pwc

Tax Bites

Adeoluwa Akintobi

The Finance Act and Net of Tax Clauses

The Finance Act 2019 introduced an amendment to the Companies Income Tax Act which has an impact on Net of Tax clauses. Companies should review their existing contracts and also take great care in the drafting of contracts going forward. An inelegantly drafted clause can expose a company to significant tax liabilities.

Introduction

There are several changes to the tax rules introduced by the Finance Act, apart from the increase of the VAT rate to 7.5%. One of these is the amendment to Section 27 of the Companies Income Tax Act (CITA), which could have an impact on "Net of Tax" clauses.

.

What are Net of Tax Clauses?

Net of Tax clauses are quite popular in business and commerce. They are simply agreements which provide that the agreed consideration in a contract is to be paid in full, free of any tax deductions. In other words, one party agrees to pay the other party the full amount of the contract, and bear any tax or levy of any kind. They are widely used in commercial and employment contracts. Some typical examples of where they are used in practice include:

a) where a foreign company wins a contract in Nigeria and does not want to bear any unanticipated tax costs because it is not familiar with the jurisdiction;
b) landlords in Nigeria that include net of tax clauses in their tenancy agreements so that they can receive the full amount they expect, whether withholding tax ("WHT") is deducted or not;
c) foreign loan agreements that have net of tax clauses on the interest payable by Nigerian borrowers.

Although the clause transfers the burden of all taxes and deductions (including VAT and stamp duty) to the person making the payment, it is best explained by zeroing on its impact on WHT.

To understand how it works from a WHT perspective, let us consider an example whereby Company A agrees to paint Company B's office premises for ₦100. By law, Company B has an obligation to deduct withholding tax of say 5%, i.e. ₦5 Naira from the ₦100 and remit to the tax authority. Company B would then pay the net amount of ₦95 to Company A. Now imagine that Company A simply wants to receive ₦100 in full for the project, regardless of whatever taxes and deductions may be applicable to the transaction. Company A would then introduce a net of tax clause in the contract, stating that Company B is to pay ₦100 for the service, net of all taxes applicable to the transaction. By so doing Company B will bear the cost of any tax which is applicable to that sum and Company A would receive ₦100 in any circumstance. A net of tax clause is therefore an effective a way in which a party shifts its tax burden to the other party. But is it legal to shift one's tax obligations to another person?

Legality of Net of Tax Clauses

The legality of net of tax clauses has for a long while been a subject of much debate. Some tax practitioners are of the opinion that it is illegal for a party to shift his tax burden to another party as it defeats the purpose of tax in the first place. Not only that, it can be argued that where party A pays the tax on behalf of party B, that tax paid is a benefit or income to party B which should also be taxed, leading to a seemingly infinite payment of tax. With respect to WHT, those who support this position refer to Section 2 of the WHT Regulations which provides that the WHT deduction should not be regarded as an additional cost of the contract to be included in the price of the contract, but as a tax due on the payment. The problem with this provision is that it does not have any penalty provision for its breach and therefore basically ineffective.

Court Decisions

Those who support the use of net of tax clauses will argue that a contractual agreement between two parties on who gets to pay a tax should not be the business of the tax authority as long as the tax is actually paid to the taxman. This argument is supported by the decision of the Court of Appeal in the case of **Total Nigeria Plc v Moshood Akinpelu**. In that case, the Appellant became a party (sub-lessee) to a lease agreement which included a net of tax clause. In paying the rental sum, the company wanted to deduct the WHT, which the lessor contested. The question before the Court of Appeal was whether, in light of the net of tax clause in the lease agreement, the company was entitled to deduct the WHT from the rent payable to the Lessor.

The Court held that the clause included in the lease agreement created a binding obligation between the parties and the statute could not be used as an excuse to avoid that obligation, particularly as the statute had not expressly prohibited such an agreement. This decision clearly suggests that it is legal for a party to shift its tax burden to someone else, as long as the parties freely agree to that position. While this case settled the legality of net of tax clauses, it did not decide the deductibility of the tax borne by the other party. It should also be noted that the case dealt with the simpler forms of net of tax clauses. It involved WHT, which is a tax that is normally remitted by the person that the clause seeks to transfer the burden to. It would have been a much more complicated scenario if the clause were structured for the payer to bear the corporate income tax obligation of the service provider, which is possible in the more complex forms of net of tax clauses.

The Amendment to Section 27 CITA

Apart from the provision of the WHT Regulations which is arguably ineffective, there was no other provision in the Companies Income Tax Act (CITA) directly addressing payments made pursuant to a net of tax clause. Companies could therefore argue that the expense is not a tax, but rather an additional consideration in the sense that the company is paying more for the supply. Therefore, the expense is a valid and necessary business expense. The Finance Act seeks to address this concern with the introduction of an amendment to Section 27 of CITA. Section 27 provides for those items or expenses which a company cannot deduct in computing its taxable profits. The amendment introduces a new paragraph (l) to subsection 1, which read together now provides that a tax deduction will not be allowed for "any taxes or penalties borne by a company on behalf of another person".

This potentially means that where a company bears the tax burden of its counterparty in an agreement, that company cannot take a deduction for that tax payment. This also extends to any penalty paid on behalf of another party. Companies now have to think twice about the potential impact of agreeing to net of tax clauses as they will have significant tax implications for the company. It seems the intention of the government is to stop companies from taking a deduction for the WHT element of the cost, where there is a net of tax clause. It is debatable whether this amendment will achieve that objective as taxpayers could argue that the tax forms part of eligible business costs, but there is a risk that the courts will rule in favour of the tax authority if the customer challenges any disallowance by way of appeal.

Suggestions

In order to avoid being caught by this new provision it is advisable for companies to;

- **Include the Grossed-Up amount in contracts**: Rather than resort to including a net of tax clause in a contract, it is advisable for companies to calculate the taxes or deductions applicable to the agreed consideration and gross up to arrive at the gross amount. This gross amount should then be included as the consideration in the contract. The disadvantage with this is that the parties will have to keep amending the contract to take into account future changes in the laws, increasing the taxes or deductions applicable to that transaction.

- **Include a properly drafted Gross-Up Clause**: Alternatively, Companies could include a properly drafted gross-up clause in the contract. There is a subtle but important difference between a net of tax and a gross-up clause. While a net of tax clause simply provides that consideration shall be paid free of any deductions or set-off, a gross-up clause goes further to say that the consideration is inclusive of the tax (in the same way that a company pays its CIT from its gross earnings). Companies could also include the grossed-up amount as the consideration at the beginning of the contract, and then include a clause which provides that the consideration will be varied if the WHT rate is varied such that the net amount after deducting the new WHT will remain the same. It is not clear how a court would view this but a carefully drafted consideration clause may provide robust protection.

- **Review all Contracts**: Companies should review all current contracts and make amendments where necessary to those clauses which suggest that the company is bearing the tax of its counterparty.

Conclusion

With the amendment to Section 27 of CITA, it is expected that the FIRS will now be on the lookout for net of tax or similar clauses in contracts during audits, with a view to disallowing the tax payments. In light of the Finance Act, Companies should review their contracts and make amendments where necessary.

Also when negotiating contracts going forward, companies should take great care in the wording of the contracts as a poorly or inelegantly drafted clause could expose a company to significant tax liabilities with no recourse to the service provider, who would in all instances collect the full amount anticipated from the contract.

Adeoluwa Akintobi is a Senior Associate in the Corporate Tax Consulting & Dispute Resolution teams of PwC. He provides corporate compliance, business advisory and dispute resolution services to clients.