
PwC secures a favourable judgement on deemed income assessment

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In brief

In a recent decision, the Tax Appeal Tribunal (TAT) says a tax authority must act reasonably in the exercise of its discretion to assess a taxpayer based on deemed income (or best of judgment assessment). In the instant case, the TAT rules that a deemed income assessment cannot be based on general expectation or what was imposed on another company.

The TAT also ruled that although the taxpayers being assessed are the employees, the employer can challenge the assessment to the extent that it alleges a breach of the employer's statutory role as an agent of the tax authority.

This decision provides clarity on the rules governing the imposition of deemed income assessment by tax authorities.

In detail

Background

A Nigerian employer is required to deduct and account for personal income tax on the employment income of its employees through the Pay-As-You-Earn (PAYE) system. As an agent of the relevant tax authority, an employer performs this role by disclosing in a return, the total emoluments paid to its employees and the amount of tax that has been deducted on the emoluments.

Section 82 of PITA provides that an employer shall be answerable to the relevant tax authority for any amount (together with interest and penalty) it fails to deduct or properly account for.

Section 54(2)(b) of PITA empowers the relevant tax authority to refuse returns filed by a taxable person and determine the amount of the assessable, total or chargeable income of the person based on its best of judgment and make an assessment accordingly.

Tax authorities usually rely on section 54(2) (b) to impose deemed salaries that are higher than the figures reported by the employer in certain cases especially where the income declared is considered insufficient. This exposes employers to liabilities for under-deduction of taxes.

Oftentimes when an employer challenges a deemed income assessment, the tax authority would argue that since the

employer is not the taxpayer, it did not have the right to challenge the assessment.

Facts of the case

In the instant case, the appellant, a Nigerian employer appealed against the refusal by the Lagos State Internal Revenue Service ("LIRS") to amend its demand notice served on the employer. The amount on the notice represented alleged liabilities for taxes ought to have been deducted through the PAYE system in respect of the expatriate employees of the appellant. The amount was computed based on deemed income imposed by the LIRS together with interest and penalties.

The LIRS relied on section 54(2)(b) of PITA to impose the deemed income on the employees of the appellant. According to the LIRS, the deemed income imposed is based on similar amounts assessed on the employees of a sister company.

The evidence before the TAT was that, though operating in the same industry, the appellant carried on a different line of business from its sister company. Also, even though the sister company protested the deemed income that was imposed, it eventually accepted the assessment due to inability to provide all the documentation required by the LIRS to support the actual income of the employees.

In contrast, the appellant was able to provide adequate documentation to the LIRS for the LIRS to confirm the actual income earned by the expatriate employees in the form of employment contracts, pay slips, payroll and audited financial statements.

The LIRS also argued that the appellant is not in a position to challenge the assessment as the company was not a taxpayer under the provisions of PITA and only the expatriate employees who are the taxpayers could challenge the liability on the demand notice.

Company's position

PwC argued on behalf of the appellant that:

- i. The demand notice alleges an under-deduction of taxes by the appellant in breach of its statutory duty as an agent of the LIRS under the PAYE system. On this basis,

the LIRS imposed interest and penalty in the demand notice. The appellant must be entitled to challenge an allegation of a breach of its statutory duty.

- ii. LIRS' exercise of discretion under section 54(2)(b) of PITA was arbitrary, biased, unfair and unreasonable because:

- ✚ It was unfair and the LIRS was unfaithful to its duties and obligations by refusing to accept the consistent information that had been provided by the appellant;
- ✚ It was arbitrary to refer to and rely on the figures that had been imposed on another company; and
- ✚ There is no proof that the appellant under-declared the actual remuneration of the employees in question.

LIRS' position

LIRS' arguments can be summed up as follows:

- The appellant lacks the right to institute the action as it is not a taxable person under the PITA.
- LIRS has the right to tax based on its best of judgment in accordance with the provisions of PITA.
- The appellant failed to satisfy the LIRS of the reasonableness of the employees' contracts.
- Employees of the sister company in the same industry earned higher

salaries as such the higher salaries should be imputed for the appellant's expatriate employees.

The decision

The issues for determination before the TAT were:

1. Whether the appellant has the right to appeal against the demand notice.
2. Whether by rejecting the contracts of employment of the company's employees and considering extraneous materials, the exercise of discretion under section 54(2)(b) of PITA by LIRS was not arbitrary, biased and unfair.

The TAT resolved these questions in favour of the appellant, vacated the assessment and directed the LIRS to assess the appellant on the actual documentation provided by the appellant. Specifically, the TAT decided that:

- i. An employer has the right to challenge an alleged breach of its statutory role as an agent of the tax authority for the deduction of tax under the PAYE system. Any allegation that the emoluments were understated can therefore be challenged by the employer.
- ii. A best of judgement assessment can only be imposed if the tax authority has prior knowledge of similar circumstances that make the particular return appear to be less than normal and the parameters that informed the rejection

- must be put in context in the decision.
- iii. While a deemed assessment must bear semblance to normal tax assessment of identical or closely related companies in similar or identical circumstances, a deemed assessment cannot be established on a prior deemed assessment.
 - iv. Deemed assessment must originate from actual industry results and the parameters must be realistic within industry context.

The takeaway

The ability to identify the issues in contention is important in the proper determination of a tax dispute. By framing the dispute as one bordering on an allegation of a breach of the employer's statutory duty, the

appellant in this case was able to convince the TAT that it should have a right to appeal the demand notice. In the past, similar cases had been argued as an appeal against a tax assessment which can only be pursued by the employees (as the taxpayers).

The TAT in this case echoed the very important principle of public policy that when a statutory body is empowered under a statute to exercise discretion on an issue, the statutory body must in all cases act reasonably, fairly and faithfully. The statutory power to exercise discretion is not without limits.

The principle articulated by the TAT in respect of deemed assessments in this case may also be applicable in cases where a company has not filed a return. In those cases, the

Companies Income Tax Act empowers the Federal Inland Revenue Service to issue a Best of Judgement (BOJ) assessment. This implies that such assessments must be reasonable and must originate from actual circumstances and industry trends.

Employers must always keep adequate documentation of the terms and conditions of their employment contracts as well as all payments or perquisites made available to employees.

The refusal to challenge a BOJ assessment by an employer may create a precedent that will be difficult to challenge in the future. The resolution of tax disputes with tax authorities must be done on the basis of enduring principles.

Let's talk

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

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