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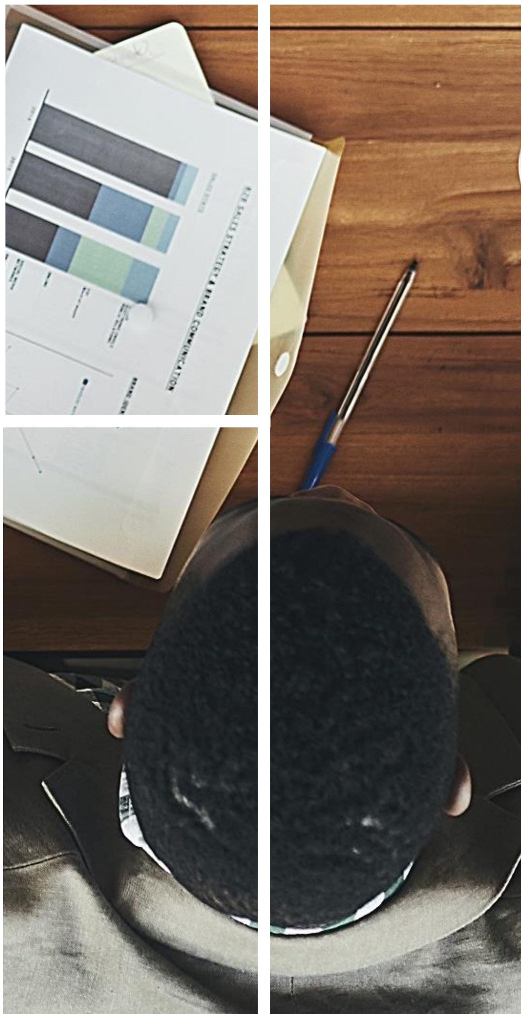
# Nigeria's Finance Bill Insights Series



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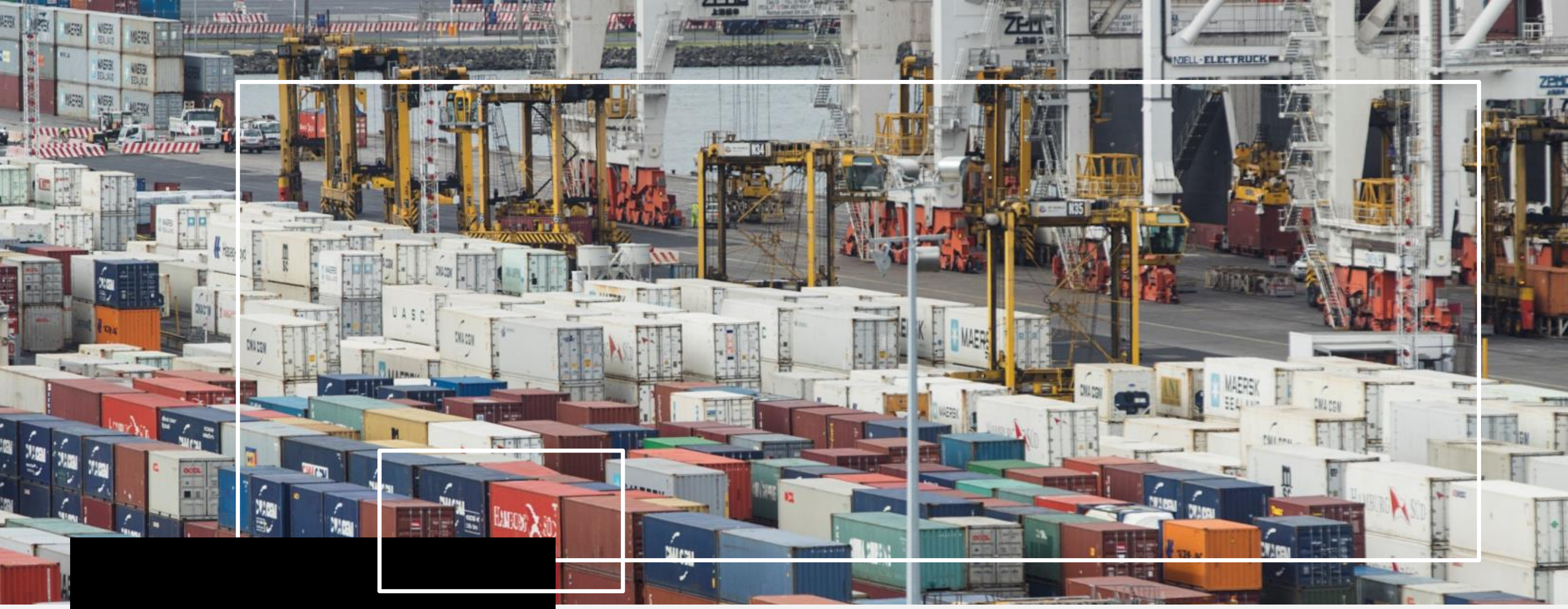

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# 1

## Overview and General Implications


## Overview and General Implications

The Nigerian economy grew by 2.28% in Q3’19 compared to 2.12% in the previous period. The marginal improvement in the economy reflected growth in oil output, the services sector, mostly driven by activities in the telecommunications, agriculture and trade sectors.

Examining other trends in the economy, inflation rose to 11.61% in October 2019. This was 0.36 percentage points higher than 11.24% in September 2019. Federal government’s external debt profile stood at N22.89 trillion by H1’19, which was 28% higher than the N17.83 trillion recorded in H1’18. Imports grew by 8.2% quarter-on-quarter in Q2’19 compared to 1.34% growth in export.

Overall, the medium-term outlook for the country from the World Bank and IMF is one of a slowly growing but stable economy. The World Bank and IMF projected GDP growth rate at 2.2% and 2.3% respectively. There is room for improvement in economic outlook, if execution of policy reforms is accelerated and regulatory uncertainty is minimised.

## The Finance Bill

With a view to consolidating these macroeconomic effects and to help reduce budget deficits, President Muhammadu Buhari submitted a Finance Bill to the National Assembly, to amend various tax laws in Nigeria. The Bill has the following strategic objectives:

- Promoting fiscal equity;
- Reforming domestic tax laws to align with global best practices;
- Introducing tax incentives for investments in infrastructure and capital markets;
- Supporting MSMEs; and
- Raising revenues for government.

## Proposed changes with general implications

### Companies Income Tax (CIT)

#### Tax on dividend distribution (excess dividend tax)

Currently, companies are charged to tax at 30% on their dividend distributions where such dividends exceed the taxable profits for the year notwithstanding that profits being distributed may have been taxed in prior years, exempt from tax, or taxed under a different tax law.

This particularly affects holding companies on dividends received from their subsidiaries thereby making Nigeria unattractive as a headquarters or group holding company location. The Finance Bill proposes changes to limit the application of the tax only to untaxed profits that are not exempt from tax.

### Tax on interim dividend

Currently, companies that declare and pay interim dividends are required to remit income tax at 30% on such dividends to the FIRS. There is a proposal to repeal this provision (which also specifies that WHT should not be applied on dividends that are not paid in money) in the Finance Bill. While the repeal will address the intended exemption of advance tax on interim dividend, it may also imply that WHT should be applied on bonus shares or dividend-in-specie.

### Commencement and cessation rules

The Bill seeks to amend the contentious commencement and cessation rules in CITA. The effect of these rules is that companies suffer tax twice on profits of at least 12 months, when they commence business. Conversely, on cessation of business, a period of up to 12 months escapes tax. The removal of these rules is considered a welcome development.

### Anti-avoidance provisions for business reorganisation

CITA empowers the FIRS to grant certain exemptions on group reorganisations, where certain criteria are fulfilled. Some of the criteria include that:
i) The companies involved should be part of a "recognised group of companies", and
ii) The transaction should be for the purpose of the "better organisation of that trade or business".

The Bill proposes that to obtain the exemption, the entities involved should be part of a recognised group of companies 365 days before the transaction, and the relevant assets should not be disposed earlier than 365 days after the transaction. The Bill defines "recognised group of companies" as "...a group of companies as prescribed under accounting standards".

## Personal Income tax Act:

- Amendment to clarify that pension contributions no longer require the approval of the Joint Tax Board (JTB) to be tax-deductible;
- On the other hand, the Bill seeks to remove the tax exemption on withdrawals from pension schemes except the prescribed conditions are met;
- Child relief (2,500 per child up to a maximum of 4) and dependent relief (2,000 per dependent for a maximum of 2) are to be deleted;
- Banks will be required to request for Tax Identification Number (TIN) before opening bank accounts for individuals, while existing account holders must provide their TIN to continue operating their accounts;
- Emails are to be accepted by the tax authorities as a formal channel of correspondence with taxpayers;
- Penalty for failure to deduct tax will also apply to agents appointed for tax deduction. This penalty is 10% of the tax not deducted, plus interest at the prevailing monetary policy rate of the Central Bank of Nigeria;
- The conditions attached to tax exemption on gratuities have been removed. Therefore gratuities are unconditionally tax exempt;
- The duties currently performed by the Joint Tax Board (JTB) as relates to administering the Personal Income Tax Act, will now be performed by the FIRS. This seems to be an error in the process of amendments to replace the word “Board” as it appears in Federal Board of Inland Revenue.

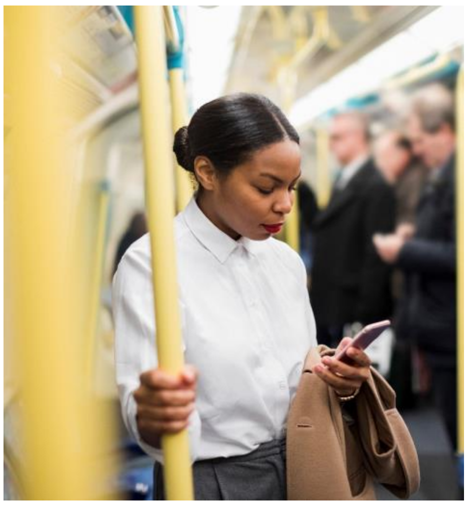
## Value Added Tax (VAT)

### Group reorganisation tax relief:

The Bill is introducing VAT exemption on Group reorganisations, provided that the following conditions are met:

- The sale is to a Nigerian company and it is for the better organisation of the trade or business;
- The entities involved are part of a recognised group of companies 365 days before the transaction, and the relevant assets are not disposed earlier than 365 days after the transaction

The current practice is that companies send an approval request letter under CITA Section 29(9) to the FIRS, and include a VAT exemption request, even though there is technically no basis for this in the VAT Act.



### Penalties

- Penalty for VAT late filing of returns increased to N50,000 for the first month and N25,000 for subsequent months of failure;
- The penalty for failure to register for VAT is reviewed upwards to NGN 50,000 for the first month of default and NGN 25,000 for each subsequent month of default;
- The penalty for failure to notify FIRS of change in company address to be reviewed upwards to N50,000 for the first month of default and N25,000 for each subsequent month of default. This penalty also covers failure to notify FIRS of permanent cessation of trade or business.

## Capital Gains Tax Act

### Group reorganisation tax relief:

Similar to the VAT amendment, the Bill is also introducing CGT exemption on Group reorganisations, provided that the following conditions are met:

- Assets are sold to a Nigerian company and is for the better organisation of the trade or business;
- The entities involved are within a recognised group 365 days before the transaction, and the relevant assets are not disposed earlier than 365 days after the transaction

The current practice is that companies send an approval request letter under CITA S29(9) to the FIRS, and include a CGT exemption request.

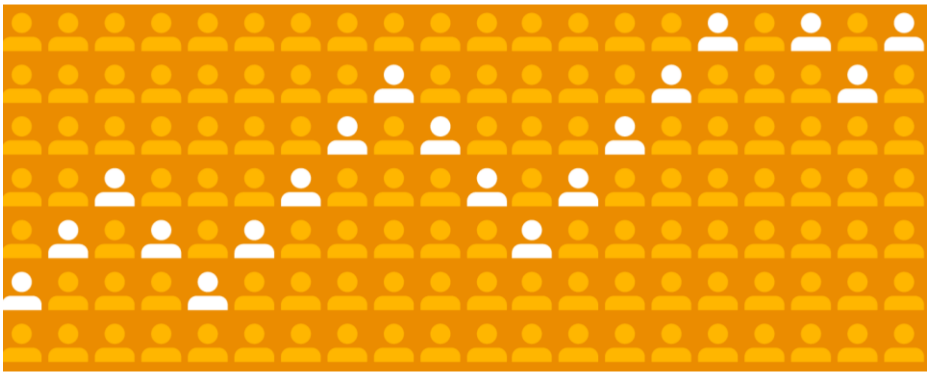
### CGT on “compensation for loss”:

Currently, the CGT Act imposes CGT on compensation for loss of employment above N10,000. The Bill seeks to expand the coverage of this provision by renaming it "compensation for loss" and increase the minimum threshold from N10,000 to N10 million.

## Takeaway

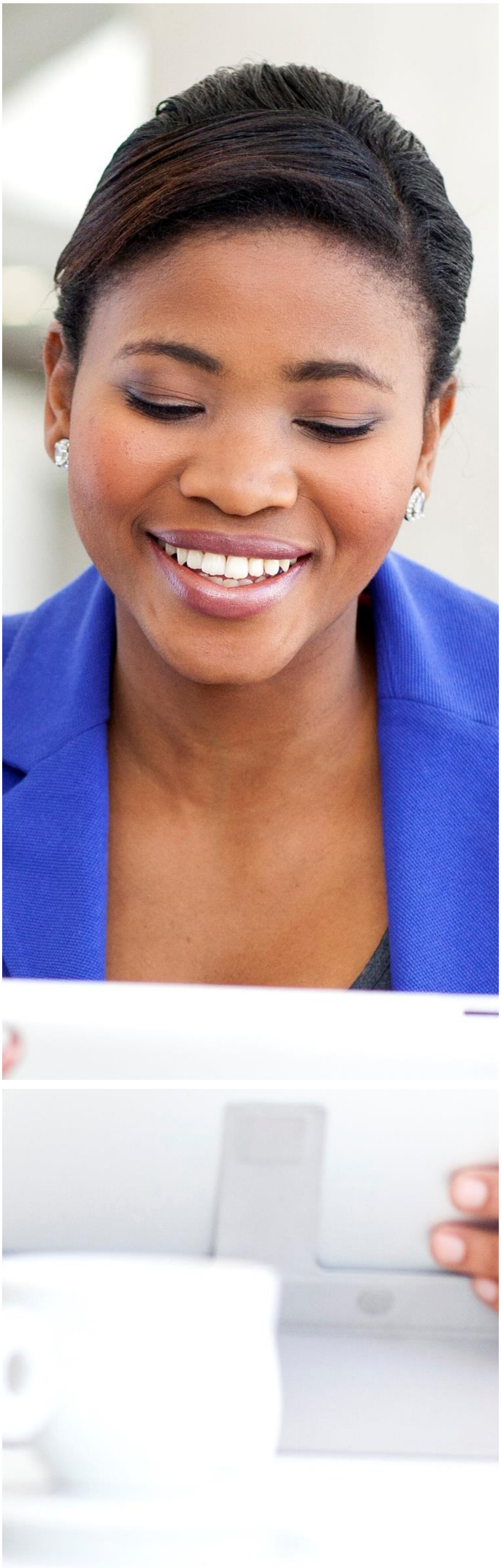
Quite significantly, the Finance Bill seeks to introduce sweeping changes to the tax laws covering seven different tax laws. Many of the changes are expected to have positive impacts on investments and ease of paying taxes especially for MSMEs.

Going forward, we hope that changes to the tax laws will be on an annual basis to ensure that Nigeria’s tax system continues to evolve in line with changes in business and economic conditions.

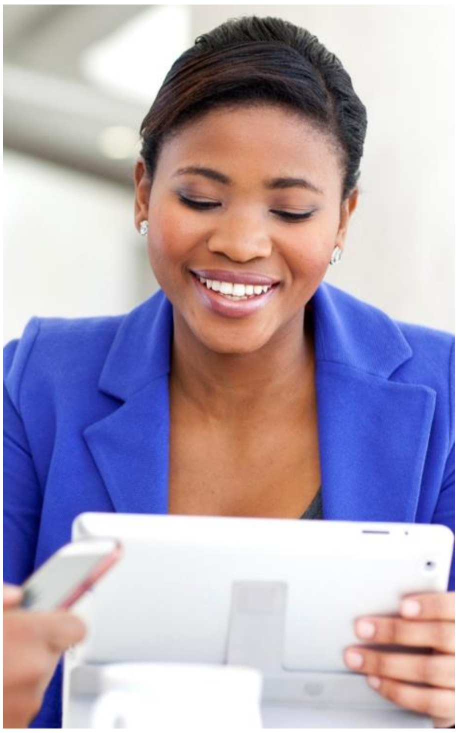


# 2

## Implications for the Banking Sector and Capital Market




## Implications for the Banking Sector and Capital Market



### Background

The financial services sector contribution to GDP advanced by 3.14% in H1'19, higher than the 2.02% half year GDP growth in 2018. Some of the trends in the banking industry include digitisation induced by fintechs, new CBN regulations including proposed recapitalization of banks, increased financial inclusion with the introduction of telecoms players to financial services, the licensing of new banks, among others.

To enhance the effectiveness of the banking sector intermediation in the real sector, the CBN raised Loan to Deposit ratio from 55% to 65%. Banks' loan books grew by 5.4% from N15.4 trillion in June to N16.23 trillion in September 2019. The recent move by the CBN restricting individual and corporates' participation in OMO is also meant to foster deposit growth in the banking system to enable further growth in lending.

With respect to the capital markets, activities in the equity markets have been bearish. The ASI declined by 14.6% between November 2018 and November 2019. Foreign portfolio inflow to the equity space declined form US$58.1 billion in Q2 2018 to US$41.3 billion in Q2 2019.

On the other hand, domestic debt market activity increased in Q2 2019, by 80%, in terms of value raised by issuers compared to Q2 2018. There has also been an increase in investors' appetite for green bonds following the introduction of the green bond framework in the Nigerian capital market, and the issuance of the first sovereign green bond in Africa, by Nigeria in 2017.

The proposed 2019 Finance Bill seeks to bring about several changes which will affect the banking and capital markets sector. Significant among these changes are the following:

### Non-deductibility of expense incurred in generating tax-exempt income

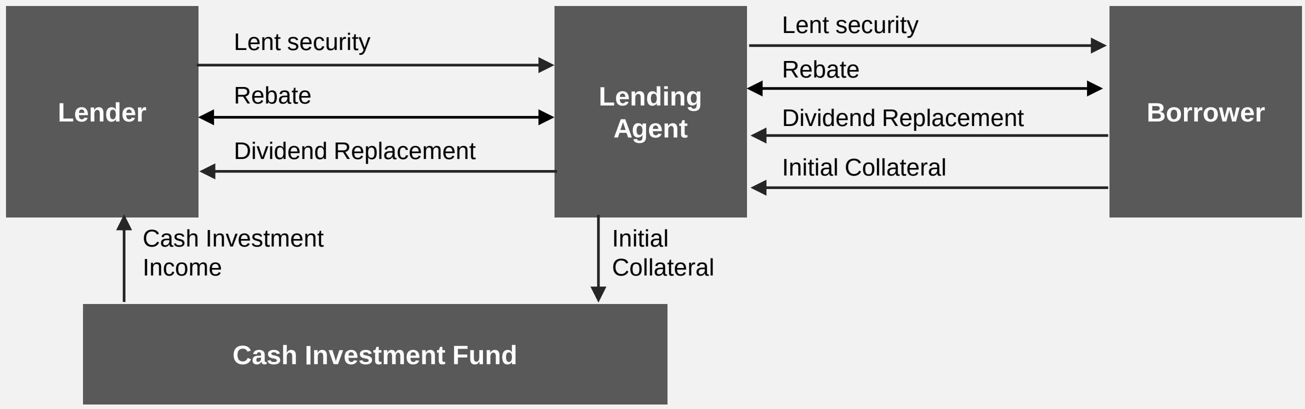
The ability to deduct business expenses for tax purposes is an important consideration for companies. The current provisions as contained in the Companies Income Tax Act (CITA) grants deductions for expenses wholly, reasonably, exclusively and necessarily (WREN) incurred in generating profits. In 2011, the Federal Government introduced the Companies Income Tax Exemption Order (the Order) which exempted interest income on corporate and government securities from taxes for 10 years. Consequently, financial institutions earn significant amounts of exempt income and often claim full deduction for their expenses without excluding any portion relating to tax-exempt income. The Bill introduces amendments by stating that expenses must be WREN incurred for generating profits that are **'chargeable to tax'.** It also states that expenses would be disallowed if they are *'… incurred in deriving tax-exempt income, losses of a capital nature and any expense allowable as a deduction under the Capital Gains Tax Act...'.*

The amendment however does not address how to apportion general expenses incurred to earn both taxable and exempt income.

### Provisions to clarify the tax treatment of securities lending transactions in the capital market

The Bill seeks to provide clarity on the tax consequences of Regulated Securities Lending Transactions (RSLT). Generally, an RSLT may involve the exchange of shares between a Lender and Borrower for short selling for example in a regulated securities market as illustrated below:

## Overview of Securities-Lending Transaction Collateralized With Cash




Source: Morningstar Analysts

Although this activity is not captured under existing tax laws, the Bill provides clarity in the following ways:

- Extends the definition of "interest" and "dividends" under the charging section of CITA to include compensating payments made by a "Lender to a Borrower" and by a "Borrower to a Lender" respectively.
- Recognises that the exchange of securities and shares in a RSLT between a Lender, Borrower approved agent which are subsequently returned would not constitute disposal of an asset.
- Applies deduction of withholding tax (WHT) on interest only at the point of payment to the Borrower. If paid through an agent, the agent would be responsible for the WHT and if paid directly, the lender would deduct WHT.
- Applies deduction of Withholding tax (WHT) on dividends only at the point of payment to the Lender.
- Allows the Lender to take a deduction for compensating payments which qualify as interest, made to the agent or borrower. Conversely does not allow the Borrower to take a deduction for compensating payments which qualify as a dividend to the Lender. The agent is also not allowed to deduct compensating payment qualifying either as interest or dividend as such payments should be a pass-through for the agent.
- Exempts documents, shares and securities relating to a RSLT from stamp duty.

### Introduction of 'thin capitalisation' rules

Currently there are no thin capitalisation rules in Nigeria. However, in practice, FIRS sometimes seeks to disallow interest deductions considered excessive, albeit arbitrarily. The Bill now introduces a specific benchmark of thirty percent (30%) of earnings before interest, taxes, depreciation and amortization (EBITDA) as the limit for interest deduction on loans **by a foreign 'connected person'**.

Any excess interest expense can only be carried forward for 5 subsequent years. The Bill exempts Nigerian subsidiaries of foreign companies engaged in banking and insurance from this rule.

The proposed benchmark is consistent with the recommendation of the Organisation for Economic Cooperation and Development (OECD) through its Article 4 on base erosion and profit shifting (BEPS) project.

### Amendment to the Stamp duty

The Stamp Duty Act (SDA), one of the oldest laws in Nigeria is riddled with outdated references that do not reflect current economic realities. One of such references, which is being repealed by the Bill, is the imposition of stamp duties on receipts with a value of four naira (NGN4) and above. Another is the lack of reference to electronic transactions and reliance on physical adhesive stamps.

To broaden the instruments and transactions that are liable to duties, the Bill redefines terms used in the SDA to include electronic stamping. The Bill also legalises the charge of NGN50 on electronic receipts or electronic transfers made to any bank account on transactions of NGN10,000 and above with exemptions granted for bank transfers between own accounts.

### Removal of 100% WHT exemption relating to interest on foreign loans

Under the current wording of the CITA, a range of partial to total exemption from Withholding Tax (WHT) is granted to interest on foreign loans, depending on specified criteria. Full exemption was possible to foreign loans where the loan term is above 7 years including a moratorium of 2 years. Partial WHT exemption is available for loans of shorter terms and grace periods. FIRS often interprets the grace period inconsistently as:

- only principal is suspended,
- both principal and interest is suspended,
- interest is suspended and not accrued,
- interest is suspended but may be accrued.

| Repayment period including Moratorium | Moratorium period (previously grace period) | Tax exemption (CITA) | Tax exemption (Finance Bill) |
|---|---|---|---|
| Above 7 years | **Not less than 2 years** | **100%** | **70%** |
| 5-7 years | **Not less than 18 months** | **70%** | **40%** |
| 2-4 years | **Not less than 12 months** | **40%** | **10%** |
| Below 2 years | **Nil** | **Nil** | **Nil** |

The Finance Bill seeks to reduce the maximum exemption to 70% of WHT rate with consequent reductions for loans with lower tenors and moratorium. In addition, The Finance Bill includes definitions for the terms "Moratorium" and "Repayment Period" and has deleted the term "Grace period".

### Unit trusts

Section 23(1)(f) which relates to Unit Trusts will be excluded from the list of income that must attract WHT deduction. However, Section 80 that imposes WHT on dividends has not been amended to specifically exclude dividends from unit trusts.Therefore the uncertainties regarding applicability of WHT, corporate income tax and excess dividend tax may remain unresolved contrary to the intention and best practices to ensure that unit trusts are tax transparent.

## Connecting the dots

### Financial inclusion

The CBN recently issued a directive for banks to charge a stamp duty of NGN50 on Point of Sale (POS) transactions of NGN1,000 and above. This directive has been viewed by many as retrogressive and contrary to the government's plan to reduce the proportion of financially excluded adults to 20% by the year 2020. The Bill however provides some succour by raising the minimum threshold of NGN1,000 to NGN10,000.

### Loan to deposit ratio (LDR), restriction on investment in OMO Bills and economic growth

Banks and other operators in the capital markets have made notable investments in government securities due to their low risk nature and tax benefits. Such investments have led to the crowding out of small and medium enterprises and other key players in the real sector. In order to mandate investment of funds into other sectors, the CBN adopted measures such as the mandatory minimum Loan to Deposit ratio (LDR), currently set at sixty five percent (65%) to channel deposits to the real sector. The Bill aims to further encourage lending to the real sector by disallowing tax deductions for expenses related to tax-exempt income.

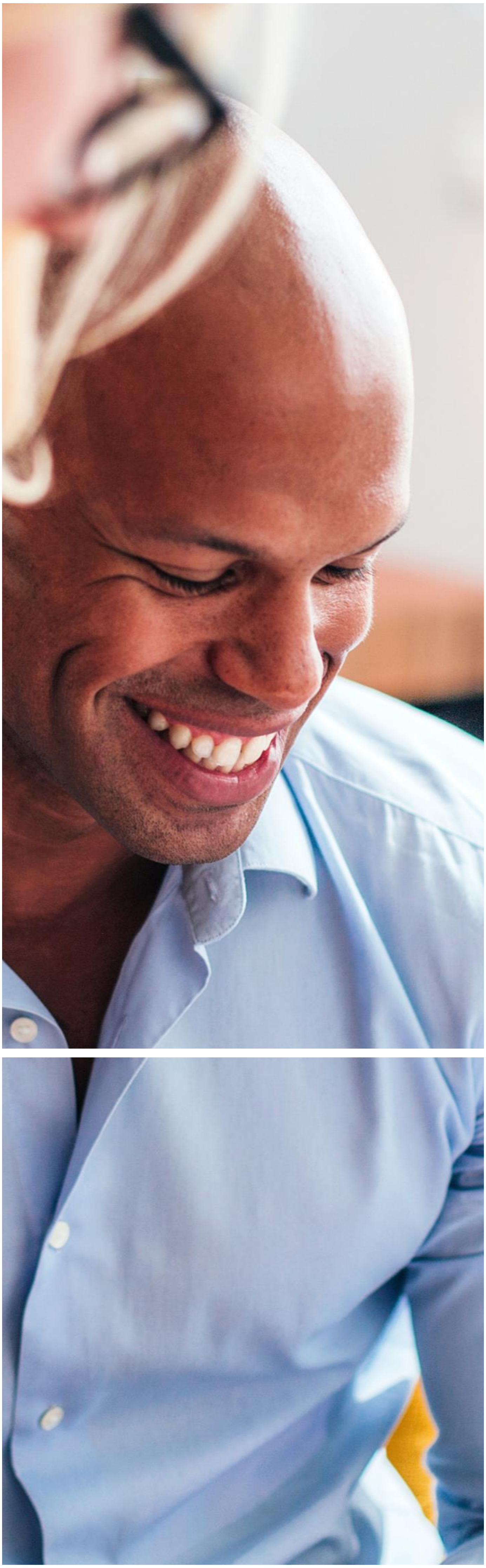
The CBN has also excluded resident individuals and non-bank corporates from participating in its open market operations (OMO) at both the primary and secondary market. This is an indication that there may not be an appetite for government to extend the current tax exemption on treasury bills and corporate bonds beyond the 10 years i.e. 2 January 2022.

## Takeaway

Overall, we expect the general changes being introduced by the Finance Bill and the specific amendments targeted at the banking sector and the capital market to have a positive impact especially in the medium to long term. The clarifications provide better certainty around taxation for companies operating in the sectors. It is also expected to bring about a significant increase in investments and stimulate activities in the capital market. Nonetheless, there are areas that still require further clarity for example the amendment does not solve the ambiguity of how general expenses would be attributed to tax-exempt income for tax purposes. Also, the thin capitalisation rule will require detailed guidelines or subsidiary legislation to address grey areas that may arise regarding definitions and interpretations. Therefore, affected companies should carry out an impact assessment and engage with government early to ensure best outcome and limit disputes with the tax authority.

# 3

## Implications for the Insurance Industry



# 3

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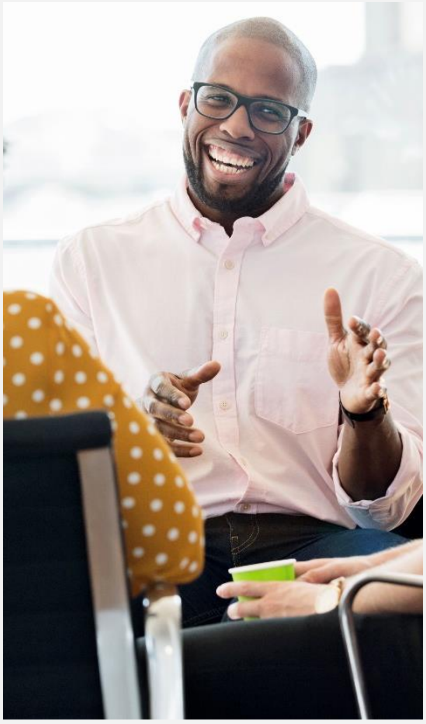


### Background

Over the past three years (2016 – 2018), the asset base of Nigerian insurance companies has grown by a Compound Annual Growth Rate (CAGR) of 17%, to N1.3 trillion as at December 2018. The estimated Gross Life Insurance written in 2018 is N166.91 billion as compared to the N152.56 billion in 2017, this reveals a positive but slow increase.

The National Insurance Commission (NAICOM) is spearheading a recapitalization policy with a deadline of June 2020. The policy is aimed at expanding the capital base of insurance companies, with the goal of enhancing the industry capacity for risk management. It is expected that this could spur some mergers & acquisitions, as well as international investments in the industry.

The capital requirement of insurance companies has been raised from N5 billion to N18 billion for life insurance companies and N3 billion to N10 billion for property and casualty insurance.

The industry is faced with low insurance penetration (currently 0.31%), as most Nigerians are uninsured due to lack of awareness of insurance products and services. The insurance companies are also prone to low profits, driven by inflation. It is envisaged that the Nigerian microinsurance scheme would help expand the scope of insurance to low-income earners.

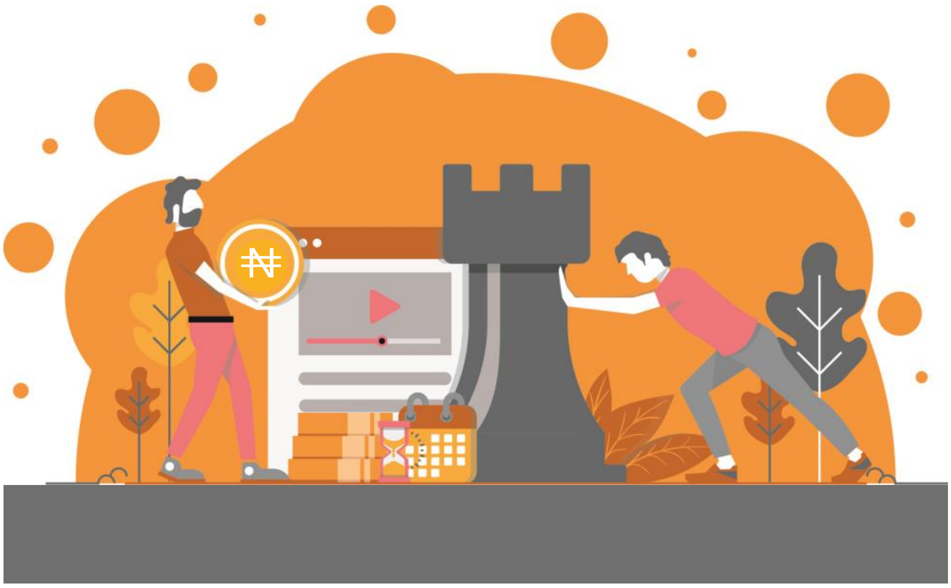
The Finance Bill 2019 proposes several changes that will affect the Insurance companies. We have analysed these changes below.

### Current Provisions

#### Life business

a) **Taxable income for life insurance business -** Section 16(2)(a) of the CITA taxes all investment income less management expenses including commissions subject to further limitations.

b) **Life Insurance minimum tax** – Section 16(9)(c) suggests that after all deductions have been granted to life insurance companies, the company must have 20% of its gross income available as taxable profit. This is a type of minimum tax provision different from the general minimum tax provision in Section 33(1) of the CITA. This effectively means that insurance companies are almost always subject to a higher basis of minimum tax compared to other companies.



### Non-life business

c) **General Insurance (Tax deduction of reserve for unexpired risk)** – Section 16(8)(a) of the CITA limits the amount of deduction for unexpired risks to 25% of total premium for marine cargo and 45% of other classes of general insurance business. This is inconsistent with Section 20(1) (a) of the Insurance Act which prescribes time apportionment as a basis for determination of the provision of unexpired risks.

d) **General Insurance (Claims and Outgoings)** – Tax deductions for other reserves, claims and outgoings is capped at 25% of total premium. Restricting the tax deduction for claims is a significant disruption to insurance business as payment of claims drives customer confidence.

e) **General insurance minimum tax** - Section 16(8)(b) limits the tax deduction allowed for a general insurance company such that after deductions and capital allowances, there will be an amount of "not less than 15% of taxable profit for tax purposes". This phrase is ambiguous and has been redundant since its introduction in 2007. Some insurance companies however used it to their advantage, depending on their ability to convince the tax authorities.

### Tax losses for life and non-life businesses

f) **Term limit for tax losses carried forward –** Section 16(7) of the CITA limits the period of carrying forward tax losses for life and general insurance businesses to four (4) years of assessment.

## Proposed Amendment & Analysis

### Life business

a) **Taxable income for life insurance business –** Section 4(a) of the Finance Bill 2019, limits the investment income captured for tax purposes to income derived from the investment of shareholders' fund.

**Analysis** - This provides a current year exemption from tax for investment income earned on funds obtained from policy-holders and not shareholders. There is a question around the effectiveness of this incentive given that a major percentage of income streams earned by life insurance businesses are tax exempt based on the current income tax regime e.g. income from treasury bills, government bonds etc. There is a tax planning opportunity in relation to funding investments during any financial year. An area of ambiguity can also arise as a result of the lack of definition of the term "shareholders' fund".

b) **Life Insurance (Minimum tax) –** This provision of CITA is to be deleted.

**Analysis** – This current provision rendered ineffective the benefits of earning tax exempt income by life insurance companies. The elimination of this draconian provision will have a positive impact on insurance businesses.

### Non-life business

c) **General Insurance (Tax deduction of reserve for unexpired risk)** – The Finance Bill proposes that the claim for reserve for unexpired risks in a financial year, should be calculated on a time apportionment basis of the risks accepted during the financial year.

**Analysis** - This seeks to ensure that the tax deduction obtained is in line with the requirements of section 20(1)(a) of the National Insurance Act. However, these are all overridden by the requirements of the International Financial Reporting Standards (IFRS). Going forward, the claim would be based on the unearned premium reserve. The inclusion of the phrases 'time apportionment basis' and 'risks accepted during the year' are indications that only a treatment that aligns with the financial statements would be acceptable. This means that the position taken by some insurance companies whereby a deduction is taken during the year for the balance of the reserve in the statement of financial position may no longer be possible.

d) **General Insurance (Claims and Outgoings) –** The Finance Bill eliminates the restriction of tax deduction for claims and outgoings to a cap of 25% of total premium. The Finance Bill also introduces an additional allowance of 10% of estimated outstanding claims for claims incurred but not reported at year end. Any portion of the allowance not utilised against claims and outgoings will be added to the total profits of the following year.

**Analysis** - This seeks to ensure that the tax deduction obtained is in line with the requirements of section 20(1)(b) of the National Insurance Act. Although in line with the International Financial Reporting Standards, the provision for such claims is based on actuarial valuations. The elimination of the restriction of claims and outgoings is positive for the industry as valid business expenses of insurance companies would no longer be disallowed from a tax perspective.

e) General insurance minimum tax - The ambiguous provision of the law has been deleted.

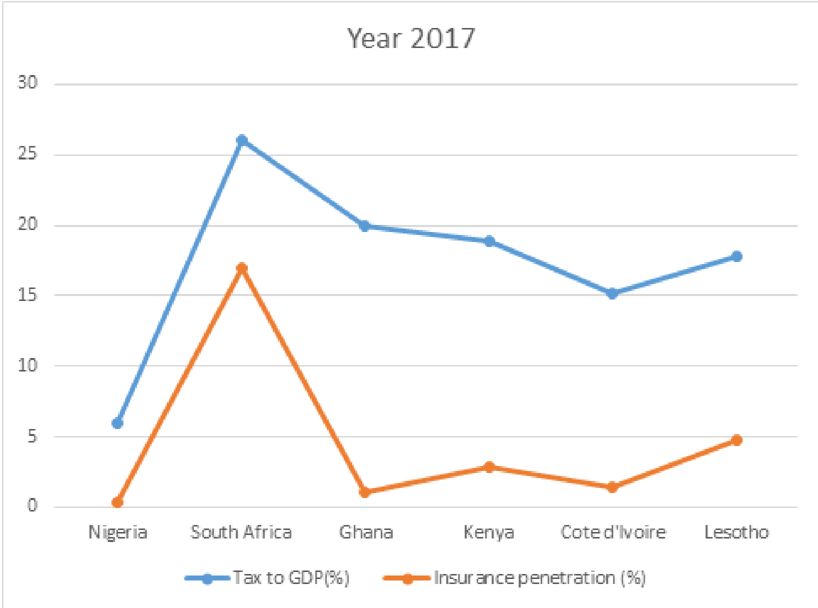
**Analysis** - This eliminates the inconsistent treatment in the industry and the opportunity for one taxpayer to be treated more favourably than others based on 'relationship' with the tax authorities.

### Tax losses for life and non-life businesses

f) **Term limit for tax losses carried forward** – Section 4(b) of the Finance Bill 2019 provides for the deletion of the phrase limiting the term of tax losses being carried forward.

**Analysis** - This provides fiscal equity by aligning the treatment of tax losses in the Insurance sector with the treatment in other sectors of the economy. The sector has longed for this amendment for many years.

## Connecting the Dots


The graph above shows some correlation between insurance penetration and tax collection in developing countries. The graph shows some comparable countries and demonstrates that tax and insurance move in the same direction. Many factors contribute to this correlation. One of the most important factors for Nigeria may be cultural i.e. a culture of not paying taxes and not taking up insurance. People are likely to pay taxes if they are inclined to buy insurance; and likewise, people are unlikely to buy insurance if they do not pay taxes.

Irrespective of this clear correlation, the tax laws in Nigeria had provided dis-incentives to the sector by limiting their losses, placing an obligation to pay significant minimum tax when they make losses or earn little profits and restricting claims for unearned premium reserve. The proposals in the Finance Bill is a good step in addressing this gap.

This step by the federal government complements the actions of NAICOM in the past to reform the tax laws and provide more certainty for investors through a friendly fiscal regime.

## Takeaway

The proposed changes will drive positive growth in the industry and encourage foreign direct investment into the sector. This will also reduce the cost of compliance for insurance companies as ambiguous sections of the law are either eliminated or amended. The proposals also reduce uncertainty of tax treatments and the need for negotiation with tax officials which could sometimes provide an avenue for compromise.

# 4

## Implications for the Energy and Utilities Sector

4

## Implications for the Energy and Utilities Sector

Nigeria moved up 15 places on the ease of doing business index to 131st position globally in the latest report by the World Bank. In Africa, the country moved up one spot to 21st in Africa, still much behind countries such as Mauritius, Rwanda, Kenya, Tunisia and South Africa – the top 5 on the Continent. The overall GDP growth has trended downward since 2015 and remains below population growth rate following the economic recession in 2016. GDP performance of the oil sector has also been lacklustre. FDI flows to the oil and gas sector in Nigeria has been low since 2016, due to regulatory complexity and uncertainty, as well as competing forces for viable investments in other African countries with less complex issues.

Crude oil prices, production and exports have trended lower since 2015 as global oil demand succumb to the global economic slowdown, policy shifts to electric cars and cleaner fuel sources as well as shale oil supply growth. Actual oil revenue inflow lags behind the budgeted oil revenue targets with the variance widening since 2015. Petroleum under-recovery costs (or subsidy), has been rising since 2017. The federal government allocated N450 billion to petrol subsidy in its 2020 budget proposal.

Nigeria's oil sector is in recovery with 4 consecutive quarters of negative growth from Q2'18 to Q1'19. The crude petroleum sector contributed 8% of the national GDP in Q2'19, and 8.6% in FY'2018. The sector accounted for 59% of the Federal government's budgetary revenues and 82.3% of the country's exports in 2018. The sector grew by 5.15% in the second quarter of 2019 as production increased to 1.96 million barrels per day (mbpd) and with global prices averaging US$67.47 in the same period. Despite this, the share of the oil sector in the GDP declined quarter-on-quarter from 9.2% in Q1 2019 to 8.8% in Q2 2019.

Through the Finance Bill, the government has proposed several changes that would affect the Energy and Utilities sector. Some of the changes will have significant impacts on investment decisions as they materially reduce shareholder returns. We have analysed these changes below.

### Proposed changes

#### Downstream gas utilisation incentive

The Companies Income Tax Act ("CITA") provides that companies engaged in gas utilisation (downstream operation) are granted a series of incentives for utilisation of gas. These incentives include:

- A tax-free period for up to five years
- Accelerated capital allowance after the tax-free period
- Tax-free dividends during the tax-free period
- Tax deductibility of interest payable on loans obtained with the prior approval of the Minister for a gas project

The Finance Bill proposes to modify Section 39 through the following:

- Capital allowances will be computed and considered utilised during the tax-free period such that after the tax-free period, capital allowance will be claimable on the tax residual value of qualifying capital expenditure (QCE)
- Deletes the need for Ministerial approval for tax deductible interest
- Companies cannot claim Gas Utilisation Incentives (GUI) and Pioneer Status Incentive (PSI) on the same QCE

## Investment tax credit on obsolete plant and machinery

Section 41 of the CITA grants an incentive to companies that replaced obsolete plant and machinery, whereby a company that incurs an expenditure for the replacement of obsolete plant and machinery, are granted fifteen per cent investment tax credit. The Bill proposes to repeal this Section and eliminate the incentive going forward.

## Treatment of dividends paid out from upstream petroleum operations that suffered tax under the Petroleum Profits Tax Act (PPTA)

Section 60 of the Petroleum Profit Tax Act (PPTA) exempts dividends paid out of petroleum profits from further tax in recognition of the relatively higher corporate income tax rate on petroleum operations. This meant that withholding tax was not charged on dividends from upstream operations.

This is also supported by Section 43 of CITA.

The Finance Bill seeks to repeal Section 60 of the PPTA and Section 43 of CITA. This means that dividends from upstream companies will henceforth be subject to withholding tax. The current rate is 10% (or 7.5% if payable to recipients of a treaty country).

## Taxation of technical and management fees

Oil and gas companies tend to incur significant costs by way of technical, management, consultancy or professional services carried out by non-resident companies. The Bill creates a proxy for such activities performed outside Nigeria if there is a significant economic presence for the services provider in Nigeria. The Nigerian recipient of such services will now be required to deduct WHT from the applicable fees which will be regarded as the final tax in the hands of the recipients. This could increase the costs of such services to Nigerian companies where the service providers pass on the withholding tax costs through "net of tax" clauses especially if there is no tax relief available to the foreign company in its home country.

# Analysis of the changes

## Downstream gas utilisation incentive (GUI)

**1. Consolidated incentive scheme**

The proposed amendments tries to consolidate the GUI and PSI into one incentive framework that would be applicable to downstream gas utilisation. Under the new consolidated framework, the tax-free period under the GUI is renamed as 'pioneer period'. This means that companies that obtain the GUI could argue that they should be automatically treated as pioneer companies (with some exceptions as considered below). The Bill introduces a clause which prevents companies that have enjoyed incentives under the Industrial Development (Income Tax Relief) Act (i.e. PSI) from utilising the GUI defined under CITA. Prior to this amendment, companies who have enjoyed the GUI, which is a three to five-year tax-free period could, theoretically also apply for PSI under IDITRA, thereby enjoying another three to five-year tax free period. The proposed amendment removes this possibility. The use of the term 'pioneer period' in the revised GUI which is meant to exclude companies from enjoying PSI under IDITRA however appears to be a contradiction.

**2. Capital allowances to be deemed utilised during the pioneer period with no additional investment allowance of 15%**

Under the Finance Bill, companies that benefit from the GUI are required to compute capital allowances during the 'pioneer period' and treat the capital allowances as utilised against their pioneer assessable profits. Under the current rules, there are no clear provisions on how companies should treat their asset for capital allowance purposes if they apply the GUI without using the principles applicable under the PSI where companies can suspend the claim of capital allowance until after the tax holiday period. This results in significant tax optimisation where companies would first benefit from the tax holiday and subsequently, they are shielded from tax by relieving all their investment in the gas assets through capital allowances post pioneer. The proposed changes in the Finance Bill eliminates this advantage for gas companies even though other pioneer companies would still be able to benefit from it.

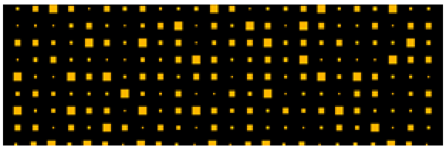
Also, in the current GUI, 15% additional investment allowance is granted to gas companies after the tax-free period. This allowed companies to claim 15% investment allowance in addition to 10% investment allowance, since the law does not make the claim of one exclusive of the other. In the proposed Bill, the 15% investment allowance has been deleted and therefore after the pioneer period, a gas company can only claim the general 10% investment allowance on its plant and equipment.

**3. Interest on loan would be subject to general CITA rules**

The Finance Bill proposes to eliminate the requirement that tax deductions would be taken for interest payable on any loan for a gas project as long as the loan has been approved by the Minister. This proposal means that the general rules on tax deductibility of interest on loans would be applicable to gas companies and if they obtain related party loans, they would be subject to Transfer Pricing rules as well as the new thin capitalisation rules.

## Investment tax credit on obsolete plant and machinery

The deletion of the investment tax credit of 15% granted for investment in replacing obsolete plant and machinery rationalises the available incentives and eliminates the ambiguity as to what is considered as 'obsolete'. The removal of this incentive would reduce disputes which could arise from difference in interpretation between the FIRS and taxpayers.



## Withholding tax on dividends from upstream petroleum operations

The proposal to repeal section 60 of the PPTA and Section 43 of CITA means dividend distributed from profits already charged to Petroleum Profits Tax would be subject to WHT up to 10%. This could be quite adverse for the upstream oil and gas exploration and production sector which are chargeable to the highest tax rate (up to 85% in some instances). This will affect the valuation of oil and gas assets; global competitiveness and investment appraisals going forward.

Upstream oil and gas companies with significant retained earnings may consider distribution before the Finance bill is passed into law as there are no grandfathering rules in the proposed Bill.

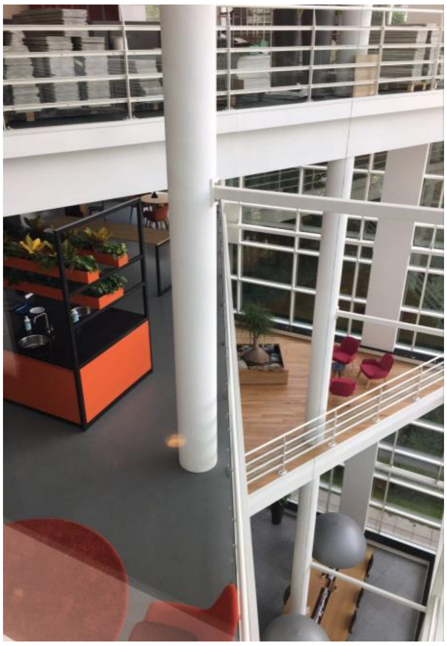
## Connecting the Dots

The amendments affecting the industry are focused on increasing revenue for government through introduction of WHT on upstream dividends, the deletion of investment tax credit on replacement of obsolete plant and machinery, deemed utilisation of capital allowances for gas companies in pioneer and the elimination of 15% investment allowance. These changes are all focused on increasing government revenue. It is clear that the government considers the oil and gas sector as an important sector for funding the 2020 budget.

The Deep Offshore and Inland Basin Production Sharing Contract Act enacted in 1993 was introduced to grant certain incentives whereby oil companies would fund government's participation in oil and gas assets. These incentives ranged from reduced royalty rates to lower tax rates to encourage investments in these areas. The PSC Amendments introduces provisions for price-reflective royalties, 8-year periodic review of the PSCs and penalties for non-compliance with the Act. This further supports the position that the government considers the industry as a 'low-hanging-fruit' to achieve its revenue objectives in the short-term.

The Petroleum Industry Bill (PIB) which was initially introduced in 2012 to change the regulatory and fiscal landscape of the industry has faced challenges unlike the Finance Bill. In order to overcome these challenges, the Bill was split into different components including one to deal with governance and regulatory and another to deal with fiscal issues.

With the renewed focus of the National Assembly on tax matters, we expect some traction on the petroleum bills in 2020.



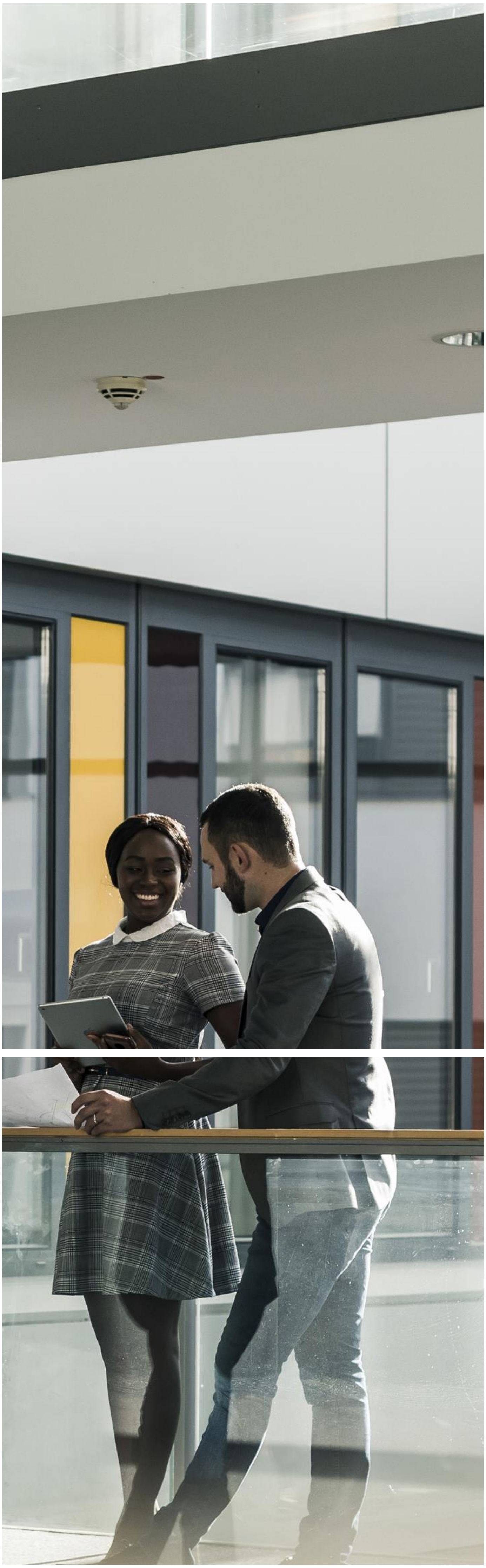
## Takeaway

If the Finance Bill is passed into law, the energy and utilities sector (in particular, oil and gas) would witness an increase in their tax costs including royalties. Contrary to the outlook of the 2020 budget proposal that envisages that the non-oil sector would contribute more to revenue generation, we expect that the oil and gas industry may in fact contribute more than it did in 2019, based on the current proposals.

The lack of certainty around the fiscal outcomes of impending PSC reviews may also be an additional disincentive for future investments in the sector. Affected companies should assess the commercial impact of these changes on their current and future cash flows / returns.

# 5

## Implications for the Consumer and Industrial Products Industry




## Implications for the Consumer and Industrial Products Industry

### Background

The need to diversify Nigeria's economy has led to a drive by the government to boost the consumer and industrial products industry by creating an enabling environment for investors.

The industry is hampered by low capacity utilisation induced by erratic power supply and other infrastructure deficits. Other challenges include multiplicity of taxes, inconsistent trade policies, low aggregate demand, high cost of importing raw materials for production, among others.

Opportunities in this industry could be spurred by the recent border closure, which is expected to encourage domestic production and reduce the competition from imported products. Also, the restriction of FX for certain products offers another potential opportunity for investment in the industry. Government initiatives at boosting the manufacturing sector include the Economic Recovery and Growth Plan (ERGP), which includes plans to grow small and medium scale manufacturing activities.

The Finance Bill contains a number of tax changes that will impact the sector. We have provided an analysis below.

### Proposed amendments and analyses

#### Excise duties on imported goods

Certain locally manufactured items are subject to excise duties at specified rates. These include tobacco, spirit and alcohol. Other items in the schedule of excisable products include perfumes, cosmetics, toilet papers, non-alcoholic beverages, telephone recharge vouchers, soaps and detergents, paper packaging, spaghetti, noodles and so on. However, excise duties on these items were suspended and currently not applied.

The Bill aims to amend the Custom, Excise Tariff etc. (Consolidation) Act (CETA), to subject importation of excisable products to excise duties at the same rates applicable to locally manufactured items. This aims to create a level playing field for local manufacturers and raise revenue for the government.

#### Replacement of obsolete plant and machinery

Section 41 of the Companies Income Tax Act (CITA) grants a 15% tax credit to a company that incurs capital expenditure to replace "obsolete" plant and machinery. This is in addition to the capital and investment allowances ordinarily available on such capital expenditure.

The Bill has deleted this provision in order to rationalise incentives and due to the ambiguity on what constitutes an "obsolete" plant or machinery, making the incentive redundant in practice.

#### Changes to the Value Added Tax (VAT) regime

a) **Increase in VAT rate:** The Bill seeks to increase the VAT rate from 5% to 7.5% to help reduce budget deficits, fund the new minimum wage and provide social services. In Nigeria (unlike most other countries), VAT incurred on fixed assets and services cannot be claimed as a credit against VAT collected from sales. The implication is that the VAT rate increase will result in higher cost production and investment, which will be passed on to the consumers.

b) **Expansion/clarification on exempt items:** The Bill includes a definition of "basic food items" for the purpose of VAT exemption. This is defined as "agro and aqua based staple foods…" and include items such as bread, cereal (raw or semi-processed), cooking oil, culinary herbs (if raw and unprocessed), fish (other than ornamental), flour and starch (refined or unrefined), fruits (including dried), milk (including powdered), nuts and pulses (including roasted, fried, boiled, salted), roots (also in the form of flakes), salt (excluding industrial), vegetables (dried or ground), and water (excluding sparkling or flavoured). The Bill also includes sanitary items in the exemption list, and clarifies that services provided by Microfinance Banks, and tuition paid for nursery, primary and secondary education are VAT exempt. The clarification for microfinance banks is long overdue as microfinance banks replaced the old community banks which were exempt from VAT under the current law.

**C. Definition of "Goods" and "Services":** For the purpose of applying VAT, the bill defines "goods" as movable tangible properties excluding money or securities, and transferrable intangible products, assets or property, excluding interest in land. It also defines "Services" to include anything other than goods, money or securities which is supplied excluding services provided under a contract of employment.

Under the current interpretation of VAT laws, the supply of incorporeal and intangible property is considered outside the scope of the VAT Act. However, the definitions in the Bill seek to capture these transactions.

**D. Deleting definition of "imported service":** The current definition of "imported services" has been deleted to align with the destination principle.

**E. Definition of "exported service":** Exported services are defined in the Bill as "services provided within or outside Nigeria to a non-resident person provided that the non-resident person is neither a fixed base nor a permanent establishment in Nigeria.

**F. VAT registration threshold:** Only a business that has an annual turnover of NGN 25 million and above, will be required to register for VAT, charge and collect VAT on its sales. This enhances competitiveness of small businesses, and avoids the burden of administering VAT on such small businesses by the FIRS.

However, a potential downside of this is that such businesses will be unable to recover input VAT incurred on their purchases, especially those involved in the supply of VATable products. Some large firms may in fact prefer to engage suppliers who are registered for VAT to enable them claim all input VAT across the value chain.

**G. Cash basis**: The Bill specifies that VAT is to be accounted for on a cash basis. In this regard, output VAT will be based on VAT collected and input VAT will be based on VAT paid while the difference will be remitted to the FIRS or treated as future credit / refund as the case may be.

**Excess Dividends Tax (EDT) will only apply on the distribution of untaxed profits that are not tax exempt**

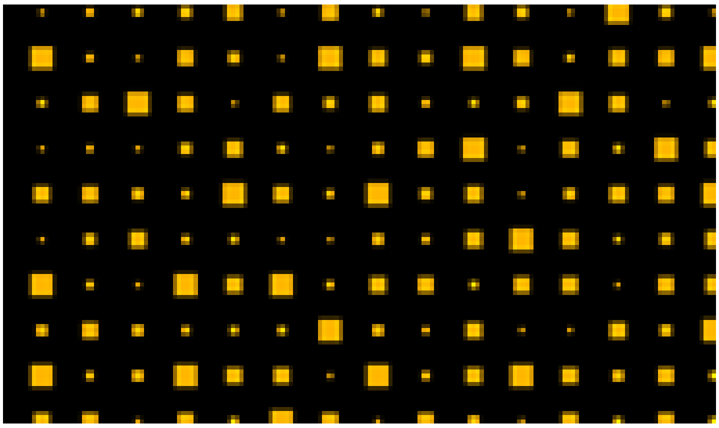
The EDT rule mandates a Nigerian company, when it pays out a dividend as profit, to compare the dividends it distributes with its taxable profits of the same year. Where the dividends exceed such profits, income tax at 30% is applied on the dividends.

EDT is imposed whether the dividend is being paid out of previously taxed retained earnings or from tax-exempt income. This has led to double taxation and has been a major issue for Nigerian holding company structures, entities that reinvest their profits over time before paying dividends, and those that earn significant tax-exempt income.

Based on the Finance Bill, EDT will no longer apply to:

a) Dividends paid out of previously taxed profits included in retained earnings;
b) Dividends paid from profits that are exempt by any tax law;
c) Distributions made by a Real Estate Investment Company.

This addresses the major concerns around the EDT provision. Going forward, companies will need to keep track of their profits from these sources to avoid EDT exposure upon distribution.



### Introduction of Thin Capitalisation (thin cap) Rules

Nigeria currently does not have any thin cap rules. However, interest charged between related parties is expected to be at arm's-length. The tax authority may disallow any related-party interest considered to be excessive, and sometimes consider a rule-of-thumb debt:equity ratio of 3:1 as appropriate.

The Bill introduces a specific benchmark of thirty percent (30%) of earnings before interest, taxes, depreciation and amortisation (EBITDA) as the limit on tax deductible interest on loans granted to a company **by a foreign 'connected person'**.

Interest expenses not fully deducted in a tax year can be carried forward for a maximum of 5 subsequent tax years. Violation of this provision will attract a 10% penalty on the interest adjustment, in addition to interest at the CBN monetary policy rate plus a spread to be determined by the Minister.

The definition of "debt" in the amendment is worded broadly, to capture expenses that are in substance interest, even though their form may differ. The amendments also include third party debt arrangements which have a (related party) guarantee.

The Bill states that thin cap rules do not apply to "Nigerian subsidiary of a foreign company which is engaged in the business of banking and insurance". This exemption is ambiguous, and can be interpreted to mean that locally owned banks/insurance companies will not be exempted. Also, it seems to suggest that it is the foreign company that must be engaged in banking. In other countries where similar exemptions are granted, it is the local company that must be engaged in banking to qualify for the exemption.

### Transfer Pricing to replace ministerial/NOTAP approval for deductibility of certain expenses

CITA currently requires companies to obtain the approval of the Finance Minister to get tax deduction for management fee, and expenses incurred to earn management fee income. CITA also requires the FIRS to approve expenses incurred outside Nigeria. In practice, approvals obtained from the National Office for Technology Acquisition and Promotion (NOTAP) are considered acceptable.

The Bill proposes to amend these provisions by stating that for related party expenses to be tax-deductible, such expenses should be consistent with the Nigerian Transfer Pricing Regulations.

The effect of this change is that management fees, costs to earn management fees, and foreign expenses relating to third party transactions will be tax deductible to the extent that they meet the WREN test (i.e are wholly, reasonably, exclusively and necessarily incurred for the business). Where such expenses are between related parties, they need to be consistent with TP guidelines. Therefore, there will be no need for approval from the Minister, NOTAP or the FIRS for tax deductibility.

The effect of the above is that now, more than ever, companies must ensure that their related party transactions are fully compliant with the TP Regulations.

### Stamp Duties

The CBN recently released a directive for banks to charge a stamp duty charge of NGN50 on electronic transactions of NGN1,000 and above. This directive has been viewed by many as retrogressive and contrary to the government's plan to reduce the proportion of financially excluded adults to 20% by the year 2020. The Bill however provides some succour as it raises the minimum threshold for applying the stamp duty charge from NGN1000 to NGN10,000.

## Connecting the dots

In view of the African Continental Free Trade Area agreement to which Nigeria is a signatory, introduction of excise duties on the importation of excisable products will ensure that local manufacturers of such products are not disadvantaged.

The FIRS recently stated that it has started putting together a framework to enforce collection of VAT on online transactions, by mandating banks to deduct such VAT at source. The Bill contains no provision in this regard and therefore the implementation may face a legal challenge.

Also, the FIRS recently issued a Public Notice on the deduction of VAT and WHT on rebates and similar compensation to agents, dealers, distributors and retailers. Companies need to ensure that their arrangements with such parties are properly structured to avoid exposures.

In addition, the removal of the need for ministerial/NOTAP approvals for certain expenses in the Finance Bill, aligns with a recent Court of Appeal (CoA) judgment. In the ruling, the CoA held that NOTAP approvals were not required for such expenses to be paid or recognised in the financial statements.

## Take Away

Generally, the proposed changes aim at raising revenue for the government, and easing tax compliance burden on taxpayers with a focus on small and medium scale enterprises (SMEs).

However, one major issue that needs to be addressed is making VAT in Nigeria a proper pass-through, where only the final consumer bears the burden. This means that businesses should be able to obtain credit for their VAT costs. Currently, VAT credit is only available for goods purchased for resale or used in manufacturing other products. The current "VAT" system in Nigeria is closer to a cascading Sales tax structure, and unfairly increases the cost of doing business along each level of the value chain. While the 7.5% VAT rate is low compared with the rate in other countries, these countries have a proper VAT system that avoids these challenges. Any further increase in the VAT rate without addressing this issue may be detrimental to the economy.

# 6

# Implications for Micro, Small and Medium-Sized Enterprises


## Implications for Micro, Small and Medium-Sized Enterprises

The Micro, Small and Medium-scale Enterprises (MSMEs) are the backbone for accelerating inclusive, robust and sustainable economic growth in any economy.

Official report puts the total MSMEs in Nigeria at about 41.5 million (compared to 17.5 million in 2010) with Lagos, the nation's commercial capital, accounting for a substantial proportion. In 2017, over 59 million people were employed by MSMEs (representing more than 86% of the national workforce) and the sector contributed about 49.8% of the national GDP. With a total number of about 17.4 million, they account for about 50% of industrial jobs and nearly 90% of the manufacturing sector, in terms of number of enterprises.

Despite the pivotal role MSMEs play in driving growth and development, they continue to grapple with key issues such as inadequate finance, multiple tax regimes, infrastructural deficit such as epileptic power supply. According to the NBS SMEDAN MSME survey conducted in 2017, for most enterprises – both Micro and SMEs – personal savings was the most common source of capital. Nationally, only 49.5% of SMEs (that are sole proprietorships) reported having access to bank credit.

It is expected that with continued support in form of policy reforms and regulations aimed at improving market conditions, the MSME sector will grow further and develop in the coming years.

The Finance Bill seeks to introduce across-the-board changes to the various tax laws in Nigeria that would impact on MSMEs and their role in sustainable economic growth. The bill provides certain incentives for businesses in this category. This article highlights the current provision, what is being proposed and the implications for MSME stakeholders.

### Current provisions in the Law

#### The Companies Income Tax Act (CITA)

*The Companies Income Tax Act (CITA) imposes* corporate income tax (CIT) on the profits of a company at the rate of 30%. The rate is 20% for agricultural, mining, export or manufacturing businesses with an annual turnover of N1m and below. Companies just commencing business are required to prepare their taxes for the first three years using the 'commencement rules'.

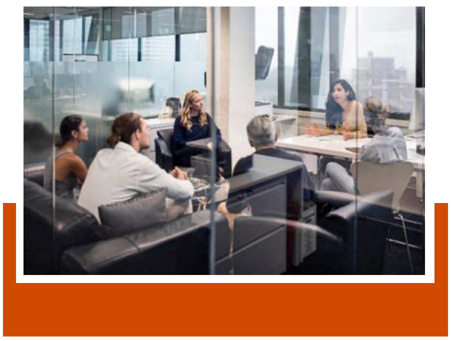
Commencement rules subjects the profit for a period of at least 12 months within that period to double taxation.
CITA was amended in 2007 to delete the previous 4 years restriction of losses. However, some wordings were not deleted which did not allow the carry forward of tax losses beyond the fourth year of commencement of business.

The FIRS did not enforce this provision in practice but it created some uncertainty for new investors. Failure to file CIT returns attracts a penalty of N25,000 for the first month of and N5,000 for each subsequent month where failure continues.

#### The Value Added Tax (VAT)

*The Value Added Tax (VAT)* rate in Nigeria is 5%. The Act requires all taxable persons to register for VAT within 6 months of business. Companies are generally expected to account for VAT based on invoices issued (i.e. accrual). This requires companies to render returns in the month following taxable supply or purchase. Failure to register for VAT attracts a penalty of N10,000 and N5,000 for each subsequent month where failure continues.

Exported services and basic food items are exempted from VAT. The VAT Act defines exported service as service performed by a Nigerian resident or a Nigerian company to a person outside Nigeria which is ambiguous. There is no definition of what constitutes a basic food item which has led to several disputes and court cases.



## Others

Other provisions in the law likely to impact the MSME sector include the Customs Act which limits excise duties to goods manufactured in Nigeria and the Stamp Duties Act (SDA) which defines “instrument” as every written document.

**Below are some of the important changes that Micro, Small and Medium-scale Enterprise should know about the Proposed Bill and the likely Implications**

### Amendments to the Companies Income Tax Act (CITA)

- Small businesses with turnover less than N25m will be exempted from CIT while a lower CIT rate of 20% will apply to medium-sized companies with turnover between N25m and N100m. Small businesses may have to prove to their customers that they do not meet the threshold to avoid withholding tax.
- Commencement and cessation rules have been modified to eliminate overlaps and gaps to avoid double taxation and complication during commencement.
- The restriction of carry forward of tax losses has been amended such that tax losses can be carried forward indefinitely. This is useful as startups who incur significant losses in the first few years of business can now carry forward tax losses against future taxable profits.
- Companies must now pay their CIT liability on or before the due date of filing in one lump sum; or in instalments agreed with the FIRS with the last instalment paid on or before the filing due date
- Companies will only be subject to minimum tax at 0.5% of turnover if turnover exceeds N25m.
- Companies that make CIT payment on or before 90 days from the due date for filing will be entitled to a bonus of 1% (for large companies with turnover greater than N100m) or 2% (for medium-sized companies with turnover between N25m and N100m).

### Amendments to the Value Added Tax (VAT)

- The VAT rate to increase from 5% to 7.5%.
- VAT registration threshold of N25 million turnover in a calendar year to be introduced, this implies that SMEs that do not meet the threshold would not need to register for VAT and as a result would not be able to recover input VAT on their purchases
- Penalties for failure to register will increase to N25,000 for the first month of default and N20,000 for each subsequent month
- The meaning of supply and definition of goods and services has been expanded to cover intangible items other than land, among others
- Remittance of VAT now to be on a cash basis, that is, the difference between output VAT collected and input VAT paid in the preceding month.
- A clear definition of basic food item and definition of exported service as “service rendered within or outside Nigeria by a person resident in Nigeria to a person outside Nigeria…”

### Other Changes

- Banks to request for Tax Identification Number (TIN) before opening bank accounts, while existing account holders must provide their TIN to continue operating their accounts
- Stamp duty on bank transfer to apply only on amount from N10,000 and above. Transfers between the same owner’s accounts in the same bank also to be exempted
- The scope for goods subject to excise duties based on the Customs Act now expanded to include “goods imported and those manufactured in Nigeria…”
- Under the proposed amendment, the SDA now defines ‘instrument’ to include “every written document including electronic documents”

## Connecting the Dots

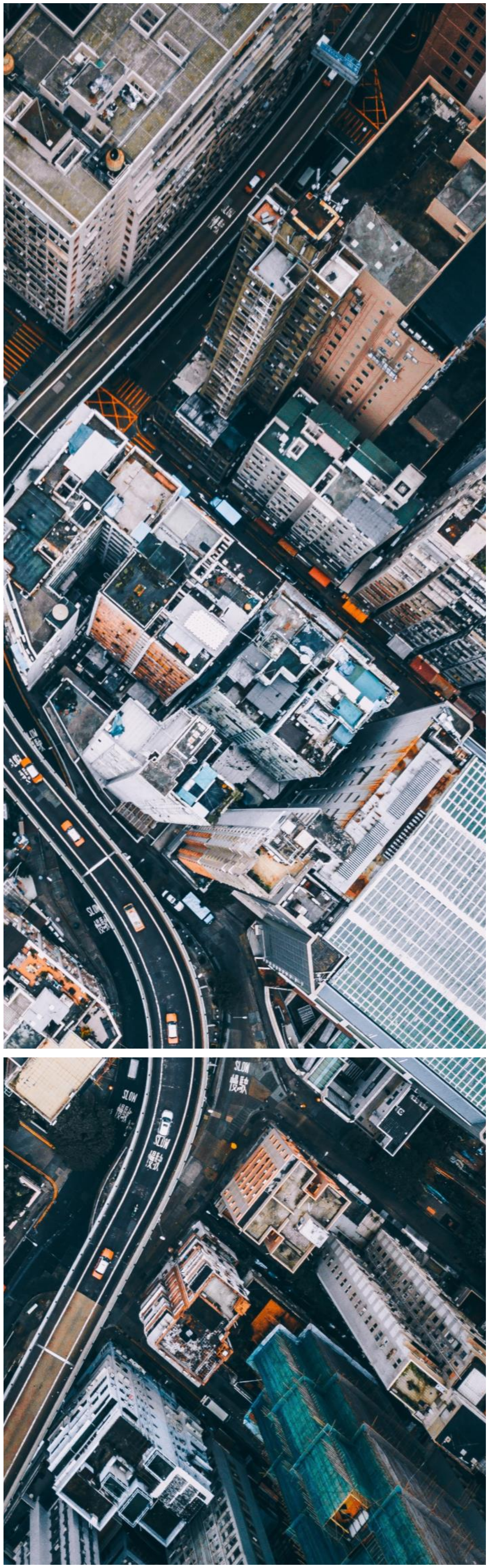
It is clear from these amendments that the government is trying to improve the fiscal policies and regulatory environment to stimulate growth in the MSME sector. However, there is also a deliberate effort to ensure that the sector contributes to revenue generation without excessive financial burden. An area of focus for the government would be to formalise these businesses through the TIN project in collaboration with the banks.

Although the definition of instruments for stamp duty has been expanded to cover electronic transactions to give legal backing to the Central Bank’s N50 stamp duty drive. The increase of the chargeable amount to N10,000 and above would reduce the challenges faced by SMEs and retailers who have recently transferred the N50 as an additional cost to their customers.

Majority of the incentives in the bill are targeted at SMEs, and we hope that this will improve the ease of doing business in Nigeria. Some other incentives that would impact the SMEs includes Export Expansion Grants and the Pioneer Incentives Schemes especially given that the effective tax rate for a small company will now be less than the personal income tax rate for an informal business owner. This presents an opportunity for many informal sector players to formalise their businesses.

# 7

## Implications for Real Estate Investment Companies



7

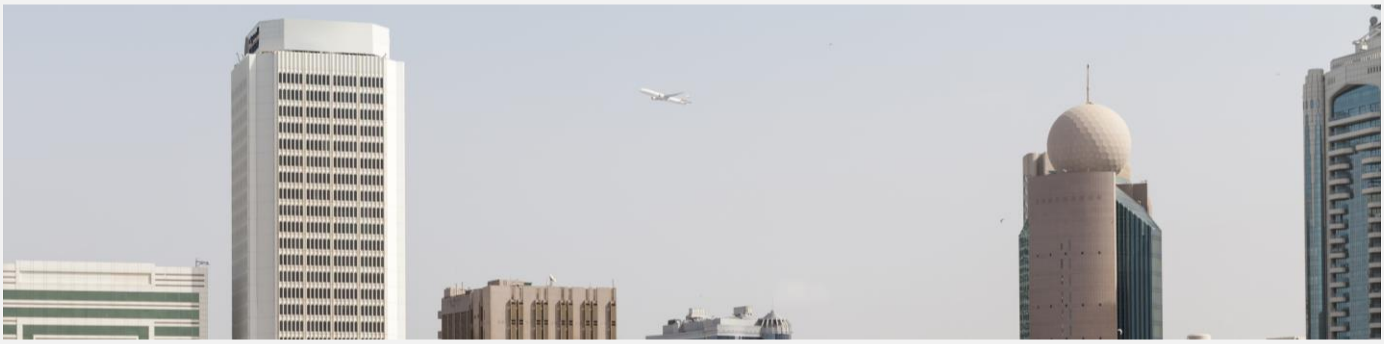
# Implications for Real Estate Investment Companies

## Real estate sector at a glance

Nigeria has a relatively youthful population of approximately 200 million people and a housing deficit estimated at 20 million units with only 100,000 housing units being developed annually. In addition the country has a significant shortfall in public infrastructure to support the rapid population and urban growth. The situation poses a particular and ubiquitous challenge to federal and state governments while at the same time presenting significant opportunities into the real estate industry across the housing, commercial, real estate and infrastructure sectors.

The major challenges in the real estate sector are difficulties in registering a property and obtaining construction permits which in turn create obstacles to securitisation of property as well as increasing the cost of investing in the sector thereby making investment in real estate unattractive. This is responsible for the significant amount of 'dead' capital in the real estate sector which we estimate this to be in the region of $900 billion. The luxury real estate market is estimated to hold between $230 billion to $750 billion of value, while the middle market carries between $60 billion and $170 billion in value.

The Finance Bill 2019 proposes several changes that will affect the sector. We have analysed these changes below.



## Background

Currently, Real Estate Investment Companies (REICs), are arguably liable to Corporate Income Tax (CIT) at 30% of their profits and a further 2% Tertiary Education Tax (TET). In addition, the distribution to the shareholders could be liable to Withholding tax (WHT) at 10%. This is contrary to the treatment of real estate investment trusts (REITs) globally as tax neutral vehicles. The reason for this ambiguity is lack of specific provisions in the current tax laws to address the peculiar situation.

The tax consequences that arise in a REIC make it unattractive to potential investors in units of these companies although in practice, the FIRS sometimes does not apply the law strictly. This creates potential inequity in the taxation of different REICs and uncertainty around using such a vehicle to attract investments in the real estate sector.

The proposed changes to the taxation of REICs seek to align the tax treatments with global best practices.

## Analysis

### Proposed changes

#### 1. Definition of a REIC

The Finance Bill defines a REIC as a Company duly approved by the Securities and Exchange Commission ("SEC") to operate as a Real Estate Investment Scheme in Nigeria. The SEC Rules have a clear definition of the scope and regulatory requirements for a REIC.

#### 2. Dividends and rental income distributed by a REIC to be exempt

The Finance Bill proposes to exempt dividend and rental income received by REICs on behalf of its unitholders from CIT, provided that a minimum of 75% of the dividend or rent earned is distributed within 12 months of the end of the financial year in which the income was earned.

Should the REIC fail to distribute the dividend or rental income within the stipulated 12-month period, the income would be subject to CIT and TET.

The proposed amendment does not exempt all the income of the REIC and as such management fees, profits or any other income earned for and on its own account would be subject to CIT and TET.

As an additional safeguard, the Finance Bill proposes to treat dividends and mandatory distributions by REICs as tax deductible expenses. This could have created a double-dip situation since the income would be tax exempt and the payment out would be tax deductible. However, the introduction of a specific rule by the Finance Bill that expenses would be tax deductible only to the extent that they relate to the production of taxable profit ensures that the double-dip loophole is closed.

**3. Further Exemption from TET**

The Finance Bill does not provide any specific exemption from TET but the treatment of the dividend and rental income of the REICs as tax exempt means that they would not form part of assessable profits, which is the base for TET computation.

**4. Exemption from excess dividend tax provisions**

The Finance Bill removes the distribution of rental and dividend income by REICs from the ambit of Excess Dividend tax.

**5. Distributions to REICS to be exempt from WHT**

The Finance Bill proposes that dividends or distributions received by a REIC should not be subject to WHT by the person making the payment. Therefore, where a REIC is a shareholder in a company, the company must pay gross dividends to the REIC without deducting WHT. However, the Finance Bill assumes that the REIC would then be responsible for deducting WHT when distributions are being made to its unitholders. This ensures that there is only one layer of WHT on investments made through REICs and such taxes are remitted to the appropriate authorities especially for individual unitholders liable to States Internal Revenue Services.

## Potential future changes

While the proposed changes are laudable there is a need to make additional amendments to safeguard against potential conflicts in operationalising the above provisions.

**1. Timing of distribution and filing and payment of CIT returns**

It is important to note that a REIC would still be required to file its annual tax returns by the due date which falls 6 months after the financial year end. On the other hand, the time limit within which the REIC ought to have distributed the dividend or rental income in order to enjoy the exemption is 12 months.

This potentially pits the REICs against the FIRS as FIRS may seek CIT and TET at the time of filing the returns if the condition has not been fulfilled with the promise of a refund if the conditions are eventually met. It would be more practical to amend the provisions relating to filing of returns and payment of CIT and TET for REICs to avoid this potential conflict and the rigours and uncertainty of obtaining a refund from the FIRS. In addition, the sector players need to engage the FIRS and SEC to ensure that there is consistency of interpretation and application of the rules as intended.

**2. Property transfers to attract WHT**

REICs are designed to be tax neutral. However in the case of sale of the property held directly by the REIC or property held by the REIC through an intermediary company the distribution of the disposal proceeds of the property to shareholders would be exposed to WHT which is an adverse position had the individual held the property directly or through an intermediary company.

## Connecting the dots

Nigeria is in urgent need of infrastructure and affordable housing that is reaching a critical status due to the burgeoning population growth and rural urban migration. Solving these challenges will require real innovation in new models for land administration, investable real assets portfolio as well as deliberate Public Private Partnership.

In order for the real estate market to take-off, there is a need for legislation to cover both new product types as well as new asset classes driven by changing realities such as the scope and definition of “real estate”.

In many jurisdictions, largely driven by the tax advantages of qualifying as a REIT or REIC, the scope continues to widen to cover an ever broader range of physical assets such as cell towers, billboards, golf courses, business storage, data centers, and telecom infrastructure, among others. This development has had a significant impact on the REIT market and, in fact, in a very short period of time have become some of the largest REITs by equity market capitalisation representing non-traditional asset classes.

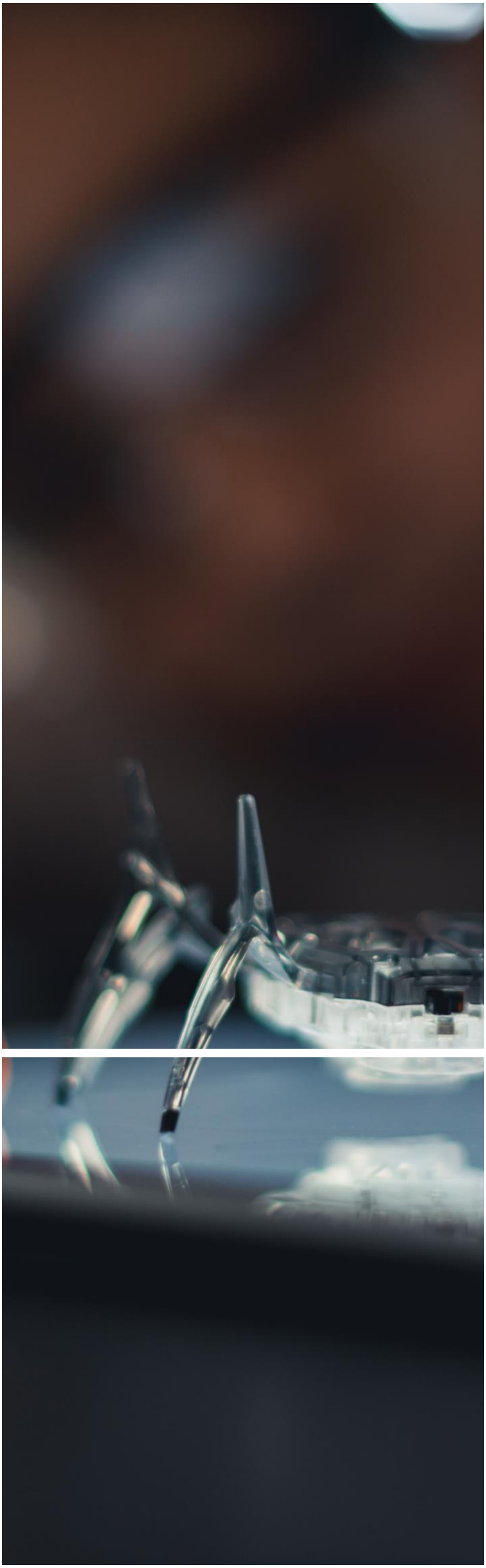
## Takeaway

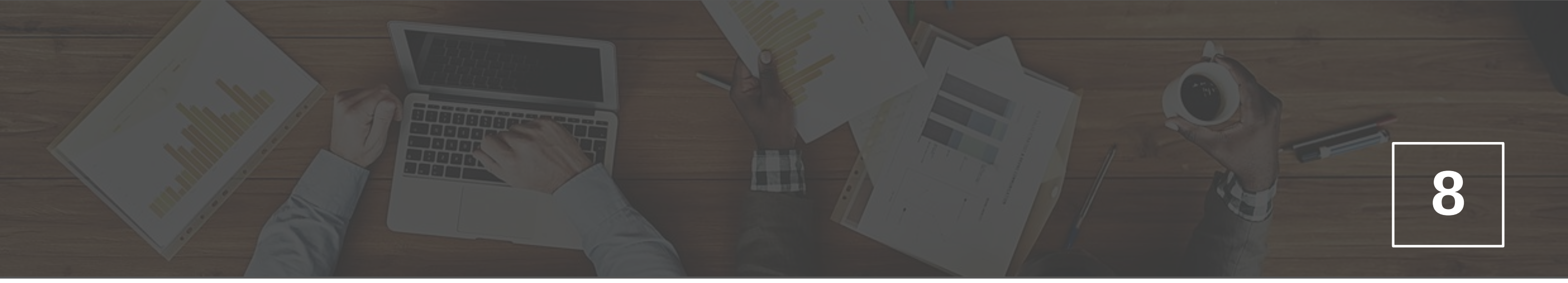
The proposed tax changes are geared towards making REICs tax transparent investment vehicles in respect of dividends and rental income and placing the obligation for tax on the respective shareholders subject to meeting the minimum distribution threshold and timing.

This would make REICs more attractive. From a legal perspective, REICs are more attractive than REITs because they offer the legal protection of a company that limits liabilities to the unpaid capital. With the Finance Bill, they become more attractive as the tax effect produces the same result as REITs. As such, this initiative has the potential to encourage public investments and mobilise more liquidity for real estate projects with a corresponding positive impact on the capital market.

# 8

## Implications for the Digital Economy

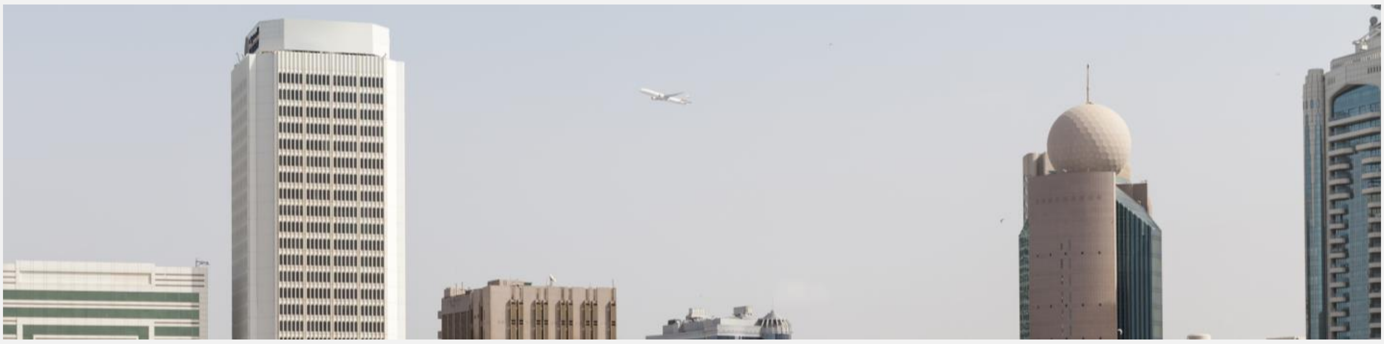





## Implications for the Digital Economy

### In summary

The new Finance Bill introduces two additional categories of fixed base (FB) to capture e-commerce and technical/management/consultancy services provided remotely by non-resident companies ("NRCs") to Nigerian consumers, *to the extent that the providers have **significant economic presence*** *in Nigeria*. It also gives the Minister of Finance broad powers to determine, by Order, the triggers and/or thresholds for *significant economic presence in Nigeria.*



### Background

Generally, an NRCs income is deemed to be derived from Nigeria (and subject to tax) under section 13 (2) of the current Companies Income Tax Act (CITA) where it:

a) has a fixed place of business in Nigeria,
b) habitually trades in Nigeria through an agent or maintains a stock of goods which are sold through an agent,
c) carries on a trade or business or activities involving a single contract for surveys, deliveries, installations or construction (e.g. EPC and turnkey projects); and
d) carries on business with a connected Nigerian company where the transactions are not at arm's length or are artificial or fictitious.

The criteria above would usually require either some physical activity in-country (either through employees or agents) or a situation whereby a foreign company has earned excessive income (artificially or fictitiously) through transactions with its related party in Nigeria. Based on this provision of the law, NRC's providing services remotely are not subject to income tax in Nigeria.

In practice however, the FIRS seeks to impose withholding tax administratively on these transactions or by using Section 9 in tax disputes. Section 9 which is the charging section of CITA states that *"the tax shall... be payable… upon the profits of any company accruing in, derived from, brought into, or received in Nigeria…".*

They argue that under Section 9, as long as an NRC derives income from Nigeria, the income should be subject to CIT (or at least WHT). The FIRS takes the view that Section 13(2) is a deeming provision (i.e. it deems when income is derived) and therefore does not cover all situations where income can be derived from Nigeria. The counter-argument to the FIRS position is that the specific legislation in Section 13(2) prescribes when the income of an NRC is derived from Nigeria and therefore, any other income of NRCs would not be subject to tax.

To address modern business realities whereby a business can be carried out remotely and to address the controversy highlighted above, the new Finance Bill proposes certain amendments which are discussed in more detail below:

### 1. Fixed based for digital commercial activities:

An NRC would be deemed to be taxable in Nigeria for quite a wide range of digital and technology activities based on a very wide definition in the Bill. However, the tax obligations would only arise if the NRC has a *significant economic presence in Nigeria*.

The intention of this amendment is to broaden the tax base to capture profits arising from cross-border technology and digital activities that have previously escaped tax under the outdated CITA. It is expected that all NRCs earning income from advertising, marketing, social media platforms etc would be subject to tax on profits derived from such activities after passage of the Bill. However, the proposal is a bit premature as other countries need to be aligned so that it does not create incidents of double taxation for these NRCs or result in a diplomatic row with the home countries of major global tech companies. In addition, the wording of this law has to be carefully considered to avoid unintended consequences if implemented in its current version. For example, a server situated outside Nigeria and owned by a 3rd party could be subjected to tax because it stores information relating to Nigerian customers on behalf of a foreign cloud software provider. Ordinarily one would have assumed that only the Software as a Service (SaaS) provider would be taxable, but the taxation could also extend to the 3rd party owner of the server because it merely receives data through the internet. There may be other unanticipated consequences which could be prevented by ensuring a more detailed review and stakeholder engagement before implementation.

NRC that are subject to tax under this rule would have to register for tax in Nigeria and file tax returns. This would create an unusual situation for such NRCs who typically would have no intention of having a presence in all the countries where their services are procured.

### 2. Fixed base for services rendered outside Nigeria

Based on the Bill, an NRC would be deemed to be taxable in Nigeria where it provides technical, management, consultancy or professional services outside of Nigeria to persons resident in Nigeria provided *it has a significant economic presence in Nigeria*.

Under current law, such services were not considered as creating a taxable presence in Nigeria, nor were they legally liable to WHT. Apart from capturing international consultancy companies that provide services in Nigeria through a ‘fly-in’ structure, the proposal could capture consultancy firms in Nigeria that have international affiliates that provide support services, depending on the criteria used for ‘significant economic presence’. The Bill has no definition for technical, management, consultancy or professional services which could lead to disputes.

Although the proposal is for services to trigger a taxable presence, the mechanism for the collection is through WHT. This reduces the compliance burden on such foreign companies as they do not have to register for tax or file tax returns. However, the obligation shifts to the recipient of the service who would have the obligation to deduct WHT and may have to bear the tax cost through ‘net of tax’ clauses.

### 3. New ministerial powers

The Finance Bill also gives the Minister of Finance powers to determine, by Order, what constitutes *significant economic presence in Nigeria* for affected NRCs.

The implications of this are:
(i) the thresholds or triggers may not be generally acceptable, and could lead to more debates even if taxpayers would have no option but to comply
(ii) until the Minister defines the criteria for significant economic presence, the proposed updates would be redundant as they can only be applied if the criteria are defined.
(iii) There is flexibility for the Minister to modify the conditions to suit changing economic circumstances and technological advancement.

### 4. Introduction of VAT reverse charge on imported services

The VAT Act requires a non-resident company that “carries on business in Nigeria” to register for VAT, and issue VAT invoices to its Nigerian customers.

Until recently, the generally accepted position was that VAT did not apply on services provided by NRCs to Nigerian customers, where the NRC does not physically provide the service in Nigeria. However, the courts have recently ruled that VAT is applicable on services provided to Nigerian customers, even where the services are rendered outside Nigeria. This is however still being disputed through the Court process.

The Bill would eliminate any uncertainty going forward and make it a requirement for NRCs to register for VAT and include VAT on their invoices to Nigerian recipients. This VAT would be deducted by the Nigerian recipient and paid to the FIRS. Even where the NRC does not include VAT on its invoice, the Nigerian company is expected to now “self-charge” the VAT and remit.

## Takeaway

A bit more engagement would be required to avoid double taxation in the area of corporate income tax. The FIRS may need to provide some clarification on what mode of returns would be required for the permanent establishments. The FIRS may also need to invest in capacity to understand the businesses of taxpayers in this sector in order to determine what services are being provided to Nigerian residents and how to fairly determine the attributable profits.

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