Rödl & Partner

# THIN CAPITALISATION

## RULES AND OTHER MATTERS UNDER THE NEW FINANCE ACT

# THIN CAPITALISATION RULES AND OTHER MATTERS UNDER THE NEW FINANCE ACT

The President of the Federal Republic of Nigeria on the 13th of January, 2020 gave his assent to the Finance Act. With the introduction of the Finance Act, substantial amendments have been made to the Companies Income Tax Act ("CITA"), Value Added Tax Act ("VAT Act"), Petroleum Profits Tax Act ("PPTA"), Personal Income Tax Act ("PITA"), Capital Gains Tax Act ("CGTA"), Customs and Excise Tariff Etc. (Consolidation) Act ("CET Act"), and the Stamp Duties Act ("Stamp Duties Act") respectively.

## Thin Capitalisation Rules

Notably, one of the changes brought by the Finance Act is the introduction of the Thin Capitalization Rule which has risen to prominence around the world in recent years. Prior to this Act, the practice was that the Federal Inland Revenue Service would carefully scrutinise interest deductions and disallow those which it considers excessive. In a broad sense, thin capitalisation which has been adopted by countries such as Russia, United States and Canada refers to a situation where an enterprise employs more debt than equity to finance its business operations. Companies can, therefore, be referred to as thinly capitalised and highly leveraged where they have more debt than equity capital Typically, foreign companies in other countries would seek external loans from their parent companies with the aim of expanding investment. Subsidiary companies are also know to exploit this technique in avoiding tax.

Over time, it has been observed that a foreign company in one tax jurisdiction with higher tax rate

Over time, it has been observed that a foreign company in one tax jurisdiction with higher tax rate finance its subsidiary in another tax jurisdiction with lower tax rate through debt capital. Since interest expenses on debt capital are deductible for tax purposes in most tax jurisdictions of the world, deductions of interest expenses on debts would likely cause a lower assessable profits and potentially reduce tax revenue for tax authorities. Companies with high debt funding are more likely to enjoy tax reliefs on interest charges. This becomes an incentive for companies to increase their debt ratio and a tool for tax avoidance as subsidiaries of foreign companies can engage more of debt financing with the aim of profit repatriation under the cover of repayment of interest on loan.

The need to reduce base erosion and profit shifting has fuelled the inclusion of Thin Capitalisation Rules into the new Finance Act in Nigeria and similar legislations in other countries. The thin capitalization rule adopted under the Finance Act in Nigeria provides that where a Nigerian company (excluding a banking or insurance company) incurs any expenditure by way of interest or of similar nature in respect of debt issued by a foreign "connected person", the excess interest (an amount exceeding 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) of the Nigerian company) will not be an allowable deduction. However, the silver lining provided to companies is that a company will be permitted to carry forward the disallowed interest expense for up to five consecutive years.

## Penalty For Breach

In line with the Organisation for Economic Cooperation and Development (OECD) recommendation on base erosion and profit shifting, the Finance Act provides that a defaulting company shall be liable to a penalty at 10% and an interest at the central bank of Nigeria monetary policy rate plus a spread to be determined by the Minister.

The Federal Government by this enactment amongst others seeks to promote fiscal equity, raising revenue for the government, supporting small and medium scale enterprises, introducing tax incentives for investments in infrastructure and capital markets and reformation of domestic tax laws to align with global best practises. In light of this, below are some few changes made to each Act respectively;

# OTHER CHANGES IN THE NEW FINANCE ACT

## A. Company Income Tax Act

i) Taxable Companies : The Act introduces provisions that create a taxable presence for Non Resident Companies carrying on digital activities, consultancy, technical, management or professional services in Nigeria, provided that they have "significant economic presence" (SEP) in Nigeria and profit can be attributable to such activity;

ii) Deletion of certain inhibitive rules for insurance companies: Under the Finance Act, insurance companies would be able to carry forward losses indefinitely as opposed to the 4-year restriction which was formerly in place. Investment income taxable on life assurance businesses will be based on income derived from the Shareholders Fund. Furthermore, for non-life assurance businesses, the cap on reserve for unexpired risks and claims and outgoings has been relaxed;

iii) Exceptions to Excess Dividend Tax: Section 7 of the Finance Act expressly provides that excess dividend tax will no longer apply to the following:

1. Dividend paid out of the retained earnings of a company where the dividend had previously been subjected to income tax, profit tax or capital gains tax.
2. Dividend paid out of profit exempted from income tax under the Industrial Development (Income Tax Relief) Act, Petroleum Profit Tax Act, Capital Gains Tax Act or any other legislation.
3. Franked investment income; and
4. rental income and dividend income which a real estate investment company distributes to its shareholders.

iv) Expansion of the categories of exempt income: The Act seeks to expand categories of exempt income to include the profit of a small company and dividends declared from small manufacturing companies. The exemption also covers rental income/dividend of Real Estate Investment Companies and secondary payments under "Securities Lending" transaction; thereby eliminating any potential double taxation on compensating payment mimicking interest/dividends;

v) Expansion of the categories of allowable deductions and the introduction of thin capitalisation rules;

vi) The Act has removed the Ministerial approval requirement for expenses incurred relating to management services between non-related parties before such expenses could be tax-deductible;

vii) The introduction of new commencement and cessation rules

viii) The Act has introduced new company income tax rates, based on respective companies' revenue;

ix) The Finance Act has reduced the percentage of withholding tax exemptions on interest on foreign loans. The highest exemption is 70% for loans with a repayment period (including moratorium) of more than 7 years and a grace period of not less than 2 years;

x) The introduction of early tax payment bonus: taxpayers who pay their tax liability at least 90 days before due date would be entitled to a bonus of 2% and 1% of the tax paid for medium and large companies respectively.

## B. Value Added Tax Act

i) The Act has gone ahead to Include the definition of "goods" and "services". This seeks to eliminate ambiguity with respect to the application of VAT to certain transactions.

ii) Definition of exported services: The Act defines "exported services" as "a service rendered within or outside Nigeria by a person resident in Nigeria to a person outside Nigeria". The Act by this definition erased ambiguity that arose formerly in the application of the word exported services to transactions;

iii) There is now an increase in Value Added Tax rate from 5% to 7.5%;

iv) The introduction of N25million revenue threshold for taxable persons required to register for VAT and file returns;

v) Exemption of assets sold in a restructuring exercise The Act exempts assets sold or transferred to a related party in a restructuring exercise provided such assets are not sold by the acquiring company within 365 days after the date of restructuring.

## C. Personal Income Tax Act

i) The Act has deleted certain provisions that grant certain personal reliefs;

ii) Contributions to pension, provident and other retirement benefits fund, society or scheme would constitute allowable deductions for tax purposes;

iii) Banks are now mandated to obtain tax identification number (TIN) from customers prior to transactions;

## D. Custom and Excise Tax Act (CETA)

By virtue of section 48 of the Finance Act, Goods imported to Nigeria and specified in the Fifth Schedule will be subject to excise duties. This eliminates any unfair advantage on imported products over local products. It ensures a level playing field between local producers and imported products.

## E. Petroleum Profits Tax Act (PPTA)

The Act seeks to repeal the provision of PPTA that exempts dividends paid out of profits derived from petroleum operations from withholding tax. Taxpayers in this space would now be saddled with the responsibility of withholding tax when paying dividends.

## F. Stamp Duties Act (SDA)

I) The Act increases the stamp duty on receipts to N50 on every transaction from N10,000 and above; and further expands the definition of receipt to cover electronic transactions. This provides a legal justification as to what is already being practised by Nigerian banks, but however raises the threshold from N1,000 to N10,000.

ii) The Stamp Duties Act was also amended to exempt transactions on Regulated Securities Lending Transactions (RSTL) which are exempted from stamp duties.

## G. Capital Gains Tax Act (CGTA)

Transfer of assets during reorganization within a group of companies would be exempt from CGT. However, an anti-avoidance provision was included to ensure companies do not create fictitious group structures to take advantage of this exemption. Notably also, compensation received for loss of employment of up to N10million would be exempted from CGT. This creates an incentive for payment of compensation for loss of employment below the N10million threshold as termination benefits rather than terminal benefits, which would have been subjected to personal income tax.

## CONCLUSION

The Finance Act is indeed a welcome development as it seeks to promote the governments overriding objective of creating an enabling environment for business in Nigeria. With the introduction of the thin capitalisation rules and other policies in the Finance Act, the government clearly seeks to revamp its revenue drive by reducing tax evasion and promoting best international practises.