The Federal Inland Revenue Service (FIRS) has released the Income Tax (Transfer Pricing) Regulations 2018 (“TPR” or “the Regulations”). The Regulations take effect for financial years commencing after 12 March 2018 and revoke the Income Tax (Transfer Pricing) Regulations, 2012. It incorporates some of the revisions to the OECD’s TP Guidelines (OECD TPG), as well as provisions contained in the African Tax Administration Forum’s (ATAFSA) Suggested Approach to drafting TP legislation (ATAFSA).

The TPR has significant changes that will impact the conduct of intercompany transactions involving persons operating in Nigeria. While a few of its provisions will reduce the TP compliance burden for certain categories of taxpayers, a number of the revisions are however controversial such as: the introduction of significant penalties for noncompliance, restriction of tax deductions for IP royalty payment, rules on commodity transactions etc. In the first article in this series, we provide an overview of some of the provisions of the new Regulations.

Penalties for non-compliance

These are new and relatively material including penalties for:

- a) failure to file a TP declaration - N100 million in the first instance and N10 million for every day failure continues
- b) failure to file an updated TP declaration/change notice about directors - N250 million for every day in which the default continues.
- c) failure to file a TP disclosure - the higher of: N10 million or 1% of the value of related party transactions not disclosed; and N10 million for every day in which the default continues.
- d) incorrect disclosure of transactions - the higher of: N10 million or 1% of the value of related party transactions incorrectly disclosed.
- e) failure to file TP documentation upon request – the higher of: N10 million or 1% of the value of all related party transactions; and N10 million for every day in which the default continues.
- f) failure to furnish information/documentation upon request -1% of the value of each related party transaction for which information/document relates; and N10 million for every day in which the default continues.

While the Regulations allow the FIRS to grant extensions to filing deadlines under certain conditions, the full penalties will apply if a taxpayer is unable to meet up with the extended timelines.

Substance requirements and cap on royalties

The Regulations provide that the content of contracts alone will not be sufficient to prove that a payment for the rights to use an intangible (e.g. a royalty) is arm’s length. The arm’s length royalty due to a licensor will depend on the extent to which it performs functions and assumes risks relating to the development, enhancement, maintenance, protection and/or exploitation (DEMPF) of the intangible asset in question. This is consistent with the guidance in the OECD TPG.

In addition, the TPR controversially provides that where there is a transfer of rights in an intangible asset for any payment for the exploitation of those rights will be capped at 5% of earnings before interest, tax, and depreciation and amortization (EBITDA). This provision has been adopted from the ATAFSA.

We anticipate that there will be disputes around the legality of the cap on tax deductibility of royalty payments. In addition to the fact that such a provision is not consistent with the arm’s length principle, it is debatable if such a restriction on royalty payments can be introduced via a Regulation.

Furthermore, this provision introduces another level of complexity and uncertainty for taxpayers who exploit intellectual property owned by related parties. This is because royalty rates are already the subject of the legality of some of the prescriptive rules for pricing intercompany transactions. Some of these rules will increase the burden of proof required for taxpayers to justify the price of their intercompany transactions and others will have the effect of limiting the amount that they can charge. Taxpayers should evaluate how the new Regulations will impact them and decide how best to respond.

Taxpayers need to pay attention to the new penalty regime. It is advisable for taxpayers to make TP compliance a top priority to avoid these penalties notwithstanding that the legality of some of the penalties may be contested.

Customs valuation

The TPR expressly state that the prices applied for customs valuation purposes will not automatically be accepted by the FIRS as arm’s length for TP purposes. This position potentially exposes taxpayers to double taxation and this is not in line with the spirit of the National Tax Policy.

Dispute resolution

The composition of the Decision Review Panel (DRP) – the panel responsible for resolving transfer pricing disputes – has been expanded from 3 to 5 members. Notably, under the new Regulations the right to refer a case to the DRP will now be that of the Head of the FIRS’ TP Division. Under the old Regulations, the right to refer an assessment from the FIRS to the DRP was that of the taxpayer.

It is not clear if taxpayers will be allowed representation at the DRP but we expect that this would be the case.

Conclusion

The new Regulations introduce a number of prescriptive rules for pricing intercompany transactions. Some of these rules will increase the burden of proof required for taxpayers to justify the price of their intercompany transactions and others will have the effect of limiting the amount that they can charge. Taxpayers should evaluate how the new Regulations will impact them and decide how best to respond.

Taxpayers need to pay attention to the new penalty regime. It is advisable for taxpayers to make TP compliance a top priority to avoid these penalties notwithstanding that the legality of some of the penalties may be contested.

Taxpayers who are behind on compliance need to take steps to quickly address all non-compliance. In addition taxpayers must ensure that going forward, they are able to comply as and when due.

Our follow up article will discuss other provisions of the new Regulations including the new requirements for TP documentation, intra-group services; capital and low function companies; and safe harbours.