FIRS issues Regulations for taxation of institutions offering non-interest financial products and services in Nigeria

KPMG in Nigeria

November 2022

The Federal Inland Revenue Service (FIRS or "the Service") recently published the *Non-Interest Finance (Taxation) Regulations 2022 ("the Regulations"),* which provide a framework for the taxation of financial institutions offering non-interest financial products and services in Nigeria. The Regulations, with a commencement date of 1 April 2022, were issued pursuant to the FIRS' power under Section 61 of the Federal Inland Revenue Service Establishment Act (FIRSEA).

On 9 June 2022, the Central Bank of Nigeria (CBN) had issued the revised Guidelines for the operation of non-financial instruments to provide a uniform set of rules for authorised institutions to access non-interest financial instruments (NFIs) contained in its Circulars: "*Guidelines for the Operation of Non-Interest Financial Instruments by the Central Bank of Nigeria*" of December 2012 and "Introduction of Two New Instruments - "*Funding for Liquidity Facility and Intra-Day Facility for Non-Interest Banks*" of August 2017, respectively.

Therefore, the Regulations provide tax and regulatory framework for the operation of NFIs offered by the CBN for authorised institutions operating under the principles of Islamic Commercial Jurisprudence to ensure equal treatment of both conventional and non-interest financial services transactions in Nigeria.

The Regulations are divided into seven (7) parts and address twelve (12) different NFIs provided by authorised institutions and their tax implications.

We have summarised below the relevant instruments listed under the various product categories and their tax treatments as provided in the Regulations:

1. Sale-based products

The Regulations describe three types of sale-based products, namely:

i. Murabaha (Cost plus mark-up)

Here, a financial institution, at the request of a customer, purchases an asset from a vendor and resells to the customer at a markup, also known as *Murabaha.*

Paragraph 3 of the Regulations requires the financial institution to treat the initial purchase price as a loan to the customer. Further, the resale price, excluding the markup, will be treated as a loan repayment and will not be subject to value added tax (VAT), stamp duties and capital gains tax (CGT). However, the markup element will be treated as interest payable on the loan and subject to withholding tax (WHT). Similarly, the purchase of the asset from the vendor will be subject to both VAT and WHT respectively.

ii. Istisna or Parallel Istisna

Paragraph 4 of the Regulations addresses the *Istisna* instrument where a financial institution undertakes to finance a customer's project for the construction or manufacture of goods or assets and engages the services of a third party for the construction or manufacture of the goods or assets, and thereafter, transfers the goods or assets to the customer upon completion.

The Regulations provide that the financing arrangement with the customer will be treated as a loan, which will not be subject to VAT and WHT. However, the transaction between the financial institution and the third party will be subject to VAT and WHT, respectively.

Further, the repayment of the principal amounts (or Istisna contract sum) by the customer will be treated in the same manner as a loan repayment. Therefore, only the markup portion, similar to an interest, will be liable to WHT. The customer will treat the capital portion and markup as qualifying capital expenditure (QCE) for income tax purposes, in line with the provisions of the Second Schedule to the Companies Income Tax (CIT) Act (as amended).

iii. Salam or Parallel Salam

Salam refers to the purchase of a commodity for deferred delivery in exchange for immediate payment. Thus, in a *Salam* contract, the price is paid in full in advance while the delivery of the commodity is deferred to an agreed date in the future. Subsequently, the financial institution contracts with a third party to purchase the commodities.

Based on Paragraph 5 of the Regulations, the agreement between the financial institution and the customer will be treated as a loan agreement, and not liable to VAT and WHT. However, the transaction with the third party will be treated as a regular sales transaction, which will be subject to VAT and WHT accordingly.

2. Equity-based products

i. Musharakah

A *Musharakah* is a joint venture arrangement where the financial institution and customer enter into a partnership, for a limited duration, to finance the acquisition of an asset or a project, and both share in the profits in a predetermined ratio. However, losses are borne based on capital contribution. The customer may choose, subsequently, to acquire the share of the financial institution in the partnership.

Based on Paragraph 6 of the Regulations, the capital contribution by the financial institution will be deemed as a loan, while its share of profit will be treated as the interest on the loan and subject to the same tax treatment as interest on a conventional loan, i.e., WHT. Payments made by the customer to acquire the shares of the financial institution will be considered a loan repayment and would not be liable to tax. However, the agreement to transfer the interests of the financial institution to the customer will be subject to stamp duties accordingly.

Further, only the customer will be allowed to treat the cost of acquiring the asset or project as a QCE for income tax purposes and claim capital allowances thereon, in line with the Second Schedule to the CIT Act (as amended). The financial institution may claim its share of loss from the partnership as an allowable deduction for CIT purposes if it can prove, to the satisfaction of the FIRS, that the loss relates to expenses *wholly, reasonably, exclusively and necessarily* incurred in generating the taxable income under the agreement.

ii. Diminishing Musharakah

In a *diminishing Musharakah,* the financial institutions share is progressively reduced, and reallocated to the customer, who finally becomes the sole owner of the asset. The customer will have an exclusive right to possess and use the asset and pay the financial institution periodic rent and a consideration to acquire its share in the asset. The customer can treat the asset as QCE for CIT purposes and claim capital allowances on the cost of the asset.

Paragraph 7 of the Regulations provides that the amount contributed by the financial institution will be treated as a loan provided to the customer and shall not be subject to any tax. However, the periodic rent paid by the customer will be treated as interest and subject to WHT.

Further, the consideration paid to acquire the interest of the financial institution in the asset will be treated as repayment of the principal and therefore, will not be liable to both VAT and WHT. The instrument executed between the customer and the financial institution to transfer the latter's share of interest in the asset will, however, be subject to stamp duties accordingly.

iii. Mudarabah as deposit

In this instance, the financial institution acts as a fund manager for capital provided by the customer. Both parties share in the profits derived from the use of the capital for investment in approved activities in a predetermined ratio.

Paragraph 8 of the Regulations provides that the customer's share of the profit will be deemed, in substance, a return on investment, and taxed in the same manner as conventional return on investment.

3. Lease-based products

i. Ijarah wa iqtina (Finance lease)

Here, the financial institution will acquire an asset from a third party and lease same to the customer, who has the option to purchase the asset at the expiration of the lease period. Ownership and **major maintenance** of the asset remain with the financial institution while the customer retains only the beneficial interest in the asset for the duration of the lease. The customer will pay the financial institution an agreed periodic rental fee for the use of the asset.

Paragraph 9 of the Regulations provides that the *Ijarah wa iqtina* contract will be treated in the same manner as a finance lease. Therefore, the customer will capitalise the lease repayment as QCE for CIT purposes and claim capital allowances accordingly. The lease payments will be subject to VAT and WHT. Further, any agreement executed between the parties for the transfer of the asset at the end of the lease period will be liable to stamp duties.

ii. Ijarah (Operating lease)

The major difference in *Ijarah* is that there is no intention to transfer ownership of the asset to the customer at the end of the lease period. Therefore, Paragraph 10 of the Regulations provides that in *Ijarah,* the financial institution will recognise the asset as QCE and claim capital allowances accordingly. The periodic lease payments to the financial institution for the use of the asset will be subject to VAT and WHT accordingly. The customer will be entitled to claim the lease payments as allowable expenses for income tax purposes provided that the asset is used for the purpose of generating the income that is subject to tax.

4. Fee or Agency-based products

i. Takaful

The Regulations describe *Takaful* as an agreement between a group of participants or policy holders (PHs) and a *Takaful operator* ("Operator") to contribute to a common fund held and managed by the Operator for a fee as an insurance against loss or damage incurred by any member.

Paragraph 11 of the Regulations provides that the consideration paid to the Operator, whether as management fee or a share of return on investment of the fund on behalf of the PHs will be liable to VAT. Any amount distributed as surplus of returns on investments by the Operator to the PHs will be also subject to WHT. Further, the agreement between the Operator and the PHs for *Takaful* will be liable to stamp duties accordingly.

5. Other investment products

i. Sukuk

A *Sukuk* is an arrangement between a sponsor of financial securities (SFS) and an investor wherein a special purpose vehicle (SPV) is set up to raise funds to finance a Sharia-compliant business or project, asset purchase or other approved activities. The Regulations require that the securities issued under *Sukuk* are based on the principles of non-interest finance and approved by the Securities and Exchange Commission (SEC).

The *Sukuk* arrangement will be treated in the same manner as conventional bonds, and subject to the same provisions provided under the CIT Act (as amended) and CIT (Exemption of Bond and Short Securities) Order 2011. Therefore, only *Sukuk* issued by the Federal government will be exempt from CIT.

Further, the Regulations clarify that the SPV, which is a pass-through vehicle, will be subject to tax administrative procedures provided in the relevant tax laws, including filing of returns.

ii. Islamic Fund Management

This involves a business arrangement between a fund manager and investors to pool funds together for investment in line with Shariah principles.

Paragraph 13 of the Regulations prescribes that the funds will be treated in the same manner as conventional fund management transactions provided under the CIT Act (as amended).

iii. Islamic Real Estate Investment Trusts

This involves an arrangement between investors and a fund manager to pool funds together to invest in real estate or real estate related assets that are approved by the SEC and compliant with Shariah laws and other applicable rules.

The Regulations provide that such arrangement be treated in line with the conventional real estate investment trust as prescribed under the CIT Act (as amended). This means that Islamic Real Estate Investment Trusts will be covered by the expanded definition of Real Estate Investment Company (REICOs) introduced by Finance Act, 2021. Therefore, they will enjoy the tax concessions available to REICOs, which include income tax exemption for dividend and rental income received by REICOs (provided that 75% of such income is distributed to the REICO's shareholders and such distribution is made within 12 months of the end of the financial year in which the dividend or rental income was earned), exemption from WHT for dividend and rental income received by RIECOs, etc.

6. Supplementary and General Provisions

Paragraph 15 of the Regulations provides that income earned from all non-interest finance arrangements prescribed in the Regulations will be subject to the provision of the CIT Act (as amended), Tertiary Education Tax Act, National Information Technology Development Agency Act and Personal Income Tax Act as applicable. Further, monies paid, distributed and shared to participants or customers in form of a return on investment or share of profit in a non-interest finance arrangement under the items identified in the Regulations will be subject to the provisions of the WHT Regulations.

Where a financial institution grants rebates, discounts, waives and reductions not stipulated in an agreement between it and the customers, such amounts will be considered as income to the financial institutions and taxed accordingly. The Regulations also provide that all chargeable transactions conducted in accordance with the provisions of the Regulations will be subject to VAT and WHT, whilst the documents and agreements executed pursuant to any of the instruments will be subject to stamp duties.

Commentary

We commend the efforts of the FIRS and other stakeholders who contributed to the drafting of the Regulations. The Regulations provide a framework for taxation of institutions offering non-interest financial services and related transactions based on the extant provisions of the Nigerian tax laws.

It is expected that proper and full implementation of the Regulations should reduce the incidence of tax avoidance amongst institutions offering NFIs and put them on level playing field with conventional financial institution.

However, there are some provisions of the Regulations which may require revisiting to ensure consistency with the extant laws and avoid unnecessary dispute with taxpayers:

i. The powers bestowed on the FIRS by Section 61 of the FIRSEA only permit it, with the approval of the Minister, to issue regulations to give effect to the provision of the Act on the following specific issues:

- forms for returns and other information required under the FIRSEA or any other enactment or law; and
- procedure for obtaining any information required under the FIRSEA or any other enactment or law.

There are numerous instances in the Regulations that seem to suggest that the FIRS is enacting new laws. For example, the definition of markup as interest on loans subject to tax at 10% WHT rate rather than 5% or classification of contribution to a joint venture under *Musharakah* as a loan may be deemed as amending the tax laws (through the Regulations), which is the exclusive reserve of the National Assembly.

ii. The Regulations classify the contribution of the financial institution in a *Musharakah* as a loan to the customer notwithstanding that the arrangement is a joint venture partnership where both parties invest in an asset. This may be an over simplistic classification and does not consider the substance of the arrangement. For example, in *Musharakah*, the customer may choose to acquire the financial institution's share in future, which is not present in a loan arrangement, but it is in a partnership. Therefore, the evaluation of the transactions must be consistent with the substance of the arrangement to ensure consistency in the application of the relevant tax provisions to the transaction.

Further, the treatment of the financial institution's share of profit as interest subject to WHT under a *Musharakah* should be revaluated because it is based on a narrow view that the customer will collect the entire profit before remitting the agreed portion to the financial institution. In practice, this may not always be the case. For example, conventional Deposit Money Banks (DMBs) have arrangement with some FinTechs that are similar to *Musharakah* where the DMB and FinTech invest collectively in a venture. The return on investment (ROI) from such partnership is typically not subjected to WHT where each party records their ROI separately. Therefore, it will be fair to evaluate the details of how the ROI is generated and shared between the parties in order to determine the applicability of WHT on the income. This will ensure a level playing field for both conventional and non-interest financial institutions providing similar financial services.

Finally, the FIRS may have limited its interpretation of assets under Musharakah in the Regulations to property, plant and equipment. However, the asset could be an intangible such as patent or other intellectual property which may not qualify as a QCE under the Second Schedule to the CIT Act.

iii. Under *Mudarabah*, the Regulations define only an instance where the customer provides the capital managed by the financial institution. This limits the scope of the Regulations regarding the instrument. For instance, the customer could act as the fund manager while the financial institution provides the capital as is the case with the Funded Trader

Program in a conventional investment system. Under this arrangement, the financial institution offers individual traders large capital to trade, in return for a share of the profit from the trade. It may also be possible that, under *Mudarabah,* the customer can invest in a Sharia-compliant instrument to earn profit, which is then shared with the financial institution in a predetermined ratio. The Regulations can be updated to consider such alternative arrangement.

Further, the general assumption that the financial institution's share of profit under *Mudarabah* is ROI (i.e., dividend) subject to WHT may be misleading. For instance, the Regulations do not provide for a scenario where the investment is in a tax-exempt instrument such as *Sukuk* in which case, the ROI will be exempt from income tax including WHT.

iv. Finally, there is a risk of double WHT deduction on the same income under *Takaful,* as described in the Regulations. For instance, the investment will be made in the name of the Operator, and it is likely that WHT will be deducted at the point the Operator receives the ROI on behalf of the PHs. Where the ROI is an income on which WHT is the final tax, i.e. franked investment income, the redistribution of the same income to the customers should not attract additional WHT as this will amount to double taxation of the income. Therefore, FIRS may need to revise the provisions of the Regulations in respect of the instrument to consider the above comments. This will ensure that investors in *Takaful* are not worse off from their contemporaries in similar conventional instruments.

While we commend the efforts in putting together a framework to address taxation of institutions offering NFIs in line with the Islamic Commercial Jurisprudence, it is hoped that the FIRS will revise the Regulations to address the issues noted above. Further, the FIRS may consider submitting the provisions of the Regulations that may be inconsistent with the provisions of the law (as noted in i above) as proposals for amendment of the provisions of the relevant laws in Finance Bill, 2022. This will help to provide clarity to the relevant stakeholders and mitigate unnecessary disputes with taxpayers regarding the implementation of the Regulations.

Contact us

Adewale Ajayi
Partner and Head,
Tax, Regulatory & People Services
T: +234 803 402 1014
E: ng-fmtaxenquiries@ng.kpmg.com

home.kpmg/ng
home.kpmg/socialmedia

© 2022 KPMG Advisory Services, a partnership registered in Nigeria and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.