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Taxation of foreign companies operating in Nigeria

Matters arising from deemed profit basis of taxation and the way forward

… for a government seeking to simplify the tax system and improve tax compliance, it is conventional wisdom that the harder we make tax compliance, the more we provide the incentive for non-compliance and outright evasion.

In Brief

The FIRS on 24 July 2014 stated at a stakeholder meeting that the income tax returns filed by foreign companies doing business in Nigeria will no longer be accepted unless accompanied with audited financial statements as well as tax and capital allowance computations among other requirements.

In Detail

The Companies Income Tax Act (CITA) defines a **"Nigerian company"** as any company incorporated under the Companies and Allied Matters Act or any enactment replaced by that Act. A **"foreign company"** means any company established under any law in force in a territory or country outside Nigeria. Such foreign companies are generally referred to as non-resident entities.

While a Nigerian company is taxable on its worldwide income, a non-resident entity is liable to tax in Nigeria on its profit attributable to the business or trade carried on in Nigeria. Although there are legal questions regarding what a foreign company can and cannot do in Nigeria without incorporating a Nigerian company, it is nonetheless legally possible for a non-resident company to directly derive business income from Nigeria. In any case, the CITA imposes tax on any investment (passive) income earned by a non-resident company such as dividend, interest, royalty and rent by way of withholding tax being the final tax. To earn this income, a non-resident company does not require a presence in Nigeria and therefore need not worry about tax registration and filing obligations, hence the rationale behind treating the withholding tax deducted at source by the Nigerian payer as the final tax.

On the other hand, where a non-resident entity earns business (active) income from Nigeria, it will be required to register for tax and file full tax returns just as a Nigerian company. This legal requirement however comes with enormous challenges. The major one being how to verify actual expenses incurred abroad and determination of capital allowances attributable to the Nigerian operation in order to establish the actual profit to be taxed. Hence, section 30 of the CITA empowers the Federal Inland Revenue Service (FIRS) to assess companies to income tax based on a reasonable percentage of turnover. This is referred to as the deemed profit basis, best of judgement assessment or presumptive taxation.

In practice, in assessing non-resident companies to tax, the FIRS prescribed a deemed profit of 20% of turnover derived from Nigeria (assuming all tax deductible expenses and capital allowance of 80%), which is then taxed at the corporate income tax rate of 30%. This results in an effective tax of 6% of turnover. This assessment basis has been widely adopted by non-resident companies, mostly due to its simplicity and the fact that disputes regarding tax deductibility of costs would be avoided.

However, the deemed profit basis is meant to be an alternative basis of assessment. The primary requirement in line with the CITA is that companies file their returns based on actual profits.
Historically, the FIRS had always accepted (and in fact enforced) the deemed profit basis accompanied with a statement of turnover derived from Nigeria as sufficient for tax returns purposes by non-resident companies.

Matters Arising

The Transfer Pricing Division of the FIRS issued a letter on 24 July 2014, stating that the income tax returns submitted by non-resident companies were not compliant with the provisions of Section 55 of CITA. Section 55 stipulates that companies should submit their duly completed self-assessment tax returns together with audited financial statements, tax and capital allowance computations; and any other relevant documents as may be required.

Legally, the deemed profit basis of taxation is to be applied solely at the discretion of the FIRS. The taxpayer is required to submit full information as required by law including audited financial statements and actual profit calculation. However, given that the FIRS had to date prescribed the deemed profit basis for non-resident companies, the proposed change of stance raises more questions than answers.

Key Questions and Issues for Further Considerations

This new position of the FIRS, which is coming as a result of transfer pricing implementation, is meant to provide the FIRS with useful information to ensure full tax compliance and address potential transfer mispricing. This however raises a number of issues for consideration:

1. Would it not be more efficient to request for the additional information on a case by case basis during desk review or tax audits as the cost of providing the full information required may outweigh the benefits in many cases?

2. Should there not be sufficient advance notice to allow a change over given that the FIRS had accepted this established practice to date? In fact, any attempt to file tax returns based on actual profits in the past had been resisted by the FIRS.

3. Does this mean that going forward tax should be paid on actual profit or still on deemed profit? If on actual profit will the FIRS refund excess tax where the 5% withholding tax is more than the tax due?

4. How will the FIRS verify costs, including head office charges, and deal with capital allowances on assets not wholly attributable to the Nigerian operation?

5. Would it be sufficient to provide the non-resident company's own financial statements or must it be audited accounts of the Nigerian operations? What if the foreign accounts are in a different language, or prepared under a different set of accounting standards such as US GAAP, would there be an extension of time to allow for a translation to English and must the accounts be converted to International Financial Reporting Standards (IFRS) applicable in Nigeria?

6. Should there not be a threshold where turnover information could be considered adequate (say based on amount and/or where the duration of a project is less than one year)?

7. In providing tax and capital allowance computations, how will a non-resident company deal with commencement and cessation rules in the case of a short term project where there is an overlap of the rules?

8. Does the FIRS have sufficient capacity to handle this change and will this be the best use of their available resources at this time?

The Way Forward

The FIRS' directive that non-resident companies must include audited financial statements and 'actual profit' tax computation in their returns is in line with the law albeit there are questions regarding practicability and usefulness of the information within the context of a deemed profit tax regime. Also, the fact that the FIRS had before now enforced the use of the deemed profit basis of taxation, then it is not illegal to file only the statement of turnover as envisaged by section 30 of CITA.

A related issue that must be addressed is the requirement for a foreign company that earns investment income from Nigeria, such as dividend, to register and obtain a Tax Identification Number (TIN) without which the Nigerian payer will not be able to remit the withholding tax deducted. This clearly has no basis in our extant laws and in fact counterproductive for a government seeking to simplify the tax system and improve tax compliance. It is conventional wisdom that the harder we make tax compliance, the more we provide the incentive for non-compliance and outright evasion.

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