Power Sector Updates

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Tax and Regulatory Issues Impacting the Payment for Imported Equipment by Renewable Energy Companies in Nigeria

Nigeria's power sector has continued to grow, at least, in the number of participants, even if there are still concerns around the consistency and efficiency of grid power. Most of the new participants are Renewable Energy Companies (RECs), who with the available grants and concessionary funding from Government through agencies such as the Rural Electrification Agency (REA), Development Finance Institutions, and other Multilateral Development Agencies continues to drive growth in the sector.

The RECs would tell you though, that there is still a long way to go to solve the funding issue, given the size of the challenges in the Nigerian Electricity Supply Industry. The proportion of the country's population without access to stable and reliable electricity stands at about 46% as per a report published in the Punch Newspapers in 2022. While there have been some success stories so far, there is still significant work yet to be done.

Beyond access to capital, there are other issues which impact the desired growth in the sector. At the top of the list of these other issues is tax. In this third volume of the special edition series of our Power Sector newsletters, we will be highlighting a key issue which has significant income tax and regulatory considerations for RECs in Nigeria.

Payment for imported equipment

A significant number of RECs purchase their equipment from Original Equipment Manufacturers (OEMs) offshore. These OEMs are meant to be paid in foreign currency which is not always readily accessible through the official channels (i.e., the banking system). The RECs earn all their revenue in naira and so would have to source for foreign exchange in order to settle their obligations to the OEMs, who typically have a specified time within which they would expect to receive payment otherwise they may be unwilling to continue to do business with the RECs. Most RECs have, therefore, had to seek alternative sources of the foreign exchange.

The most popular source has been getting a related party offshore with access to foreign exchange, to pay the OEM, given the high cost of sourcing foreign exchange from Nigeria's parallel market. A receivable is then recognised, most times in form of a loan, to the related party. This has however led to several corporate tax and regulatory issues, some of which include:

(i) Tax deductibility of the interest expense

The underlying principle for the deductibility of expenses in Nigeria is that they must have been wholly, reasonably, exclusively, and necessarily incurred for the purpose of the business of the company. However, Finance Act, 2019 modified the application of the rule to interest paid to a foreign connected party. The new rule requires Nigerian companies and any fixed base of a foreign company in Nigeria to limit the deductibility of interest and similar expenses incurred by them, in respect of debt issued by a foreign connected person, to 30% of the payer's Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) in the relevant accounting period. Interest expense, in excess of this cap, will not be allowed in the current tax year but may be carried forward up to a maximum of 5 years.

A number of these RECs typically have a mid to long-term profitability forecast, and therefore are likely to accumulate interest expenses in their formative years, that they may have to write-off for tax purposes, even though it is a valid business cost. Given the peculiar circumstance that necessitates the interest expense and the need to encourage these businesses, there may be a need for the Government to reconsider how the new rule applies to RECs.

(ii) Remittance of withholding tax on interest expense

Interest payable to a foreign connected person is liable to WHT in most instances. The WHT due is payable in the currency of the transaction, which would likely be foreign currency, the denomination of the loans. Again, the issue of how to source the foreign currency comes up as the RECs earns all its revenue in naira. In several instances, the RECs carry the loans for long periods of time without the ability to settle either the interest or the principal but still retains an obligation to pay the tax due in foreign currency. Several people have argued that there should be no WHT due given that the interest has not been paid but the law is ambiguous, and the interpretation which appears to be favoured by the tax authorities, seem to suggest that the WHT becomes due when the interest is recognised as an expense not when it is paid. The tax authorities argue that the RECs take an income tax benefit immediately the liability to pay the interest crystallises and so there is no basis to argue that the WHT obligation should wait until actual payment is made.

Despite the controversy on when the WHT is due, no one would argue about the potential negative impact that may arise if these companies are forced to begin to source foreign currency from the parallel market to cover the taxes. These funds may have been better applied to improving their impact in the market.

(iii) Regulatory considerations

There are established regulatory procedures that must be followed when foreign investment in form of equity and or debt is brought into the country. The commercial bank through which the fund is received must be given prior notice and clarified on the nature of the investment (i.e., debt or equity). The entity which brings in the funds is then issued a Certificate of Capital or Loan Capital Importation within 24 hours of receipt of the funds into the Nigerian entity's bank account. The process appears very straight forward, however, when applied to the RECs the fault lines begin to show clearly. This is because in most cases, there are no actual inflow of funds. The documentation most of the RECs have indicate that they purchased equipment from an independent OEM. The payment transaction between their foreign connected party and the OEM does not pass-through Nigeria and occurs/ occurred long after the initial transaction and at a time when the REC has become frustrated with its attempt to obtain the foreign exchange in the country and is at risk of termination of its business relationship with the OEM. Therefore, the current straight forward process of obtaining the Certificate of Capital or Loan Capital Importation may become tedious in this instance. Some RECs have been able to cut through the complex process of getting the certificates, but these are mostly small businesses that ought to be spared the cost and burden of this regulatory challenge so they can focus on their primary objective. There is, therefore, a basis to argue for a simplified process of obtaining the relevant certificates for the equity or debt investment that takes into consideration the peculiarities of the RECs and similar businesses, or alternatively make foreign exchange more accessible to the affected RECs.

(iv) Transfer Pricing (TP) compliance considerations:

The CIT Act requires that transactions between connected persons and/ or related parties are consistent

with the arm's length principle. The Revised Income Tax (Transfer Pricing) Regulations 2018 (the Regulations) issued by the FIRS provide the guidelines for the application of TP rules on transactions between related parties including procurement arrangements, intra-group services, intangibles, safe harbour, transfer pricing documentations, filing of transfer pricing documentations and dispute resolution processes. The Regulations also provide exorbitant penalties for non-compliance with the provisions of the Regulations. The payment for the equipment by a related party and the corresponding recognition of a payable to the related party, therefore, falls squarely under purview of the TP Regulations. This is a point that is easily missed by most RECs and may leave them at risk of sanctions from the tax authorities if not addressed.

Conclusion

RECs are well suited to plug the energy demand gap in Nigeria's rapidly changing electricity industry given that renewable energy sources tend to be modular. However, to ensure that the burden of the corporate tax and regulation does not impede their ability to remain profitable and scale up, due consideration must be given, at the planning stage, to the issues discussed above. There may also be a need for the Government to continue to consider how it can support these businesses as they are an integral part of the Country's mission to improve to access to clean, reliable, and sustainable power as part of the Nation's energy transition plan.

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