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Base Erosion and Profit Shifting (BEPS):

Explanatory Note and Implications for Nigeria

Newsletter

On 5 October 2015, the Organization for Economic Cooperation and Development (OECD) released the final reports of the Base Erosion and Profit Shifting (BEPS) project. The final package was negotiated by OECD members, the G20 and non-OECD members (including Nigeria) on an equal-footing basis. The project seeks to fix a global tax system which is believed by some to allow multinational enterprises (MNEs) to reduce their effective tax rate in a jurisdiction without corresponding reduction in value-creating economic activities.

The purpose of the BEPS' Actions is to 'ensure that profits are taxed where economic activities take place and value is created'. There is concern that the international tax rules that were designed more than a century ago may no longer be adequate to address the current business environment. The BEPS approach focuses on three broad measures:

(i) Coherence in tax systems globally;
(ii) Economic substance in cross border dealings; and
(iii) Transparency with respect to relevant taxpayers' data to assist revenue administrations' tax investigation efforts.

The Actions will be implemented through changes to domestic laws and practices and provisions of tax treaties. The Federal Inland Revenue Service (FIRS) has already incorporated some of the principles in its audit procedure. For instance, the FIRS is scrutinizing transactions between Nigerian subsidiaries and their foreign related parties especially those located in tax-friendly jurisdictions. The aim is to ensure that these entities actually provide the services contracted and are not simply letter-box companies.

This newsletter reviews the BEPS' Actions and their impact on tax administration in Nigeria:

1. Addressing the tax challenges of the digital economy

The emergence of new information technology has significantly altered the way businesses are conducted. Information now flows real time and it is possible for a service provider to operate in a location different from that of the recipient. As a result, tax authorities believe that companies can artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed.

The first BEPS' Action recommends adoption of destination principle for collection of Value Added Tax (VAT). This is to circumvent artificial tax avoidance scheme when the tax is collected at any other point other than the end of the value chain. The other major recommendations aimed to prevent artificial definition of permanent establishment (PE) are discussed under the relevant sections below.

OECD expects that the Actions recommended will be helpful in preventing the MNEs from taking advantage of perceived tax loopholes within the digital economy.

2. Neutralizing the effects of hybrid mismatch arrangements

OECD defined hybrid mismatch as arrangements that 'exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral'. It therefore recommends that countries deny taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction.

This may expose profits from related party transactions derived by special purpose vehicles (SPVs) or letter-box companies based in tax-friendly jurisdictions to Nigerian tax. FIRS is currently probing some of these transactions. The Nigerian tax authority may however not be able to penalize any established case of mismatch until the tax laws are amended, unless it can prove that the transactions are artificial.

3. Designing effective Controlled Foreign Company (CFC) rules

CFC can simply be described as companies that are incorporated in jurisdictions other than where the companies' shareholders are based. CFC rules are therefore designed to address the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries, by shifting income into a CFC. The rule, once promulgated in a country, will permit the tax authority of the jurisdiction where the shareholders are resident to subject the profit earned by CFC to tax. The tax will be based on the percentage of control or influence.

Nigeria does not currently have CFC rules. It is however very likely that the rule will soon be put on the gazette. This may affect some Nigerian conglomerates that currently use SPVs incorporated in tax-friendly jurisdictions as intermediate holding companies (IHCs). The profit earned by the SPVs will be exposed to Nigeria tax if the tax rate in those jurisdictions are much lower.

4. Limiting Base Erosion involving interest deductions and other financial payments

Some MNEs are believed to achieve favourable tax results by increasing the amount of debt in a group entity to enable it enjoy significant interest deductions. Action 4 recommends the design of rules that limit deductibility of interest and other financial payments made to third parties and related parties. It suggests a Fixed Ratio Rule (FRR) where an entity's deductible interest expense would be limited to a fixed ratio of the entity's earnings before interest, tax, depreciation and amortization (EBITDA). The fixed ratio should be between 10% and 30%. Hence, excessive interest expense will not be tax deductible.

Currently, FIRS is not able to limit the deduction of interest expense even where it is established that net interest expense to EBITDA ratio is unjustifiably high. Rather, it has only been able to adjust or disallow interest expense that is proved not to be at arm's length. Nigeria may therefore introduce thin capitalization rule sooner than expected.

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5. Countering harmful tax practices more effectively, taking into account transparency and substance

OECD seeks to prevent profit shifting associated with preferential tax regimes. Preferential tax regimes, otherwise known as tax-friendly jurisdictions, are those offering advantageous treatment to non-residents or enterprises that are not active in the domestic market. Thus, under the new arrangement, MNEs that are benefiting from preferential tax regimes will need to demonstrate that there is substantial activity in the host country. This is to show that the taxpayer actually engaged in active economic activities and incurred expenditure.

The Action complements the efforts of the Nigeria tax authority to subject all companies, irrespective of residency, to tax on actual profit basis. Hitherto, non-resident companies pay tax on deemed profit basis. MNEs with links to preferential tax regimes will need to refine their structure to ensure that there are substantial activities and evidenced by tax deductible expenditure. Failure to comply may expose the subsidiaries in those jurisdictions to higher tax liability in Nigeria.

6. Preventing the granting of treaty benefits in inappropriate circumstances

Taxpayers engaged in treaty shopping and other treaty abuses undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted.

OECD therefore recommends inclusion of both a Limitation of Benefits (LOB) article and general anti-abuse provisions in the form of a principal purpose test (PPT) in their tax treaties.

7. Preventing the artificial avoidance of permanent establishment (PE) status

This Action called for a review of the definition of PE to prevent the use of certain tax avoidance strategies. The document cited instances where arrangements are made through which taxpayers replace subsidiaries that traditionally act as distributors by commissionaire. This results in shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country.

OECD will also outline how countries can introduce anti-fragmentation rule to ensure that it is not possible to benefit from PE exceptions through the fragmentation of business activities among closely related enterprises.

The recommendations may also encourage FIRS to probe many contractual arrangements that currently shield the offshore component from Nigeria tax. Companies that benefit from contract splitting arrangements will therefore need to align terms of contract with their conduct to prevent the FIRS from setting aside any arrangement that may be deemed artificial.

8-10. Aligning Transfer Pricing (TP) outcomes with value creation

Tax authorities believe that the existing international standards for TP rules can be misapplied so that they result in outcomes in which the allocation of profits does not align with economic activity that produced the profits. The revised guidance (Actions 8 to 10) takes the form of amendments to various chapters of the OECD Guidelines.

One of the key changes is the requirement that taxpayers should carefully delineate their actual transaction between the associated enterprises by analyzing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct.

The Nigerian tax authorities have commenced a painstaking review of companies' TP policies and compliance documentation. The process also involves interviewing taxpayers' officers that perform key functions in the related party transactions. It is expected that the recently released BEPS' guidance will further strengthen the resolve and determination of FIRS to penalize contractual arrangements that vary from parties' conduct. Companies with inadequate documentation may be exposed to significant adjustments.

11. Measuring and monitoring BEPS

Measuring the scale of BEPS proves challenging given its complexity and the serious data limitations. In addition to significant tax revenue losses, BEPS causes other significant adverse economic effects.

OECD plans to work with governments to report and analyze more corporate tax statistics and present them in an internationally consistent way. For example, statistical analyses based upon Country-by-Country Reporting (CBCR) data have the potential to enhance the economic analysis of BEPS.

12. Mandatory Disclosure Rules

The lack of timely, comprehensive and relevant information on aggressive tax planning strategies is one of the main challenges faced by tax authorities worldwide. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits or changes to legislation or regulations.

This Action calls for recommendations regarding the effective and efficient design of mandatory disclosure rules to the tax authority.

13. Transfer Pricing Documentation and Country-by-Country (CbyC) Reporting

Action 13 focuses on enhancing transparency for tax administrations by providing them with adequate information to conduct transfer pricing risk assessments and examinations which are critical to tackling the BEPS problem.

Thus, MNEs are required to develop and make available to the relevant authorities, a three-tiered standardized TP documentation. These are the master and local files together with the CbyC Report. The reports are expected to articulate transfer pricing positions and provide tax administrations with useful information to assess TP risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

In the first instance, the enabling TP Regulations envisaged the proposed changes in OECD documentation standard and taxpayers are required to comply immediately. It is however also interesting to note that FIRS has started requesting Nigeria conglomerates to submit CbyC report. This was incorporated into audit process. One may therefore conclude that, in the absence of any judicial challenge by the taxpayer, FIRS is relying on the existing tax legislation to implement this Action.

14. Making dispute resolution mechanisms more effective

Eliminating opportunities for cross-border tax avoidance and evasion as well as effective and efficient prevention of double taxation are critical to building an international tax system that supports economic growth and a resilient global economy. Countries agree that the introduction of the measures developed to address

The Nigerian tax authorities have commenced a painstaking review of companies' TP policies and compliance documentation. The process also involves interviewing taxpayers' officers that perform key functions in the related party transactions.

BEPS should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues.

To this end, Action 14 focuses on improving the effectiveness of the mutual agreement procedure (MAP) in resolving treaty-related disputes. This will actually be beneficial to taxpayers in Nigeria involved in cross-border transactions because it will reduce the risk of double taxation.

15. Developing a multilateral instrument (MLI) to modify bilateral tax treaties

The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. As at 15 October 2015, 90 countries were participating in the development of the MLI. When implemented, MLI will have the effect of amending existing bilateral treaties and put into law, treaty-related aspects of BEPS actions such as those on PE without any need for separate bilateral negotiations.

Concluding Remarks

The impact of BEPS' Actions cannot be over-emphasized. It is expected to impact how businesses are conducted, compliance with tax laws and companies' final tax liabilities. Most countries will also seize the opportunity provided by the introduction of the BEPS' Actions to shore up their revenue base. Companies are therefore encouraged to proactively examine the potential gaps that may arise from full implementation of the BEPS' Actions, perform in-house cleaning and be ready to comply to help mitigate significant tax risk exposures

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