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Taxation of Non-resident Companies in Nigeria

By Adewale Ajayi

The significant decline in oil prices, oil theft and the vandalization of oil pipelines have adversely affected the Nigerian Government's revenue. Consequently, the government has implemented several initiatives in this regard. This article focusses on the review of the basis of taxation of nonresident companies only. It examines the history of taxation of nonresident companies, changes to the basis of taxation, implications of the changes and next steps.

I. History of Taxation of Nonresident Companies[1]

Section 55 of the Companies Income Tax Act ("CITA"), which is the enabling legislation on the taxation of profits of non-oil producing companies, provides that all companies (including those registered in or outside Nigeria) must prepare and file annual income tax returns. The returns should comprise audited accounts, tax and capital allowances computations and other particulars that may be required for the purpose of the Act. However, section 30 empowers the tax authorities to assess andcharge tax on the turnover of companies where there are no assessable profits, where the assessable profits are lower than expected or where the assessable profits are difficult to determine.

The Federal Inland Revenue Service (FIRS) have relied on the provisions of section 30 to apply a turnover basis of assessment (Deemed profits) to nonresident companies ("NRCs"). Prior to 1993, each NRC had to engage with the FIRS to negotiate and agree the deemed profit rates applicable to its business operations in Nigeria. This process resulted in varying rates of deemed profits, ranging from 5% to 15% of turnover. In most cases, companies in the same life cycle and sector had different deemed profits rates. The deemed profit rate therefore depended on the negotiation ability of the companies and their consultants.

The above situation triggered the need to address the issue of lack of uniformity in the application of deemed profits rate. The government therefore decided to harmonize the deemed profit rate in 1993, by adopting a uniform rate of 10%. However, at this time, the withholding (WHT) rate applicable to the services provided by NRCs was 2.5%. Given the corporate tax rate of 35%, the effective tax rate was 3.5%, which was higher than the WHT rate. The increase in 1995 of the WHT rate to 5% created a refund situation as the effective tax rate of 3.5% was lower than the WHT rate. In 1996, the government increased the deemed profit rate to 20%[2] and also reduced the income tax rate to 30%. This resulted in an effective tax rate of 6%, compared to the WHT rate of 5%. The deemed profit basis emphasizes simplicity and certainty and is therefore generally acceptable to all the NRCs. The basis ensures that all NRCs will pay annual corporate tax, irrespective of whether they are in a loss situation or not. NRCs have therefore been preparing and filing their income tax returns on the deemed profit basis prior to the recent changes in the taxation of NRCs announced by the FIRS.

II. Summary of the New Changes

In July 2014, the FIRS directed all NRCs to start preparing and filing their income tax returns based on actual profits basis. The tax authority subsequently issued a public notice in January 2015 to provide some clarity on some of the concerns raised by stakeholders.

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However, the public notice only clarified the commencement date as 2015 year of assessment and the application of the directive to only those companies deriving active income[3] without addressing other significant issues arising from the change.

III. Issues Arising

The FIRS's directive is consistent with the provision of the enabling legislation and is part of the global move towards the implementation of country-by-country reporting. However, there are many areas that the FIRS are yet to clarify and this has generated concern on the part of taxpayers/consultants. These issues include the following.

A. Commencement date

The commencement date is given as 2015 year of assessment, covering the basis period of an accounting period ending in 2014. In Nigeria, income tax returns are prepared on preceding year's basis and these returns are due for submission to the tax authorities within six months of the relevant year-end. Therefore, the income tax returns for an accounting year ended December 31, 2014, were due for submission by June 30, 2015. Given that the FIRS only provided clarification on the commencement date in January 2015, the fear is that the NRCs will not have sufficient time to comply with the change.

B. Reporting Framework

The fundamental principle for the preparation of financial statements is that the reporting entity must be clearly identifiable and that the financial statements must reflect the economic activities of that entity. There are some NRCs that do not have dedicated companies for their Nigerian operations. Such NRCs cover business operations in multiple countries. The key question therefore is what financial statements would such NRCs submit? Should the financial statements be for their global or Nigerian operations? Can a Nigerian audit firm express an opinion on the financial statements of business operations outside Nigeria since Nigerian law will only recognize the accounts audited by Nigerian audit firms? How will the Nigerian audit Firms satisfy themselves as to the true and fair view of such business operations outside Nigeria? Who is going to bear the significant cost associated with this?

Where the NRCs do not have dedicated entities for their Nigerian operations, the FIRS should accept the global audited financial statements. However, this must be supported by a schedule showing the profit and loss account for the Nigeria operations. This will help in managing the potential cost of another audit solely for the Nigerian operations. For taxation purpose, the entities can determine the amount of applicable capital allowances by applying to the total depreciation, the ratio that the profit from the Nigerian operations bears to the global profits.

C. Tax Basis for Qualifying Capital Expenditure and theComputation of Capital Allowances

In the 1996 circular on taxation of NRCs,[4] the FIRS had clarified that the deemed profit would be equal to taxable profits. In other words, the costs (80% of turnover based on the 20% deemed profits rate) allowed under the regime will also include capital allowances. This is arguable as the relevant section of CITA appears to be referring to assessable and not total profits.

Even if the FIRS argument is sustained, the issue of how to determine capital allowances on assets utilized in multiple jurisdictions is still unresolved. Would the related capital allowances on such assets be apportioned and if yes, on what basis? Which tax authority will certify such apportioned capital allowances? Would the NRCs only need to prove that the related assets are in the country at the end of the basis period for them to claim the full capital allowances in Nigeria?

To address these issues, the capital allowances should be determined as discussed in Section C above. The FIRS should place reliance on the financial statements already certified by the foreign audit firms for this purpose. The fact that most countries have adopted the International Financial Reporting Standards (IFRS) will also make this practicable and easier.

D. Applicability of the change to companies engaged in specialized business

The CITA makes provisions for special rules governing the taxation of businesses such as shipping, air transport and cable companies[5]. The relevant provisionsonly require these companies to determine their taxable income based on the difference between adjusted profits (derived by applying to the income accruing from Nigeria the ratio of adjusted profits to global profits) and the depreciation allowance (derived by applying to the income accruing from Nigeria the ratio of total depreciation to global profits). These rules presume that the **FIRS** must be satisfied that the foreign tax authority has certified both the adjusted profit and depreciation ratios. In the absence of such certification, will the **FIRS** require the NRCs concerned to submit global audited accounts and will this be sufficient for the purpose of the new directive? Won't this contradict the requirement for audited accounts by Nigerian registered audit firms? Will the NRCs involved in such specialized business be exempted from the change and simply pay the minimum tax of 2%?

The FIRS should simply adhere to the existing provisions in the tax laws and not place any unnecessary burden on these specialized businesses. In other words, the global audited accounts should be sufficient for this purpose.

E. Situations Where Actual Profit is Less Than Deemed Profit

In the January 2015 public notice, the FIRS had stated that "compliance with the filing requirements of CITA does not prevent the FIRS from exercising its discretion to assess a company to tax based on the company's turnover, where necessary, in accordance with Section 30 of CITA". The FIRS seem to believe that this section gives them the power to assess tax based on deemed profit where it is higher than actual profit. However, there is no basis for such belief as the section clearly articulates the situations under which the FIRS can apply such discretion (as discussed under the history of taxation of NRCs above). Simply put, the FIRS will need to demonstrate the existence of such situations before it can apply such judgment.

IV. Conclusion

It is clear from the above that there are still many unresolved issues that the FIRS have to address before they can effectively implement the changes in the taxation of NRCs. The FIRS need to engage with all the stakeholders to jointly provide solution acceptable to all parties. Otherwise, any attempt to forcefully implement the change will result in avoidable and unnecessary conflicts. The role of any tax authority is to ensure equity, certainty, economy, simplicity, expedience, productivity and convenience in the administration of tax. FIRS should therefore reconsider the timing of the commencement date of the change to allow sufficient time for engagement with the various stakeholders on the grey areas.

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Notes

[1] Nonresident companies are companies incorporated outside Nigeria but are carrying on business in Nigeria.

[2] 1996 Press Briefing (p.60) by the then Honorable Minister of Finance.

[3] NRCs deriving investment income from Nigeria are exempted from this directive. However, NRCs carrying on business in the country, including those performing management and technical services, are covered by the directive.

[4] Taxation of Non-Residents in Nigeria No. 93/02/1993.

[5] Sections 14 and 15 of CITA.

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