

FIRS Finance Act Circular

Clarifications on sundry changes to the Companies Income Tax Act

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Background

The Federal Inland Revenue Service (FIRS) issued a circular to clarify some of the changes to the Companies Income Tax Act (CITA) introduced by the Finance Act (FA) 2019.

We highlight the key issues below:

Highlights

Excess Dividends Tax (EDT)

EDT applies where a company distributes dividends in excess of its taxable profits. In such case, the dividends will be taxed at 30%. The FA amends the EDT provision to exclude dividends:

- paid out of taxed retained earnings;
- paid out of profits specifically exempt under CITA or other income tax laws;
- distributed from franked investment income; and
- distributed by Real Estate Investment Companies from rental and dividend income.

In order to implement the changes, the FIRS has provided the following clarifications:

- Taxpayers are to maintain and submit a schedule to track the sources of dividends paid and evidence of tax paid where applicable.
- In computing EDT, dividend will be compared with taxable profits of the year in which the dividend was declared, and not the year in which the dividend was paid.
- A Last-In-First-Out (LIFO) approach will apply in determining the order of dividend paid out of current accounting profits and retained earnings.

CIT exemption for Small Companies

The amended CITA exempts a company that earns a turnover of N25m or less from CIT. The FIRS clarifies that:

- The exemption covers CIT and Tertiary Education Tax (TET) and is subject to a small company registering for tax, filing its tax returns and complying with other provisions of CITA otherwise the exemption will be forfeited.
- Capital allowances during the tax exemption period will be deemed as fully utilised. Only capital allowances arising in tax years where a small company becomes taxable can be claimed.
- WHT will continue to apply on qualifying payments to a small company notwithstanding the CIT exemption. Eligible small companies may apply for refund.
- A small company is expected to continue deducting WHT on qualifying payments to its suppliers.
- The FIRS will apply the general anti-avoidance provision in CITA to counter artificial arrangements designed to exploit the tax exemption.

Exemption of Export Proceeds

CITA exempts profits on exported goods from CIT, to the extent that the export proceeds are used to purchase raw materials, plant, equipment and spares. Profits relating to export proceeds not utilised in such manner will be proportionately taxed. An eligible company is required to maintain a schedule and evidence of utilisation. Expenses relating to such exempt profits will not be tax-deductible.

Thin Capitalisation (Thin Cap) rules

Deductible interest expenses on loans or debts obtained from a foreign connected person is limited to 30% of earnings before interest, tax, depreciation and amortisation (EBITDA).

The FIRS has clarified that:

- The Thin Cap rules do not replace the Transfer Pricing (TP) Regulations. Related party loan arrangements are expected to also comply with TP rules.
- In computing the 30% of EBITDA, the interest to be considered is the total interest paid or payable, including third party interest.
- Interest incurred to generate tax-exempt profits will be disallowed in the first instance and will not be considered in the analysis.
- The Thin Cap rules will apply to financial charges including discounts, fees, premium, share of profits, finance cost element of finance leases, forex losses in respect of a loan/debt, or any other payment in relation to derivatives used in hedging a loan or debt
- EBITDA will be computed as assessable profits plus interest expense.
- "Excess interest" not deducted in a year may be carried forward for 5 years. Tax deduction will be on a First-In-First-Out (FIFO) basis.
- Thin cap will not apply to Nigerian banks or insurance companies that are subsidiaries of foreign entities. However, the rules will apply to Nigerian banks or insurance companies that are parents to foreign companies.
- A breach of the thin cap provisions will attract relevant penalties and interest.

Expenses incurred in generating exempt income

- CITA disallows any expense incurred in earning tax exempt income, losses of a capital nature and any expense allowable as a deduction under the CGT Act.
- Expenses incurred to generate both exempt and taxable income will be apportioned on a simple ratio basis, to determine the deductible amount.

Taxes or penalties borne on behalf of another person

- Any tax or penalty borne by a company on behalf of another company is not deductible.
- The Circular clarifies that this includes WHT on contracts that are agreed net of taxes, and other taxes borne by the payer on behalf of the supplier.

Finance Act transition

The FA will apply to CIT returns which are due for filing after 13 January 2020.

Minimum Tax

- Minimum Tax is the lowest amount of CIT that a company is required to pay in a given year. The rate is 0.5% of gross turnover less Franked Investment Income (FII).
- "Gross turnover" includes all operating incomes or revenues earned by a company. The illustration in the circular depicts that all income, such as proceeds from sale of discontinued operations, non-core operating activities, and so on, form part of "gross turnover".
- The following companies are exempt from minimum tax:
 - a) Companies with less than N25m gross turnover
 - b) Companies carrying on agricultural business
 - c) Companies in their first 4 calendar years of business
- Minimum tax exemption is no longer available to companies with at least 25% imported equity.

- This general minimum tax provision will not apply to insurance companies given their specific minimum tax provision.

Gas utilisation incentive (GUI)

- The GUI provides tax holiday and/or investment allowance incentives to companies that utilise gas in downstream operations in Nigeria.
- The Circular clarifies that a company that enjoys GUI will no longer require ministerial approval to obtain tax deduction for interest on loans obtained for gas projects. Such interests will be subject to the general provisions in CITA regarding the deductibility of expenses.
- The circular reiterates that a company that benefits from pioneer tax incentives is not eligible for GUI, and vice versa in respect of the same capital expenditure.

Rate of tax

Graduated rates shall apply to companies based on their turnover:

- a) Large companies (with N100m and above in turnover): 30%,
 - b) Medium companies (with turnover between N25m and N100m): 20%
 - c) Small companies will not be taxed, subject to meeting required conditions.
- Companies that have not started trading will no longer be required to pay preoperational levies to obtain their Tax Clearance Certificates (TCCs).
 - Also, provisional taxes no longer apply.

Filing and payment of CIT

- The due date for payment of CIT is now the same as the filing due date, which is 6 months after a company's year-end date. Where CIT is paid in installments, the final installment is due on the filing due date. CIT not paid by the due date will attract penalty and interest.
- Large and medium companies that pay their CIT 90 days before the due date will be entitled to a bonus of 1% and 2%

respectively, of the tax paid. This bonus can be used as a credit against future CIT.

WHT on construction contracts

- WHT at a reduced rate of 2.5% will apply on contracts involving the construction of roads, bridges, buildings or power plants.
- Other types of construction and activities apart from the actual construction attract 5% WHT. Examples include contracts for supply of material, labour, architecture, surveys, design and so on. However, ancillary activities embedded in the construction contract will qualify for the reduced WHT rate.

WHT relief for foreign loans

CITA specifies some WHT reliefs available on interest on foreign loans, depending on the loan term and grace period for repayment of principal and interest. Before the FA amendments, interest on loans with at least 7 years tenor and 2 years grace period, obtained a 100% WHT exemption. The exemptions have now been modified as follows:

- a) At least 7 years tenor and 2 years grace period: 70% WHT exemption
- b) 5 - 7 years tenor and at least 18 months grace period: 40% WHT exemption
- c) 2 - 4 years tenor and at least 12 months grace period: 10% WHT exemption

Takeaway

The new FIRS circulars supersede past positions of the FIRS in the event of any inconsistencies and may be reviewed or amended at any time. The clarifications provided in the new circulars will go a long way in addressing many of the past tax controversies and improving the tax system. Unfortunately, the new circulars also introduce some interpretations which may lead to fresh controversies going forward. Some of these are highlighted below.

Excess Dividend Tax

With respect to EDT, the LIFO treatment regarding current and retained profits can create fresh controversies in determining EDT.

The only consideration should be whether dividends paid exceed taxable profits after adjusting for the items which are now exempted from EDT, regardless of whether the profits relate to current or prior years. It is not clear if profits that are subject to minimum tax will be regarded as taxed profits exempt from EDT.

CIT Exemption for Small Companies

To make the exemption for small companies meaningful, FIRS needs to make the tax refund process seamless for such companies in respect of WHT deducted on their income.

Thin Cap rules

The FIRS has interpreted the thin cap rules in a manner that restricts deduction for interest payments due to third parties. The Finance Act seems to have aided this interpretation. However, this approach is contrary to the intention of the law and international best practices as it discourages companies from debt financing even from unrelated parties. Also, the intention to interpret EBITDA as assessable profits plus interest expenses is contrary to the ordinary and technical accounting meaning, in the absence of a specific definition in the law.

Expenses incurred in generating exempt income

The FIRS has prescribed a pro-rata basis for apportioning expenses incurred in generating both exempt and non-exempt income. However, there is no guidance regarding expenses incurred exclusively to earn either taxable or exempt profits. Our view is that such expenses should be allocated rather than apportioned.

Reduced WHT rate

With regards to the reduced WHT rate on construction activities, companies may need to explore the extent to which ancillary activities can be included in a principal construction contract to qualify for the reduced WHT exemption, as separately contracting for such activities will expose them to the higher WHT rate.

For a deeper discussion, please contact any member of our Tax team below or your usual contact within PwC Nigeria:

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