Why Nigeria’s significant economic presence rules will not override the provisions of existing double tax agreements

While we agree that the SEP Order is silent on DTAs, we do not believe that this invalidates the operation of all other legal provisions and principles that deal with the interaction of DTAs and domestic legislation.

Introduction

When we published our tax alert on the Significant Economic Presence (SEP) Order in June, we made the point that the SEP Order would generally not create new tax obligations for a foreign company that is resident in one country that has a Double Tax Agreement (DTA) with Nigeria. A few people who had different views reached out to us. Although we helped them to understand our perspective, we thought it would be useful to also share our thoughts here for the benefit of others who may have similar concerns.

This article will discuss the reasons why the DTAs will generally supersede, and in most cases, prevent taxation under the SEP Order. We will also discuss the possible exceptions to this rule. We will start with a brief overview of the SEP Order and DTAs.

What new tax obligations does the SEP Order create?

The SEP Order, together with Section 4 of the Finance Act 2019 (we will call both the SEP rules), create corporate income tax (CIT) obligations for foreign companies that derive income from Nigeria through (i) digital transactions; or (ii) the provision of technical, professional, management and consultancy services to Nigerian residents. These companies will now be taxable in Nigeria even if they do not have any form of physical presence in Nigeria. Before the changes to the law, these companies would generally only have CIT obligations in Nigeria if they performed business activities physically in Nigeria through their staff or agents. The SEP rules therefore represent a significant departure from how foreign companies are normally taxed in Nigeria.

How do DTAs affect the taxation of non-resident companies?

One of the reasons countries sign DTAs is to prevent double taxation. Double taxation can happen when a company that is resident in one country sources income from another country and both countries tax the same income under their domestic legislations.

DTAs prevent double taxation by allocating the rights to tax different categories of income between the parties to the agreement and providing rules for the granting of reliefs to prevent double taxation.

DTAs also include specific rules for the taxation of specific types of income (e.g. shipping and air transport, interest, royalties, etc.) and a general rule for the taxation of income from business activities. Under the general rule for taxing business activities, a non-resident company will only be liable to tax on the business income it sources from another country if it has a Permanent Establishment (PE) in that country. Broadly speaking, a PE is created if the non-resident has some form of physical presence or operates through a dependent agent in the country. Nigeria’s DTAs also follow this general rule.

Why do people think DTAs will not affect the operation of the SEP Order?

Two of the common justifications that we have heard people present are:

1. The SEP Order has specific provisions relating to multilateral treaties and not bilateral treaties; and
2. Nigeria’s DTAs do not specifically cover digital transactions.

We will address each of these below.

The SEP Order recognises multilateral treaties and not digital tax treaties

The SEP Order provides that if Nigeria enters into a multilateral agreement on how to tax digital transactions in the future, the provisions of that agreement will override the provisions of the SEP Order. Some people are quick to state that since the SEP Order does not say anything about bilateral agreements, a DTA (which is a bilateral agreement) will not affect the operation of the SEP Order.

While we agree that the SEP Order is silent on DTAs, we do not believe that this invalidates the operation of all other legal provisions and principles that deal with the interaction of DTAs and domestic legislation. We will consider just a few of them below.

First, Section 45 of CITA expressly states that the provisions of Nigeria’s DTAs with other countries will supersede any provisions of the CITA that are inconsistent with such DTAs.

Secondly, the Supreme Court in General Sani Abacha & Ors v. Chief Gani Fawehinmi, has recognized the precedence to be given to treaties over domestic laws. Although the Court acknowledged that a state could depart from its treaty obligations by passing domestic law that is inconsistent with the treaty, the Court made it clear that the legislation must expressly amend or repeal the treaty because “suspension or repeal by implication is not, as a general rule, favoured by the courts in the absence of clear words to that effect.”

Finally, Section 19 of the Constitution states that Nigeria would, as a matter of policy, respect its international treaties. Therefore, in the absence of express words, the SEP rules cannot be interpreted to override the provisions of existing DTAs. It is however important to note that this is only relevant where the DTA has been given effect in line with the provisions of the relevant laws.

Digital transactions are not covered by DTAs

Many of Nigeria’s DTAs were signed at a time when the digital transactions that are now part of out operations (e.g. through staff or agents) in Nigeria would, as a matter of policy, respect its multilateral treaties.

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Digital transactions are not covered by DTAs

Many of Nigeria’s DTAs were signed at a time when the digital transactions that are now part of everyday life did not exist.

It has therefore been argued that since the negotiators of the DTAs could not have anticipated these digital transactions, they are not covered by the DTAs. A closely related argument is that since Nigeria’s DTAs do not contain specific Articles on digital transactions, these transactions are not covered by the DTAs.

Again, these arguments are not correct.

First, the Articles in DTAs are structured to apply to broad classes of income. The income from digital transactions will usually fall under one of these classes. In most cases it will be categorized as “business income” for DTA purposes and will therefore be subject to the “business profits” article of the DTA (this is usually Article 7 in most DTAs).

This article only allows the taxation of the business profits of non-residents when they physically carry out operations (e.g. through staff or agents) in Nigeria. It is also possible that, on occasion, income from digital transactions will be classed as royalties, in which case, the royalty article of the DTA will apply.

In the unlikely case that the income does not fall into any of the categories provided in the DTA, the transaction will be subject to the operation of the “other income” article of the DTA (this is Article 22 of many of Nigeria’s DTAs). Depending on the provision of the DTA, the income may or may not be taxable in Nigeria. If it is taxable, then it will be taxed in line with the SEP rules.

We consider this to be the main exception to the rule that the SEP Order will not create a new tax obligation where a DTA exists. We however think that it is unlikely that, in practice, a digital transaction will fall to be taxed as “other income” under a DTA.

Conclusion

While in principle, the DTAs will supersede the SEP rules, one cannot rule out the possibility of a dispute with the FIRS in practice. In line with the new guidelines on claiming treaty benefits, affected taxpayers will first need to apply to the FIRS and demonstrate eligibility for the treaty benefit. If a dispute arises, taxpayers can explore various options including instituting a mutual agreement procedure (MAP).

The MAP will allow the FIRS and the tax authority of the taxpayer to explore solutions that will ensure that the taxpayer does not suffer double not suffer double taxation.

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