The Windfall Tax Conundrum:
navigating the fiscal impact on Nigerian Banks

Introduction

In the ever-evolving landscape of Nigeria's economy, the Central Bank of Nigeria's (CBN) commendable efforts to harmonise exchange rates and curb inflation have led to a significant devaluation of the Naira. This monetary policy shift has had a profound impact on the financial sector, particularly on banks, which have experienced a windfall due to their foreign currency holdings. However, this has also introduced a complex tax dilemma regarding the nature of these gains—whether they should be considered revenue or capital. The proposed windfall tax on Nigerian banks aims to address this issue, but it brings with it a host of challenges and implications for the banking industry, the broader economy and investors (both local and foreign).

The Devaluation Effect and Its Disparate Impact on Businesses

Over the past one year, Nigeria has faced some harsh economic headwinds that have resulted in a significant devaluation of the Naira. This remarkable shift has had a polarising effect on businesses, depending on which part of the divide they stand. Banks and other entities with long positions in foreign currencies have reaped substantial profits, while those with unprotected foreign currency liabilities have suffered considerable losses. This dichotomy has not only affected the financial health of businesses but has also raised questions about the equitable treatment of gains and losses within the tax framework.

Taxation Dilemma: Revenue or Capital Gains?

The taxation of foreign exchange gains presents a conundrum for governments. Sometimes, the tax rules lack clarity on whether such gains should be treated as revenue, which is typically subject to Corporate Income Tax (CIT), or as capital, which may be subject to Capital Gains Tax (CGT). Globally, the norm is to tax gains and allow deductions for losses only when they are realised. This approach avoids the taxation of paper gains, which may never materialise into actual profit. This issue is humorously captured in Trevor Noah's anecdote about Elon Musk, who could not be taxed on his unrealised gains from Tesla shares, yet he could leverage their increased value for substantial loans.

International Precedents and the South African Example

Countries grappling with similar issues have sought to legislate clarity. South Africa, for instance, introduced laws in 2013 that allowed for the taxation of fair value adjustments on certain financial assets and liabilities held by brokers and banks. For countries that introduce special rules to tax unrealised gains, the rationale behind such measures is that if shareholders can receive dividends based on valuation gains, or if these gains can be used as credible collateral, then the government should have a right to tax the perceived value. However, this perspective is countered by the argument that governments should not engage in speculative taxation of unrealised profits and must also provide deductions for revaluation losses on the same basis.

The proposed Windfall Tax on Banks in Nigeria

The government has not exactly caused any upset in terms of retaining the current position of taxing gains and deducting losses only when realised. However, they have literally caused some disruption around the tax rate. The windfall tax, though not yet official, has stirred considerable debate. The proposal documents suggest that the Nigerian government intends to tax only realised profits from exchange transactions at a rate of 50%, as opposed to the standard 30% CIT rate. This bifurcation of tax rates raises practical concerns for banks, particularly regarding the allocation of expenses between different revenue streams. It could create contradictions where the banks apply a principle different from what they have used in allocating profits to tax-exempt income in the past. There would also be an impact on the effective tax rates of the banks as the deferred tax liabilities recognised on those unrealised profits was previously recognised using the 30% CIT rate.

Furthermore, the proposal anticipates retrospective application of the tax on profits from the financial year 2023, which the banks already filed and paid in June 2024. It also proposes that banks must enter into a deferred payment agreement with the Federal Inland Revenue Service (FIRS) and must complete the payments under the plan before 31 December 2024, otherwise, the banks would be liable to penalty at 10% per year of default and interest at the Monetary Policy Rate (MPR) per annum.

The practical administration of this could pose legal and perception challenges around the principles of equity, fairness, and constitutionality. It may create a new level of uncertainty for investors around their view of the fiscal policy environment, although the government may say it is only seeking its 'share' from a fair profit earned by the banks from the monetary policies of the CBN. It can be argued that such revenue would ultimately benefit the economy, as in this case, the windfall tax would be used to fund the NGN2trn accelerated stabilisation and advancement plan and the additional N6.2trn for infrastructure and the Federal Government wage bill with increase in minimum wage.

Controversy and investor sentiment concerns

The proposed retrospective imposition of the windfall tax has sparked a debate on its legality and the potential erosion of investor confidence. The principle of non-retroactivity in law is a cornerstone of legal fairness and certainty. A similar principle was supported by the courts in the case between Accugas Ltd and the FIRS where it was ruled that taxes should not have retroactive application. By taxing profits already realised and reported, the government risks being perceived as unpredictable, which could deter future investment and impact confidence in the financial markets.

Operational Challenges and Compliance

The operational implications for banks are significant. Tracking unrealised exchange differences is a complex task, and the FIRS's recent Circular dated 24 June 2024 and titled “Tax Treatment of Foreign Exchange Transactions” indicates that this will be an area of increased scrutiny.

Banks must now contend with new compliance requirements and the potential for disputes with tax authorities.

The Circular actually indicates an interest of the FIRS in receiving returns that tracks how unrealised exchange differences are being tracked and treated for deferred tax purposes. For the trained tax eye, it is not a coincidence that the Circular comes just before this proposal. The legislation on the windfall tax must therefore be read in parallel with the intention of that Circular. For banks, it is no longer business as usual. The treatment of the windfall tax in financial year 2023 is just the early signs of what is to come. There may be an increased tax accounting burden on banks to justify the treatment of unrealised exchange gains they have exempted in the past, why they have never been realised, and whether they should not be realised in financial year 2023 when the windfall tax kicks in. Banks may also need to invest in technology to identify and report these forex transactions, and work with tax and treasury experts that can help them navigate the impact of this big-bang policy change, since they have already paid dividends to shareholders and will not be able to claw any of that back to meet this new obligation.

Conclusion: A new era of banking and taxation

The introduction of the windfall tax marks a departure from the status quo for Nigerian banks. It signals a new era of fiscal policy that requires careful navigation by both the banking sector and the government. While the tax aims to ensure that banks contribute their fair share to the national coffers, it must be implemented in a manner that upholds legal principles and maintains investor confidence. As Nigeria treads into this uncharted territory, the outcomes of this policy will have significant implications for the country's financial system’s stability and economic growth.

Finally, if the final legislation taxes only realised profits in 2023, there would only be a marginal revenue that would be generated, and this would not fulfil the revenue objectives of the government. For most banks, the gains were only realised in 2024 when the CBN mandated banks in February 2024 to adjust their net open position.

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