# Court of Appeal upholds previous rulings on capital allowances and "Excess Dividend Tax"

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## In brief

In a judgment issued in March 2015, the Court of Appeal (CA) upheld the earlier rulings of the Federal High Court (FHC) and Body of Appeal Commissioners (BAC), which rejected a claim of 100% capital allowances in a tax year by a company that is not fully engaged in agro-allied or manufacturing activities.

The judgment also sustained an assessment for Excess Dividend Tax (EDT) issued by the tax authorities on the basis that the dividends in question were paid out of profits which had not been subjected to tax.

## In detail

### Background

The Companies Income Tax Act (CITA) restricts the capital allowances that can be claimed by companies when calculating their taxable profits in each tax year, to two-thirds (66 2/3 percent) of their assessable profits.

This restriction is removed for a company "in the agro-allied industry or which is engaged in the trade or business of manufacturing". In other words, such a company can claim available capital allowances up to the extent of its assessable profits in a given year.

CITA also provides for the imposition of income tax at 30% on a company's dividends declared, where such dividends exceed the company's taxable profits for the year of assessment to which the accounts, out of which the dividend is declared, relates - the Excess Dividend Tax (EDT) rule.

### Facts of the case

The Appellant in this case is a company that operates as an oil marketing company and also engages in the business of manufacturing lubricants.

In its 2004 year of assessment (YOA) tax returns, the company did not restrict its capital allowance claim to two-thirds of its assessable profits; on the basis that CITA allows companies engaged in manufacturing activities to claim full allowances.

The Federal Inland Revenue Service (FIRS) disallowed the "excess" capital allowance claimed by the Company and raised additional assessments. This was done on the premise that the Company's manufacturing operations were not significant enough to qualify it for the full capital allowance claim as provided by CITA (as the company was also significantly involved in the business of marketing/trading in petroleum products).

The Company contested the position of the FIRS and filed appeals with the BAC and subsequently the FHC, where the FIRS' assessments were sustained.

In issuing its judgment, the FHC ruled that the Appellant should pay the assessed sum less 5%, to accommodate full capital allowance claim on the company's manufacturing operations – estimated to contribute only about 5% of the turnover of the Company.

In addition, the FIRS issued an assessment for EDT on the basis that the Appellant declared and paid out dividends in excess of its taxable profits in its 2004 YOA returns. These EDT assessments had also previously been upheld by the BAC and FHC.

***Appellant's position***

The appeal filed to the CA detailed the following issues for determination:

- Whether the FHC was right to conclude that the Appellant is entitled to full claim of capital allowance on only 5% of its assessable profits[1], and whether there is a threshold on the level of manufacturing activity a company is required to qualify for 100% capital allowance deduction.

- Whether the FHC was right to conclude that the dividend paid out by the Appellant in the 2004 YOA was liable to EDT.

The Company's arguments to support its full claim of capital allowances were based on the following:

- CITA does not set any threshold to be met by a company engaged in manufacturing activities for it to qualify for full claim of capital allowances.

- CITA provides that the profits of a company engaged in more than one line of business relate to profits from all sources minus allowable expense plus disallowable expenses, hence the use of the term "assessable *profits*".

- Whether a company is into another line of business is immaterial as the intent of the law is to encourage companies to go into manufacturing and agro allied businesses.

On the issue of EDT, the Appellant argued that in line with Section 380 of the Companies Allied Matters Act (CAMA), dividends are paid out of retained earnings. Therefore the FHC was inaccurate to conclude that its dividends were paid out of its accounting profits for the year (2003 financial year [FY]). The Appellants also held that Section 380 of CAMA was a specific provision relating to the payment of dividends, and therefore should override any other general provision in CAMA or other laws.

***FIRS' position***

The arguments presented by the FIRS were the direct opposite of the Appellant's.

The FIRS argued that the Appellant had always presented itself as a marketer of oil products and therefore should not be able to claim the benefits available to agro-allied and manufacturing companies.

The FIRS stated that the tax laws allow the claim of capital allowances against assessable profits, where the allowances relate to qualifying capital expenditure (QCE) acquired to generate such profits. Therefore, capital allowances on QCE for the Appellant's manufacturing and marketing operations should be proportionately applied on the profits of the two different businesses.

On the EDT issue, the FIRS argued that the dividend paid was not out of retained earnings but from the profit declared for the same year and as such EDT should apply.

The FIRS also argued that the EDT provision in CITA should take precedence over Section 380 of CAMA with regards to taxation of companies.

***The Judgment***

The CA ruled against the Appellant and upheld the previous rulings issued by the FHC on both issues.

In giving the ruling, the CA stated that although the Appellant was engaged in manufacturing activities, such activities were not sufficient to qualify the company to claim 100% capital allowances.

The judge ruled that for a company to be eligible for full claim of capital allowances, it should be shown to be in the agro-allied industry or in the business of manufacturing as a matter of indisputable fact.

It was further stated that a company partly involved in manufacturing activities should limit its full claim of capital allowances to QCE and profits relating to such activities, and that this should also be reflected in its annual returns and financial statements.

On the issue of EDT, the CA held that there was no evidence that the dividends in question were paid out of retained earnings and as such, it was clear that EDT was applicable.

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[1] The FHC judgment actually orders the Appellant to pay the tax assessed *less* 5%, and not for the company to claim capital allowances on 5% of its profits. This ambiguity was also repeated in the CA's judgment, although the eventual ruling was similar to the FHC's.

The CA also held that CITA is a special enactment guiding the taxation of companies, while CAMA was a general legislation. Consequently, the EDT provision in CITA should supersede Section 380 in CAMA which only gives guidance on the source from which dividends can be paid.

## *The takeaway*

Based on the decision by the Court of Appeal, it is recommended for companies involved in manufacturing/agro-allied businesses together with other forms of trade to establish the QCE and profits relating to their other businesses. This will help ascertain the manner and what proportion of the profits to claim full capital allowances or to restrict. However, where those other trades are incidental to the agro-allied or manufacturing activities there are arguments not to restrict capital allowances.

With regards to EDT, the affirmation of the previous BAC and FHC rulings by the CA goes some way to strengthen the inference that dividends paid out of taxed retained earnings should not be subject to EDT.

Although this point is not specifically mentioned in these rulings, it has been ruled in the 3 instances that EDT was applicable because there was no evidence showing that the Appellant paid dividends from its retained earnings. This gives some implicit credence to the view that dividends paid from retained profits should not be subject to EDT.

The outcome of this judgment is in contrast with an earlier Tax Appeal Tribunal (TAT) ruling issued in 2014 which seemed to disregard the retained earnings argument. The TAT had earlier ruled that EDT was applicable where a company's dividends exceed its taxable profits in a particular financial year, irrespective of whether they are paid from retained earnings or not.

It is expected that the CA ruling will be used as a basis to support the exemption of dividends paid from taxed retained earnings from EDT.

Ultimately, in order to finally provide clarity to this matter and certainty for investors, an amendment of the EDT provision is required by the National Assembly to the effect that EDT should not apply to profits which have already been taxed and those that are specifically exempted from income tax.

## *Let's talk*

For a deeper discussion of how this issue might affect your business, please contact:

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