Significant Economic Presence rules – what you should know as a Nigerian business customer (Part 1 of 2)

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Introduction

Many of us must have paid to download foreign apps on our phones, or placed an order on a foreign e-commerce platform, or paid a foreign streaming company so that we can binge-watch our favourite series. These have been made possible with the advent of technology. Apart from these B2C (“business-to-customer”) models, Nigerian businesses also procure digital products and other goods and services from foreign businesses.

Conventionally, most tax laws are designed such that businesses pay income tax in the country where they have some sort of physical presence or dependent agent. However, times have changed, and many businesses generate income from countries without even setting a foot in there. Businesses have moved away from “brick-and-mortar” to “click-and-mortar” or fully online, and countries have been struggling with how to tax such income. Nigeria has gone ahead of most countries to introduce a new law in an attempt to address this. As a result, some foreign entities are now exposed to Nigerian business customer to the principal vendor. A typical example is the TV set which I recently ordered from an online retail store, for delivery to Nigeria. The online store’s business model is that it does not own the inventory, but only earns a commission on sales made on behalf of the principal. Although the store may create the Digital SEP, most of the proceeds would be transferred to the TV manufacturer/trader who does not have an SEP. If a Nigerian business customer enters a similar transaction, there may be some unclarity on what to deduct WHT on. A case can be made that WHT should not apply on the portion of the invoice relating to a supply of goods, where sufficient breakdown is provided. For pass through services, the conclusion may be more complicated and would require detailed analyses by the business customers. Companies should therefore assess their risk of exposure and make a decision based on the particular cases, considering that the WHT risk lies on them in the event of an audit.

1. What exactly is Significant Economic Presence (SEP) about?
   
   The Minister of Finance has recently issued the Companies Income Tax (Significant Economic Presence) Order 2020 (SEP Order), further to the recently enacted Finance Act (FA). The Order has an effective date of 3 February 2020. Based on the Order, income earned by certain non-resident companies (NRCs) from Nigeria will now be subject to income tax, where transactions carried out by these companies meet the SEP threshold. Businesses covered by these rules include those that create a taxable presence from engaging in:

   a) Digital, online or e-commerce activities (“Digital SEP”): These businesses will be subject to income tax on profits attributable to Nigerian activities, where they earn a minimum annual revenue or NGN250m (about $70,000) from Nigeria. Such companies will be required to file annual tax returns in Nigeria.

   b) Technical (including advertising services, training and personnel), Professional, Management and Consultancy services (“TPMC SEP”): Nigerian customers are expected to deduct WHT on payments to these companies at 10%. This WHT will be final tax in Nigeria, and the foreign companies will not be expected to file annual returns in Nigeria.

   c) What WHT rate? Determining the applicable WHT rate can be complicated. For payments to NRCs that create a TPMC SEP, the WHT rate is 10%. However, for payments relating to a Digital SEP, the Nigerian business may need to analyse the transaction to ascertain whether WHT should be at 10% or 5%. For example, as against regular service contracts which should attract WHT at 5%, payment for certain software licenses may be regarded as royalties which attract a 10% WHT.

   d) What base should WHT apply on? In many instances, a Digital SEP may be created by a broker, agent or platform provider, who only earns a commission, and passes through the money received from the Nigerian customer, to the principal vendor. A typical example is the TV set which I recently ordered from an online retail store, for delivery to Nigeria. The online store’s business model is that it does not own the inventory, but only earns a commission on sales made on behalf of the principal. Although the store may create the Digital SEP, most of the proceeds would be transferred to the TV manufacturer/trader who does not have an SEP. If a Nigerian business customer enters a similar transaction, there may be some unclarity on what to deduct WHT on. A case can be made that WHT should not apply on the portion of the invoice relating to a supply of goods, where sufficient breakdown is provided. For pass through services, the conclusion may be more complicated and would require detailed analyses by the business customers. Companies should therefore assess their risk of exposure and make a decision based on the particular cases, considering that the WHT risk lies on them in the event of an audit.

2. Some compliance obligations for Nigerian business customers

   a) Who should deduct WHT? Nigerian businesses should deduct WHT on payments to non-resident SEP companies. Generally, a Nigerian individual not conducting business is not expected to deduct WHT.

   b) How do I know that the foreign digital company will meet the digital SEP threshold and will be subject to WHT? You may not know, especially if the transactions between the Digital SEP and your business are way below the N25m ($70,000) threshold. However, the conservative position many companies are likely to take is to deduct WHT notwithstanding. This is especially because the risk of non-compliance includes the unpaid WHT as well as penalty and interest. It therefore makes no sense to carry the risk on behalf of another party. The threshold is also relatively low.

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   e) Why is there no opportunity to deduct WHT in some cases? In practice, many foreign companies that provide digital-related services actually use B2C models/systems, even when transacting with Nigerian businesses. This means that business customers typically make payments with credit/debit cards and there is no opportunity to deduct WHT, as the online transaction cannot be concluded if payment is not made in full. Nigerian businesses may need to liaise with such foreign service providers, to update their systems to allow for the deduction of WHT. Also, the FIRS can be informed of such situations in the event of an audit.

To be continued...