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PwC's Tax Series

The FIRS substitution order - 2 facts and some recommendations

Introduction

Towards the end of 2018, the FIRS began to employ an aggressive tool called "substitution order". It involves appointing a 3rd party holding the asset or funds of a tax defaulter as an agent to pay the tax. The FIRS drew up a list of businesses and unilaterally determined that they were not compliant. They used their best of judgment to ascertain the turnover of the businesses based on inflows into their bank accounts. They then decided that 5% of the amount should be the VAT liability, 6% of the amount should be the corporate income tax ("CIT"), etc. The lists were sent out in phases to various commercial banks demanding for liens to be placed on the accounts. Recently, the FIRS has modified the process by sharing the names of the affected businesses and giving them a timeline to respond before placing the lien.

Agent appointment is a powerful strategy used by tax administrations across the world. But it also needs to be implemented in a way that gives taxpayers confidence in the fairness of the tax system.

Fact 1: There are gaps in the FIRS interpretation of Section 31 of the FIRS Establishment Act

Section 31 of the Federal Inland Revenue Service (Establishment Act) ("FIRSEA") states:

1. The service may by notice in writing appoint any person to be the agent of a taxable person if the circumstances provided in subsection 2 of this section makes it expedient to do so
2. The agent appointed under subsection 1 of this section may be required to pay any tax payable by the taxable person from any money which may be held by the agent of the taxable person
3. Where the agent referred to in subsection 2 of this section defaults, the tax shall be recoverable from him.

There is a similar provision in Section 49 of the Companies Income Tax Act ("CITA") and Section 50 of the Personal Income Tax Act ("PITA"), so technically, the Internal Revenue Service of the various States can start another wave of the substitution orders for PIT and PAYE.

The way the FIRS has implemented the order presupposes that they have made 2 conclusions:

- (i) They have wrongly assumed that they can request for a lien to be placed on the account. The law only allows for the tax to be paid by the agent. Freezing the bank account or placing a lien while the tax is still being determined cannot be done by Section 31 of the FIRSEA. This may seem like a mere technicality but it can have far reaching implications in a legal dispute.
- (ii) They have assumed that they can implement a substitution order without a valid tax assessment. This does not align with Section 31(2) of the FIRSEA which requires that the tax must be

payable. There is a process in the law for the establishment of a tax debt. Section 65 and 66 of CITA requires the FIRS to make an assessment. Section 68 also requires the FIRS to serve the notice of assessment on the taxpayer. The law further obligates the FIRS to spell out (in such assessments) the rights of the taxpayer to object to the assessment and the right of the taxpayer to due process (similar to how a US cop reads out the rights of a suspect during an arrest). Based on these, the law would have been broken not just by the FIRS, but by the banks, if liens are placed without assessments.

Agency appointments are not unique to Nigeria. The FIRS and the banks need to review how the law is applied in these other countries. For example, in a South African case, Nedbank Ltd v Pestana, the Bank had reversed a funds transfer effected by the customer in order to comply with the substitution order of the South African Revenue Service ("SARS"). The Supreme Court of Appeal held that their tax laws had limited powers to the extent that it did not confer the authority to freeze bank accounts; nor did it confer the power to transfer funds.

Fact 2: The FIRS process for the substitution orders creates problems

I have summarised some observation from the FIRS processes below:

- The Order is not intended to affect taxpayers who are already compliant. It is meant to apply to customers without Tax Identification Numbers ("TIN"), or those with TIN but no tax payments. However, many compliant taxpayers were affected. This means there is either a lack of coordination within the FIRS or instances where the taxpayer may have been issued two or more TINs and one TIN has no tax payments.
- Enterprises and sole proprietors are not liable to CIT but they are liable to pay VAT to the FIRS. However, there are examples (see case below) where the FIRS did not ensure that substitution orders are issued in respect of only taxes that a specific taxpayer should be liable for.
- The FIRS writes to the banks without serving valid assessments on the taxpayers. They also write to several banks for the same liability. This means that the FIRS could intend to recover say N100m from a taxpayer but then writes the same letter to 5 different banks. This means that N500m would be frozen instead of N100m.
- Once a lien is placed on an account, the taxpayer is expected to reconcile with the FIRS. The FIRS has no process to provide immediate relief if they made a mistake in freezing a compliant taxpayer's account. The compliant taxpayer has to go through the same process as a tax defaulter. The FIRS guarantees that the lien would be lifted within 24 hours after resolution. However, the 24 hours is

rarely achieved. Taxpayers (including compliant ones) have to keep chasing the FIRS while they have no access to their funds to carry on business.

The harrowing experience can be a disincentive to compliant taxpayers who are treated the same way as tax evaders. The process has to be reformed to be fairer to compliant taxpayers.

Recommendations

Apart from the wrong message a poorly effected substitution order sends, it could also lead to significant litigation and exposure to the banks and the FIRS. The recent judgment of the Federal High Court in the case of *Ama Etuwawe Esq. vs the FIRS (and GTB)* emphasises this point. The FHC held that the plaintiff (a law firm) is not liable to CIT. The FHC also awarded the law firm monetary sums as damages for illegal and unlawful freezing of its account.

The banks must collaborate with the FIRS to review the process to bring it in line with best practices. For example, SARS has a formal process for effecting similar orders in South Africa. Their legislation has also been updated to include formalities such as a requirement for a final demand for payment to be delivered to the taxpayer at least 10 business days before an appointment is issued to the banks. The changes also gives the taxpayer some time to approach SARS prior to the appointment being issued to negotiate repayment options; in which case, an agency appointment may no longer be required. This simple process achieves the same revenue objective without creating unwanted problems.

The banks need to propose a simplified procedure to the FIRS. An FIRS desk could be stationed in the bank premises with an officer who has the authority to discharge such substitution orders rather than wait for 24 hours or more. Payment of tax should earn the taxpayer such a courtesy. In the meantime, compliant taxpayers will be well within their rights to seek legal remedies when their bank accounts are illegally frozen. Banks also have rights under the law to object to FIRS substitution orders. Where proper due diligence has not been carried or no assessment has been issued by the FIRS before sending out the orders. Under Section 31(5) of the FIRSEA, the banks have the powers to object to the substitution orders like an assessment.

In the future, some aggrieved customers (especially complaint ones) may be looking to move their accounts to banks that are able to challenge wrongful orders and protect their customers. Hopefully, a bank would be able to stand up in this yuletide season and provide this level of value-added service to their customers.



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Tax Academy

December 2019 session

Topic: Managing tax uncertainties: Tax forecasting, fiscal impact modelling and predictive analytics.

Date: Tuesday 17 December

Time: 9:00am - 1:00pm

