The current foreign exchange control regime and implications for taxation and fiscal policy

The real issue is that there is rising inflation due to high cost of imports; cost of goods and services increase because many cost items are incurred at black market rates while foreign currency revenue will be reported at the lower interbank rate resulting in lower tax payments.

Overview

It is tough to manage an economy even in times of boom so it is definitely tougher to do so in times of economic woes. Various governments around the world employ different monetary and fiscal policy measures in order to pilot their economies in the right direction and prevent a crash. What makes the job so difficult is that economic managers are often faced with conflicting targets such as access to finance at affordable rates which is likely to lead to high inflation, or low interest rates leading to a weaker local currency. It's like setting a target to stay up longer so you can get more work done when you also need to sleep more so that you don't breakdown.

In simple terms, monetary policy involves how government influences the quantity and value of money in circulation. This could be done using various tools such as interest rates, exchange rates, printing of more money and controlling how much money is available to banks even out of their own customer deposits. Fiscal policy on the other hand involves government's decision regarding how to impose and collect taxes and how the money collected is spent. Both policies are complementary and are aimed at ensuring a stable and prosperous economy characterised by low inflation, high level of employment, and overall economic development.

Foreign currency control measures

There are numerous rules contained in the enabling laws and regulations particularly the Central Bank of Nigeria (CBN) Act, the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act, and Money Laundering (Prohibition) Act.

Section 20(1) of the CBN Act provides that the currency notes issued by the CBN shall be legal tender in Nigeria. Section 20(5) forbids anyone from refusing to accept the naira as a means of payment in Nigeria but empowers the CBN to prescribe the circumstances and conditions under which other currencies may be used as a medium of exchange. It is clear from these provisions that pricing in foreign currency is not prohibited but refusal to collect naira as payment.

Section 1(2) of the Foreign Exchange Act (FEA) empowers the CBN, with the approval of the finance minister, to issue guidelines from time to time, to regulate the procedures for transactions in foreign currency. Section 8 requires that such guidelines issued for supervision and monitoring must be consistent with the FEA. Based on section 10, an eligible transaction for the purchase of foreign exchange includes any transaction adequately supported by appropriate documentation except where the transaction is prohibited by law.

Key issues and matters arising

Given the downward pressure on naira as a result of the steep decline in foreign currency revenue accruing to government from petroleum, the CBN has taken a series of measures aimed at addressing the issues. First, naira was devaluated in November 2014 from about 160 to 176 to the US$. A further decline took place in February 2015 when the CBN suspended the dollar auction system and set a new target of 196.5 for the interbank rate (this has just been increased to 197).

The naira devaluation did very little to stem the pressure and so in April 2015 the CBN issued a Press Release indicating that some institutions price their goods and services in foreign currencies and demand payments in foreign currencies rather than the naira, which is the legal tender in Nigeria. Reference was made to section 20 of the CBN Act of 2007, which states that the currency notes issued by the CBN shall be legal tender in Nigeria…for the payment of any amount. The focus in this case was on payment rather than pricing.

However, on 21 May 2015, another circular was issued to the effect that pricing of goods and services must only be in naira referencing section 20(5). It is however instructive to note that the section does not prohibit pricing in other currencies, it only prohibits refusal to accept payment in naira. The circular exempts certain organisations from receipts and payments in foreign currencies including revenue agencies, operators in the oil and gas industry, maritime, aviation and operators in the free trade zones.

On 23 June 2015, a directive was released by the CBN to exclude certain transactions from eligibility to access foreign exchange in the Nigerian foreign exchange market. A list of 40 prohibited items was provided including rice, cement etc. On 30 June, a circular was issued to clarify that the items which are prohibited cannot be funded through interbank, exports proceeds and Bureau de Change (BDC). On 1 July 2015, furniture was added to the list to make it 41 items. The list is subject to review at any time.

One of the reasons given for the action is to encourage local production even though it seems the main objective is to preserve the dwindling foreign reserve given that local production (of say rice) will not happen overnight and people won't stop eating in the meantime. It is the same logic that crude oil should be refined locally but the importation of refined products is not classified as "Not Valid for Forex" until local demand can be met by local supply. While the exchange rate in the interbank has been fairly stable, the rate in the parallel market has now devalued to over 240.

It is clear that the CBN is making a lot of effort to address a rather difficult situation but their job is made more difficult and less effective due to the lack of complementing fiscal policy measures.

Tax and fiscal policy implications

Under the current exchange regime, businesses that incur foreign currency denominated costs and other obligations will, in many cases, pay at much higher rates (in the parallel market) and therefore take higher tax deductions while those who earn foreign currency are required to sell at the lower interbank rate. This means they will have less income and profits on which to pay income tax. The disparity could potentially lead to round tripping by some individuals who buy at the official rate and sell at black market rate. Sadly such activities are largely in the informal and hidden economy so they don't even get taxed which increases their gains but deepens government's pains.

For upstream oil companies, their tax payments will also reduce since they incur substantial naira expenses which they will convert to US$ using the lower interbank rates resulting in higher US$ tax deductions and hence less dollar tax payments.

In addition, there will be a decline in tertiary education tax as assessable profits of companies will be negatively impacted and a deep in information technology (IT) tax revenue given the greater impact on accounting profits of affected companies as a result of significant unrealised exchange losses. Education tax is payable at 2% of assessable (tax adjusted) profit while IT tax is 1% of accounting profit before tax.

Nigerian companies who earn some foreign income and have suffered withholding tax deduction in foreign currency may find themselves paying more 'balance of tax' as their withholding tax credit notes are converted to naira at the lower rate.

Personal income tax accruing to states may increase slightly as workers demand higher wages but this will be partly offset by people who are being laid-off due to the difficult economic condition. I was told recently by a large Nigerian company that they have laid-off over 6,000 staff in the past one year alone due to the impact of foreign exchange and non-payment of contact sums from government. In real terms, there will be a decline in the tax payable by expatriates who earn foreign currency salaries as they convert to naira income using the lower interbank rates.

Capital gains tax (CGT) revenue should increase as the nominal naira value of assets go up but this will be negligible given the historical contribution of CGT to government tax revenue. Import duty collection will suffer because even if an invoice payment was sourced at the parallel market rate, the import duty will be settled at the lower interbank rate.

VAT revenue is not likely to increase significantly as the highest inflation rates, according to the National Bureau of Statistics, are recorded in basic food items (which are VAT exempt).

The way forward

While there is no golden bullet to tackle all the problems at once, it is important that the monetary policy efforts are complemented by robust fiscal policy measures. To starve importers of foreign exchange funds so as to encourage local production as substitutes is to attempt to use monetary policy measures to achieve a goal that is better served by fiscal policy.

As the gap in exchange rates widens, and the uncertainty regarding what else may be added to the "Not Valid for Forex" list, the economy seems to be suffering from the pains of naira devaluation without deriving any of its benefits like higher tax revenue. The real issue is that there is rising inflation due to high cost of imports; cost of goods and services increase because many cost items are incurred at black market rates while foreign currency revenue will be reported at the lower interbank rate resulting in lower tax payments.

The only sustainable solution is to have a coherent monetary policy framework complemented by a robust fiscal policy else it will be as unrealistic as hoping that a man standing on one leg will maintain his balance for a long time.

Taiwo Oyedele is a Partner and Head of Tax and Regulatory Services at PwC Nigeria. He is a regular writer and public speaker on accounting and tax matters.

Blog with Taiwo for in-depth analyses, unique insight and superlative perspective on tax matters: www.pwc.com/nigeriataxblog. *Subscription is free!*