

Tax Issues in Nigeria's Electricity Industry

Newsletter

Introduction

The Electric Power Sector Reform Act (EPSRA), passed in 2005, signaled the beginning of a new phase in Nigeria's electricity industry. Its main thrust was the unbundling of the government-controlled monopoly, the Power Holding Company of Nigeria (PHCN), into 18 "Successor Companies" (6 power generating companies (Gencos), 1 transmission company (Transco) and 11 distribution companies (Discos). This process kick-started a privatization process, which climaxed in November 2013 with the transfer of major stake in the Gencos¹ and Discos to private owners. Only the Transco remained wholly government-owned; though its management at the time was ceded to a private company.

It has been over 3 years since, but the industry is still faced with a number of issues; though mostly tied to liquidity. These issues include: the devaluation of the Naira against the United States Dollar that has impacted the cost of gas and other raw materials as well as exposed the companies to significant foreign exchange losses, inadequate collection from end-users, increased cost of doing business and significant collection losses.

In addition, the tax authorities and the private owners are still coming to grasp with the peculiar tax challenges in an otherwise green sector. To this end, KPMG organized a joint session with the tax authorities to review some of the peculiar challenges faced by the industry and their tax implications. This Newsletter summarises the discussions held at the joint session.

• Treatment of Value Added Tax across the industry's value chain

Electricity should qualify as a good, given its peculiar characteristics. Input Value Added Tax (VAT) in Nigeria can only be recovered against output VAT where the item on which the input VAT was incurred is stock-in-trade used in the direct production of a new product or

stock purchased for re-sale. A significant percentage of the energy generated in Nigeria today comes from gas-fired power plants whose key stock-in-trade i.e. natural gas, is liable to VAT. The Gencos should therefore be able to recover the VAT suffered on the gas purchased from any VAT charged on energy sold to the Discos or to the bulk trader, the Nigeria Bulk Electricity Trading Company (NBET). The Discos should also be able to recover the input VAT paid to the Gencos (or NBET) from that collected from customers.

There were, however, doubts as to whether the Discos could be deemed to have incurred any input VAT given that the invoices issued by NBET to them do not disclose the tax separately. Also, where it is argued that the energy charge contains an implicit VAT charge, it would be the responsibility of NBET to account for the VAT and remit same to the FIRS from the amount paid over to it by the Discos, and this will further worsen the current liquidity challenge in the industry.

It would, therefore, be in the best interest of the industry to review the operations of VAT in the Sector.

• Application of Minimum Tax to the Successor Companies

Section 33(1) of the Companies Income Tax Act (CITA), as amended, prescribes that in any year of assessment that a company has a tax loss, no tax payable or tax payable that is less than minimum tax, the company must pay minimum tax for that year of assessment. The exceptions to this provision are where the company is in its first four calendar years of operation, is engaged in agricultural trade or business, or if the company has at least 25% imported equity capital. The minimum tax, which is ascertained on the basis of indices such as the company's turnover, gross

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profits and net assets, can be substantial.

Since 2013, a significant number of the companies have reported huge losses as they struggle to come to grips with the issues in the sector. However, as a result of their huge turnover and net assets, the companies are exposed to the payment of minimum tax, the amount of which has been very significant. This is despite their current cash flow challenges.

Following the letter of the law, very little can be done to assist any of the companies that do not meet the minimum 25% imported equity capital requirement. However, given the importance of the Sector to the economy and its growth imperatives, it may be necessary for the Government to consider a special dispensation for these companies.

• Applicability of Withholding Tax and Value Added Tax deduction at source to Discos

Under the applicable provisions of the tax laws, withholding tax (WHT) should be withheld at the prescribed rate whenever payments on qualifying transactions become due from or payable by one company or individual to another, and remitted to the relevant tax authority. The tax so deducted represents an advance payment of income tax by the company from whose income it is deducted, and it is applied as a tax credit against the company's

¹ The hydroelectric power stations were not sold but concessioned to private investors.



income tax liability. In the case of VAT, where a taxable person is a ministry, statutory body, government agency/ parastatal or a company operating in the oil and gas sector, the taxable person is required to withhold the VAT charged by its supplier and remit directly to the Federal Inland Revenue Service (FIRS).

The erstwhile government-owned monopoly was exempted from income tax. Consequently, there was no question as to whether WHT should apply to the electricity bills issued for energy supplied to customers. However, now that the suppliers of energy (Discos) are private companies, which are liable to pay income tax, the exemption from WHT should ordinarily not apply. Similarly, government agencies and companies operating in the oil and gas sector are under obligation to deduct and remit to the FIRS, VAT charged on such electricity bills.

Recently, some companies have attempted to withhold tax on payments due to the Discos. Their position is based on the fact that Discos are private companies, which are liable to pay tax. There is also no specific direction from the FIRS that exempts payments to them from the imposition of WHT.

To address this lingering issue, the FIRS should treat the sale of electricity by Discos as "sales in the ordinary course of business" which are exempted from WHT.

- **Tax treatment of imbalance penalties**

Imbalance penalties are dues prescribed by the Nigeria Electricity Regulatory Commission (NERC) and payable by

Discos for failure to take up their power allocation on any particular day, without giving prior notice. The failure may be due to unplanned network challenges and or vandalism, which still remains a fundamental problem in the power sector. Power cannot be stored when generated and transmitted. Therefore, the imbalance penalty serves as a form of compensation to the Gencos for the power produced. It is typically charged at a lower rate than the rate applicable to power which is taken up by the Discos.

There have been arguments over whether the imbalance penalty would qualify as tax deductible, given that the power to which it relates was never received or sold to customers and so cannot be viewed as part of profits on which tax is paid. In addition, the penalties are often interpreted in the context of statutory penalties imposed by government for failure to comply with specific legal provisions, such as tax penalties, which are typically not tax deductible.

It is important to note that penalties are not listed as non-tax-deductible expenses in the CITA. There is also a difference between statutory and contractual penalties and both should not be accorded the same tax treatment. The imbalance penalties arise from contractual obligations and should therefore qualify for tax deduction.

- **Pioneer status for power sector companies**

The Industrial Development (Income Tax Relief) Act (IDA) was enacted to promote and incentivize industries and products considered pivotal to the development

of the country. Given the importance of power, the Industrial Development (Additional List of Pioneer Industries) Notice, 2008 was issued to include Utility Services industry as a pioneer industry and specifies that "Independent power generation utilizing gas, coal and renewable energy sources" is a pioneer 'product'. However, there is no mention of power transmission and distribution as pioneer "products" or industries. This is an obvious gap. One of the canons of a good tax system is equity. Therefore in order to ensure equity and create a level playing field, the Pioneer list should be extended to include the power transmission and distribution companies. This will also align with what obtains in practice.

- **Applicability of VAT on the transfer of legacy debts**

All liabilities and income due from and to the power companies for the period prior to their takeover by the private investors are expected to be transferred to the Nigeria Electricity Liability Management Company (NELMCO). However, given the challenges that the Discos had faced in maintaining separate accounts for pre-takeover bills paid after takeover, they agreed with NELMCO to pay a specified sum as full and final settlement of the outstanding pre-takeover bills. However, the settlement agreement did not take into account the VAT portion of the outstanding bills. Therefore, a key issue for determination is whether the amount paid over to NELMCO was inclusive of the VAT portion of the uncollected bills.

It can be argued that the VAT portion of the outstanding bills has been paid over to NELMCO, given that the amount paid should, in practice, represent the final payment for any bill issued pre-takeover but uncollected as at that date. Also, given that NELMCO and the FIRS are both Government agencies, it may be easier for them to liaise directly with each other for collection of the debt (if any is established).

Conclusion

It is clear that Nigeria's electricity industry is facing major challenges in its journey to sustainable growth. The industry will require as much support as possible from all stakeholders, including tax administrators, to ensure its continued growth. It is therefore important that these tax issues are amicably resolved as soon as possible to ensure that the industry can focus on its core mandate of delivering steady and consistent power.

For further enquiries on the above and information on how KPMG can assist you, please contact:

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