014, and projects that this will be followed by a futures market that will trade in currency and interests rates futures by 2016. In the same vein, the NSE's Chief Executive Officer, Mr. Oscar Onyema had announced recently that the Exchange would commence trading in Naira futures in 2017 in order to help investors hedge against movements in the local currency.

The increasing popularity of derivatives as a financial instrument traded in the Nigerian Financial market therefore calls for a circumspect attention and examination with a view to understanding the tax implications thereof. This will be particularly important to the government which aims at expanding its revenue base by seeking for revenue goldmine in which to achieve this objective.

First, the different variants of derivatives must be understood; they include...
a) **Forward**: This is a derivative contract in which the terms are similar to a cash-and-carry agreement except that delivery and transfer of ownership of the underlying asset is in the future. This market is characterised by actual delivery of the underlying asset in most cases at the pre-determined date.

b) **Futures**: A future contract is a contract by which one party agrees to sell to the other party on a specified future date, a specified asset at a price agreed at the time of the contract and payable on a maturity date. Unlike forward contracts, futures are usually performed (settled) by the payment of the difference between the strike price and the market price on the fixed future date and not by physical delivery and payment in full on that date.

c) **Swap**: This is a derivative in which the two counterparties exchange cash flows of one’s party’s financial instrument for those of the other party’s financial instruments involved. In an interest rate swap (for instance, one involving two bonds), this would involve the exchange of a fixed rate of interest against a fluctuating rate of interest on the same notional principal.

d) **Options**: 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 specified date.

Having briefly understood each variant of derivatives, it is important to analyse the tax treatment of derivatives in Nigeria. There are no specific rules for taxing derivative transactions in Nigeria presently, thus 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.

In general, the income arising from derivative transaction should be regarded as “ordinary income”. If a derivative transaction is entered into in the ordinary course of business, it should be considered as “business income”. 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. In this instance, Paragraph 27.1 of the FIRS INFORMATION CIRCULAR ON TAX IMPLICATION OF THE ADOPTION OF THE INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) 2012, provides that Fair Value Through Profit or Loss (FVTPL) held for trading or short-term profit taking such as derivatives are revenue in nature and therefore liable to CITA and shall be treated as a separate line of business. 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% as contained in S.2(1) thereof. 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.

As the derivatives instrument gradually becomes a frequently tradable instrument in the Nigerian financial market in the near projected future, it is expedient that the concerned companies trading in this instrument plan adequately for the tax implications of such transactions. In the same vein, the Relevant Tax Authorities (RTA) must also be prepared to impose relevant tax and issue guidelines to provide direction to all Revenue Staffs, Tax Practitioners, Consultants, Tax Payers and the General Public on the tax implication of these derivatives transactions. This will no doubt augur well with the revenue pursuit of the government for economic growth as well as the financial status of the concerned companies.

*Oluwaseun Viyon Ojo is a holder of LL.B (Hons) from Lagos State University, Ojo, Nigeria.