Tax Implications of Adoption of International Financial Reporting Standard (IFRS) 9 on Financial Instruments in Nigeria

KPMG in Nigeria

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Background/introduction

Since 2001, IAS 39 *Financial Instruments - Recognition and Measurement* has been the accounting standard for financial instruments. However, the Standard was affected by several shortcomings, such as:

- Complex and rules-based classification methods for financial instruments
- Multiple impairment models
- Inability to reflect economic realities.

In response to the shortcomings of IAS 39, the International Accounting Standards Board (IASB) completed the final phase of its comprehensive response to the global financial crisis of 2008 with the publication of the fourth and final version of IFRS 9 *Financial Instruments* in July 2014. IFRS 9, which replaces IAS 39, is effective for annual periods beginning on or after 1 January 2018, though early application is permitted.

The new standard introduced a logical classification and measurement model for financial assets, an 'expected credit loss' impairment model and a substantially reformed approach to hedge accounting which aligns hedge accounting principles more closely with risk management.

Expectedly, the adoption of IFRS 9 will have a significant impact on how Deposit Money Banks (DMBs), Other Financial Institutions (OFIs) and Insurers account for credit losses on their loan and other debt instruments. It is, therefore, important for DMBs particularly, and other companies within the financial services space, to assess the tax impact of the adoption of IFRS 9 in order to take advantage of available tax planning opportunities well ahead of implementation. This will surely help them manage potential cash tax outflows more effectively.

This article highlights some of the potential tax implications of adopting IFRS 9.

Effective Date and Transition

The general transition requirement of IFRS 9 is retrospective application i.e. entities are to present the financial statements as if IFRS 9 had always been applied. This requires entities to restate comparative information and present an opening statement of financial position as at the date of initial application (DIA).

However, IFRS 9 contains an exception to the retrospective application principle, under which entities may elect not to restate comparative information. If an entity does not restate comparative information, it recognizes any difference between the previous carrying amount and the carrying amount at the beginning of the annual period that includes the DIA in

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the opening retained earnings (or other component of equity, as appropriate). Entities are allowed to restate comparatives if, and only if, this is possible without the use of hindsight.

According to the Federal Inland Revenue Service (FIRS) Information Circular of March 2013 on the tax implications of the adoption of IFRS (IFRS Circular), taxpayers are required to submit a re-computation of income and deferred tax, for any financial period where there has been a change in accounting policy. This requirement may be impractical for taxpayers to comply with, as IFRS is very dynamic and a change in accounting standard could trigger a change in accounting policy.

It is important to note that, in 2013, the FIRS mandated companies to submit a statement comparing the tax effect of IFRS adoption with Nigerian Generally Accepted Accounting Principles. However, the authors are not aware of any situation where the FIRS has used the information in such statements to assess companies to additional taxes or give refunds as a result of the adoption of IFRS. Thus, the Revenue Authority may need to revise the tax requirements for change of accounting policies, to reduce the administrative burden imposed on taxpayers by the current requirement to re-file tax computations each time there is a retrospective application of a change in accounting policy.

Impairment of financial assets

The objective of the impairment requirements in IFRS 9 is to recognize 12-month and lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk since initial recognition on the basis of stage allocation. The expected credit loss also incorporates forward-looking macroeconomic forecast in its estimation, and may be assessed on an individual or collective basis.

Per IFRS 9, 12-month expected credit losses will be booked on loans in Stage I (performing loans) whilst lifetime expected credit losses will be recognized on loans in both Stage II (loans with significant increase in credit risk) and Stage III (non-performing loans). This impairment model will potentially result in the overstatement of impairment charges as it will incorporate not only incurred credit losses but also expected credit losses.

Currently, under IAS 39, the FIRS assesses the tax deductibility of impairment charges on specific (individual) and collective (general) bases. The FIRS' view and prevailing practice is to allow specific impairment on individually significant non-performing loans. However, collective impairment on performing and individually insignificant non-performing loans is disallowed for tax purposes. This treatment is based on Section 24(f) of the Companies Income Tax (CIT) Act, which allows bad or doubtful debts incurred as tax-deductible, to the extent they are estimated to the Revenue's satisfaction to have become bad or doubtful. The estimation required by the FIRS in practice, involves details that are typically only available for specifically impaired loans.

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Based on the provisions of the IFRS Circular, impairment losses on loans and advances will be subject to Section 24(f) of CIT Act (CITA). Therefore, the issue from an IFRS 9 perspective is whether Stage I and II impairment charges will be allowed for tax purposes. The authors are of the view that this is unlikely. In essence, there is a high likelihood that only incurred credit losses recognized on non-performing loans and advances under IFRS 9, will be allowed as tax-deductible.

As such, it is critical that taxpayers monitor movements in impairment loss accounts at and after the DIA, and maintain proper records, in order to claim tax deductions on disallowed impairments if/when they eventually become irrecoverable.

In the UK, the Tax Regulations require all transitional adjustments arising from the adoption of IFRS 9 in respect of credit losses to be spread over a 10 year period, regardless of when the debt falls due. Also, in South Africa, the regulators have issued a draft Taxation Laws Amendment Bill that includes proposed tax amendments that will address the tax implications of impairment losses under IFRS 9. The Bill was the product of prolonged negotiations between the Banking industry and the South African National Treasury.

Therefore, the introduction of IFRS 9 may be a good opportunity for the FIRS to further clarify the impact of the provisions of Section 24(f) of CITA on transitional adjustments and impairment losses on loans and advances.

Measurement of financial instruments

IFRS 9 requires that all financial assets are subsequently measured at amortized cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVTPL) based on both the business model for managing the financial assets and their contractual cash flow characteristics.

Furthermore, the new standard requires that all investments in equity instruments and contracts on those instruments, be measured at fair value. Changes in the fair value of the investments are to be recognized in profit or loss, except for those investments in equity instruments for which the entity has irrevocably elected to present changes in fair value in other comprehensive income (OCI). This OCI irrevocable election is available on an instrument-by-instrument basis. Thus, if an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at FVOCI. Fair value gains or losses on such instruments should be reported in OCI upon de-recognition.

Based on the IFRS Circular, financial instruments classified as FVTPL (held for trading or short-term profit taking) would be treated as revenue in nature. Thus, profits/gains from such instruments would be liable to tax under CITA to the extent that they are not specifically exempted from tax. Under the CIT (Exemption of Bonds and Short Term Government Securities) Order, 2011, short-term Federal Government (FG) securities (Treasury Bills and Promissory Notes), bonds issued by Federal, State and Local Governments and their Agencies, bonds issued by corporate bodies including supra-nationals, and interest earned from these investments, are exempt from CIT. The exemption was effective from 2 January 2012 and is, generally, for a period of 10 years. However, bonds issued by the FG will continue to enjoy the exemption after the 10-year term.

For long-dated investment securities classified as FVTPL, the tax issue will be whether the income from such investments will be treated as revenue in nature and subjected to CIT at the rate of 30%, or regarded as capital gains that fall within the purview of the Capital Gains Tax (CGT) Act[1] .

In 2014, the Tax Appeal Tribunal (TAT or "the Tribunal") adjudicated on a case between Citibank Nigeria Limited (Citibank or "the Bank") and the FIRS[2], in respect of income derived by the Bank from trading in long-term FG bonds during its 2008 to 2010 financial years. The Tribunal held that the income derived from the trading activity was liable to CIT on the basis that the act of trading in the securities made them lose their long-term attribute.

However, the Federal High Court (FHC) upturned the TAT's judgment in 2017[3], and ruled that the gain derived by Citibank from trading in the FG bonds was not liable to CIT, but rather fell within the ambits of the CGT Act. According to the FHC, the character of a bond as short-term or long-term is determined by its tenor/maturity date. Thus, trading in a long-term bond before maturity does not change its character as a long-term money instrument.

The authors align with the FHC judgment and are, therefore, of the view that profits/gains from long-dated investment securities will be liable to CGT, unless exempt from the tax.

Greater volatility in accounting profit or loss figure

It is also expected that the transition to IFRS 9 will significantly increase the number of financial instruments measured at fair value, resulting in greater volatility in the accounting profit or loss figures of reporting entities.

Based on extant tax law provisions in Nigeria, and consistent with the IFRS Circular, unrealized gains or losses arising from the increased volatility in profit or loss, will be disregarded/disallowed for tax purposes until realized. As such, there may be significant variance between accounting profits and assessable profits resulting from fair value gains and losses reported in profit or loss. Taxpayers will need to ensure that fair value adjustments through profit or loss accounts are properly tracked to ensure that proper tax adjustments are made when such gains and losses become realized.

Conclusion

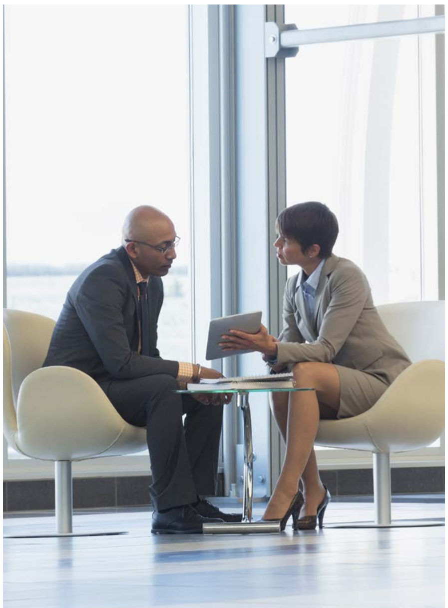
The transition to IFRS 9 will have a significant tax impact on DMBs and other companies with significant holdings in financial instruments.

One major issue with the adoption of IFRS 9 for DMBs in Nigeria is the effect of bigger and more volatile impairment losses on capital ratios. From a tax perspective, it may also mean significantly lower profits but higher scrutiny of specific impairments losses, a part of which may be disallowed for tax purposes. Furthermore, there will be an increase in the number of fair value movements through the income statement which will need to be properly tracked and adjusted for tax purposes. DMBs should consider engaging the FIRS in discussions on issues relating to the significant impact of impairment losses under IFRS 9, on their profits/capital.

Insurance companies in Nigeria may also suffer a large chunk of the adverse tax impact that the impairment model under IFRS 9 may bring. Despite the expected increase in their impairment losses, the tax-deductible portion of their total expenses (including impairment losses) would still be restricted to only 25% of total premium based on the existing provisions of Section 16(8) of CITA. This restriction would further drain the capital base of general insurance businesses.

The tax impact of the adoption of IFRS 9 by insurance companies will worsen the companies' currently unfair tax treatment, and makes the need to amend the adverse provisions of Section 16 of CITA (which forms the basis for the taxation of insurance companies) more urgent. Concerted effort must, therefore, be made in this direction by all stakeholders in the insurance industry before the effective transition date of 1 January 2018 – or at least before the companies file their first CIT returns under the IFRS 9 regime.

In light of the potentially significant tax implications highlighted in this article, it would be extremely important for companies to review their business models and contractual cash flow obligations as they prepare to adopt IFRS 9, and proactively assess how the implementation of the new standard will impact their tax position and obligations.



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[1] Under Nigerian CGT Act, capital gains are taxed at 10%; however, Nigerian Government securities, stocks and shares are exempt from CGT.
[2] Consolidated Appeal No. TAT/LZ/CIT/EDT/043-047/2014
[3] Appeal No. FHC/L/01A/2016

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