Companies Income Tax Exemption and VAT Act (Modification) Orders:

So that investment in debt instruments may be tax free...

By Taiwo Oyedele

The danger is that the exemption may create a situation where an investing company will have more distributable profit than taxable profit thereby becoming liable to tax upon redistribution. This makes the exemption an illusion rather than reality and may lead to mispricing of investment in such debt instruments.

In March 2010, the Federal Government through the Debt Management Office announced the approval by the Federal Government of Nigeria to grant tax waivers for all categories of bonds (including corporate bonds) and short term government securities such as treasury bills. The announcement also included a reduction in stamp duties for re-issue of previously executed debentures to 20% of the stamp duty payable on a new debenture.

Unfortunately, the declaration made in 2010 was at best a statement of intent which can only take effect subject to administrative and legislative processes required to give the necessary legal backing.

Furthermore, the President in the 2012 Budget Speech delivered to the National Assembly in December 2011 again stated government's intention to grant tax waivers on all bonds and debt instruments issued by all tiers of government and corporate entities.

Subsequently, the Personal Income Tax Amendment Act 2011 ("PITA Amendment") was gazetted in January 2012 with a commencement date of 14 July 2011. The PITA Amendment provides the required legal backing to the tax waiver for persons liable to tax under the PITA only. To ensure that all investors benefit from the incentive regardless of their legal status, the President and the Minister for Finance have now issued a Companies Income Tax Exemption Order and a Value Added Tax (Modification) Order respectively. The Orders which were recently gazetted both have commencement dates of 2 January 2012 exempting income and proceeds from the disposal of debt securities from income tax and VAT.

Before the PITA Amendment and the CITA gazette, the Local Loans (Registered Stock and Securities) Act of 1946 (as amended) empowers the Minister of Finance to issue bonds specifying the notional amounts, coupon rates, maturity dates and also specify the tax exemptions to be accorded such bonds.

The exemption granted by the Local Loans Act does not cover most debt securities such as Treasury Bills ("T-Bills"), state government bonds; and corporate bonds were taxable. However, Section 30 of the Capital Gains Tax Act LFN 2004 provides exemption from capital gains tax ("CGT") on the disposal of Nigerian Government securities (including Federal, State and Local government bonds), stocks and shares. Although the scope of the CGT exemption is broad, it does not provide sufficient cover as it is only useful where the income earned is considered of a capital nature rather than revenue or trading profit.

The PITA Amendment effective from 14 July 2011 exempts from personal income tax bonds issued by Federal, State and Local governments and their agencies; bonds issued by corporate and supra-nationals (including organisations like the world bank, Africa Development bank); and interest earned by holders of these bonds and securities.

The new CITA gazette grants exemption to companies on their trading income from corporate and government bonds, treasury bills and other short term securities. In this regard, there should also be no withholding tax although this is not specifically stated but can be inferred given that withholding tax is an advance payment of income tax except where it is deemed to be a final tax.

Previously, proceeds from disposal of debt instruments have not been subject to VAT in practice. The basis for this is that the Nigeria's VAT law imposes VAT on the supply of goods and services and this may not be extended to such instruments as they are neither goods nor services. In addition to this, the Federal Inland Revenue Service ("FIRS") also issued Information Circular No. 9503 in 1995 where they took the position that capital investments and returns on capital should not be subject to VAT.

The new VAT gazette exempting disposal of bonds and other debt securities from VAT could therefore have far reaching implications to the effect that it could be inferred that VAT was previously applicable. Also, at the expiration of the 10-year VAT exemption period, there is a high possibility that the tax authorities will seek to impose VAT on disposal of bonds and T-bills. The newly published VAT exemption Order will only become relevant if the new VAT law currently being drafted for consideration by the National Assembly which seeks to VAT such transactions is enacted into law.

One key area of difference between the PITA Amendment and the CITA gazette regarding the tax exemption on bonds is that the PITA exemption is not time-bound unlike the CITA exemption which is only for 10 years. Similarly, it is not clear if the commencement date stated in the gazettes refers to year of assessment or to basis period. It is also uncertain whether the exemption will only apply to instruments issued after the commencement date or whether it will apply to all income accruing after the period including those on instruments issued prior to the exemption. In my view, the exemption period should be with reference to basis period and should cover all income accruing to investors effective from the commencement date regardless of when the instrument was issued. There is therefore a need for investors to track the flow of income from relevant securities and exclude income earned during the exemption period from tax. This should include exemption from withholding tax deduction. However, by implication, any expense incurred in earning the exempt income will not be tax deductible such as broker fees.

More importantly, as a result of the tax exemption, issuers are likely to offer and investors are likely to accept a lower interest rate than they would without the tax exemption. The danger is that the exemption may create a situation whereby the income earned may be taxed upon redistribution by the investing company in the form of dividend to its shareholders given that the company will have more distributable profit than taxable profit. This potentially creates an excess dividend tax exposure at 30%. Where this happens it will nullify the effect of the exemption thereby leading to possible mispricing of the investment. It is clearly against the principles of a good tax system to grant a tax waiver with one hand and then subject the income to tax on another hand.

Overall, the tax waiver will reduce the tax burden for investors especially individuals but corporate investors need to consider the real tax cost and effective tax rate of their investments in bonds and other debt securities in view of the potential excess dividend tax exposure and non deductibility of related cost of the investment. Without this, such investors are likely to misprice their investment based on the illusion of income tax exemption and consequently be in a worse position under the exemption regime.

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