FINANCE ACT, 2019: TAX IMPLICATIONS FOR THE PRIVATE EQUITY INDUSTRY

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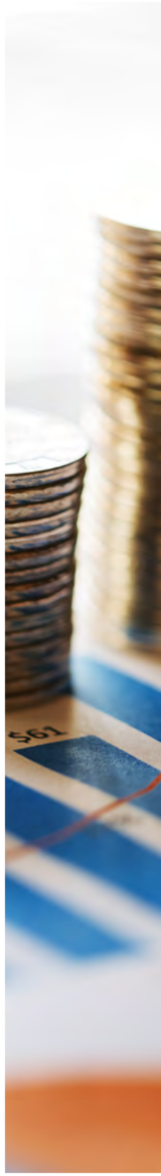


INTRODUCTION

The Finance Act, 2019 ("the Finance Act")[1] has made significant changes to the tax regime in Nigeria. The Act makes changes to legislation such as the Companies Income Tax Act ("CITA"), Petroleum Profit Tax Act ("PPTA"), Personal Income Tax Act ("PITA"), Value Added Tax Act ("VATA") and Capital Gains Tax Act "(CGTA"), amongst others.

We anticipate that some of these reforms would be of interest to private equity ("PE") and venture capital ("VC") investors and fund managers interested in Nigeria. This is because the changes will have an impact on matters such as investment strategies, tax planning and revenue forecasts.

We highlight the relevant changes and potential implications for the PE industry below.

TAXATION OF DIGITAL AND REMOTE SERVICES

A key reform introduced by the Finance Act relates to the taxation of foreign companies that provide digital content/services (or engage in digital transactions) or technical/management/consultancy/professional services to persons in Nigeria.

Before the Finance Act, the physical presence of the foreign company or its agents in Nigeria was the primary consideration whilst determining whether profits of the company were derived from Nigeria. However, pursuant to the CITA (as amended by the Finance Act), a digital or virtual presence may now suffice.

Thus, the profits of a foreign company shall be also deemed to be derived from Nigeria where:

- The company transmits signals, messages and data of any kind to Nigeria in respect of any activity including electronic commerce, online payment platforms and online advertisements, to the extent that the company has a significant economic presence in Nigeria and profit can be attributable to such activity; and

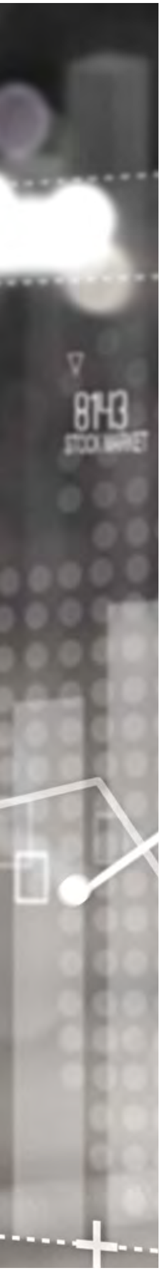
[1] The Finance Act came into force on Monday, 13 January 2020.

- The trade or business involves rendering technical, professional, management and consultancy services outside Nigeria to a person resident in Nigeria, to the extent that the company has a significant economic presence in Nigeria.

In exercise of statutory powers, the Minister of Finance issued the Companies Income Tax (Significant Economic Presence) Order, 2020 on 29 May 2020 (the "SEP Order") which became effective on 3 February 2020, stipulating what would constitute a significant economic presence of a foreign company.

Thus, where a foreign company that provides digital content/services is deemed to have a significant economic presence in Nigeria, its profits will be subject to companies income tax of 30%. Where the foreign company provides technical, management, professional or consultancy services, it will suffer 10% withholding tax ("WHT") when it receives payment for these services from a person resident in Nigeria or a fixed base or agent of a foreign company in Nigeria.

***Planning points**: Nigeria is currently a party to bilateral Double Tax Agreements (the "DTAs") with 14 countries. Nigeria's power to tax the profits of a company resident in any foreign territory covered by a DTA is only exercisable in respect of profits attributable to a 'permanent establishment' (in essence, a physical presence) in Nigeria. As such, there may be an opportunity for multinational enterprises ("MNEs") with access to benefits under Nigeria's DTAs to optimize their group structures with a view to mitigating the impact of the SEP provisions. In exploring that opportunity, it should be noted that the extent to which the DTAs would prevail over the SEP provisions is still uncertain. Also, the OECD's ongoing work on the taxation of digital economy could potentially extend the definition of a permanent establishment in the DTAs to include provisions similar to those of the SEP Order.*



REMOVAL OF FULL WHT EXEMPTION FOR LONG-TERM FOREIGN LOANS

Prior to the enactment of the Finance Act, interest paid from a Nigerian company to a foreign lender were fully exempted from WHT if the underlying loan had a repayment period (inclusive of any moratorium) of more than 7 years. Partial exemptions were available on a graduated basis for shorter tenor loans and any WHT chargeable as a result was (and continues to be) the only tax on such interest.

The amendments introduced by the Finance Act have reduced the WHT exemptions on interest on such foreign loans to a maximum of 70%.

Planning points*: Given the reduction in the tax exemptions in respect of interest on foreign loans, Fund Managers will need to recognise the drop in net interest income from portfolio companies which have been funded with long-term debt, and its impact on things like PIK notes. They will also need to reevaluate strategies for negotiating debt instruments, such as convertible loan notes.*

THIN CAPITALISATION RULES

Prior to the introduction of thin capitalisation rules by the Finance Act, Nigerian companies enjoyed unlimited deductibility of interest expense for income tax purposes, and interest not deducted could be carried forward indefinitely. Under the amended CITA, a tax deduction in respect of interest paid on a loan received from or guaranteed by a 'foreign connected party' must not exceed 30% of the taxpayer's EBITDA. However, it also appears that the 30% limit would apply to interest paid in respect of a loan received from an unrelated party but which is guaranteed by an unrelated party. Interest on debt provided by local lenders is, however, still deductible without limit. Interest not deducted due to the above restriction can still be carried forward, but only for a maximum of 5 years.

Planning points: *PE Fund Managers should be mindful of the impact of thin capitalisation rules on the after-tax profits (and consequently on the distributable profits) of their portfolio companies, where such companies are already funded using debt provided by a foreign*

related party or guaranteed by either a foreign related party or by an unrelated party. Consideration should be given to optimizing the debt mix by substituting local debt for foreign debt where possible, whilst bearing in mind transfer pricing rules that may adjust interest rates to reflect arm's length conditions.

TAX HOLIDAY FOR AGRICULTURAL COMPANIES

The provisions in the CITA (as amended by the Finance Act) relating to tax holidays for companies engaged in agricultural production may make potential investments in Nigerian agribusiness a more attractive proposition for Fund Managers.

Before now, such companies enjoyed income tax exemption under the Industrial Development (Income Tax Relief) Act for a period of up to 5 years.

However, in terms of the amended CITA, companies engaged in agricultural production may now enjoy income tax exemption for up to 8 years, subject to the satisfactory performance of agricultural production[2].

TAX-FREE EARNINGS FOR REAL ESTATE INVESTMENT COMPANIES

The amendments to the CITA (pursuant to the Finance Act) relating to the taxation of real estate investment companies ("REIC")[3] is also relevant to investors in the real estate sector.

The amended CITA provides that dividend and rental income received by a real estate investment company will be exempt from tax, provided that 75% of the dividend or rental income is distributed within 12 months of the end of the financial year in which the dividend or rental income was earned. If the distribution does not take place within this period, the tax exemption will be lost and such earnings will be assessed to tax.

[2] However, such companies will not be granted similar incentives under any other law, such as pioneer status under the Industrial Development (Income Tax Relief) Act.
[3] The Finance Act defines a REIC as a company duly approved by the Securities and Exchange Commission ("SEC") to operate as a real estate investment scheme in Nigeria.

ELIMINATION OF PUNITIVE TAXATION OF TAX EXEMPT INCOME AND RETAINED EARNINGS

Before the recent amendment of the CITA, where a Nigerian company paid dividends that exceeded its profit, the tax payable by the company would be based on the dividends and not on the lower profit. This meant that a portfolio company would be liable to income tax if it distributed dividends from tax exempt income, or, to a further income tax if it distributed dividends from retained earnings which had previously suffered tax. It also created a disincentive to use local holding companies, as a distribution of dividends received by a holding company to its shareholders would invariably trigger a further tax liability.

CITA has now been amended so that no further companies income tax will apply to dividends which are:

- paid out of retained earnings that have suffered tax under the CITA, PPTA, or CGTA;
- paid out of tax-exempt income;
- paid out of franked investment income; or
- paid by a real estate investment company from its rental or dividend incomes.

These amendments effectively eliminate the double taxation that occurs where such dividends are paid from retained earnings that have been taxed. They also ensure that tax incentives are not eroded when dividends that are paid out of tax-exempt income are distributed.

Planning points: *As a result of this reform, companies can distribute dividends from tax exempt income without paying income tax, and distribute dividends from retained earnings without paying a further income tax. Conversely, the pressure to distribute all profits in a financial year in order to avoid double taxation is removed.*

Another key implication of the reforms is that where investors determine that it is beneficial to set up a holding structure in Nigeria, that can now be done on a tax neutral basis and without concerns about the possible double taxation of the profits of subsidiaries and erosion of tax incentives.

POSSIBLE INCOME TAX AND VAT EXPOSURE FOR FOREIGN ENTITIES

Recent decisions of the Nigerian courts and the amendment of the VAT Act's definition of 'exported services' may have broader tax implications for Fund Managers who would ordinarily be considered not to be tax-resident in Nigeria, particularly if they seek to raise funds from Nigerian investors.

Prior to its amendment by the Finance Act, the VAT Act defined an exported service as a "service performed by a Nigerian resident or a Nigerian company to a person outside Nigeria". As exported services were (and still are) exempt from VAT, one view widely held in practice was that a Nigerian entity marketing funds to Nigerian residents on behalf of a non-resident fund manager was not required to include VAT in an invoice for that service or to include such transactions in its VAT returns for the relevant period.

However, in <u>Allan Gray Investment Management Nigeria Limited (Appellant) v Federal Inland Revenue Service (FIRS)</u>, the Tax Appeal Tribunal ("TAT") took the view that a South African investment manager was carrying on business in Nigeria because its Nigerian subsidiary marketed investment funds to Nigerian residents on its behalf. That finding was used to support a decision that services rendered by the local subsidiary were in fact rendered to a fixed base of the non-resident company and, therefore, could not be considered to be exported services.

The decision in Allan Gray now appears to have been codified by the Finance Act's redefinition of 'exported services' as expressly excluding services provided to the fixed base or permanent establishment of a non-resident person.

One implication of these developments is that Nigerian companies or individuals that are engaged to market foreign funds to local investors on behalf of non-resident fund managers will now be required to issue VAT invoices in respect of such services.

There is also a chance that the tax authorities and courts could begin to take the view, following the TAT's reasoning in the Allan Gray decision, that foreign PE funds sourcing investors through local representative offices should be deemed to have a permanent establishment or fixed base in Nigeria, and therefore be liable to pay income taxes in Nigeria.

Planning Points: *It is necessary for Fund Managers resident outside Nigeria to assess their operations and existing relationships (with local representatives or agents) to determine whether the prevailing circumstances are such that their firms may be deemed to have permanent establishment or fixed base in Nigeria and therefore become liable to pay taxes such as VAT and companies income tax.*

VAT AND CGT EXEMPTIONS ON BUSINESS REORGANISATION

Prior to the Finance Act, the transfer of assets in the course of a business reorganisation was construed as a disposal for the purpose of CGT. Such transfer of assets was also deemed as a 'supply of goods' to the transferee and was, therefore, subject to VAT. This was so even if the transferee was a wholly owned subsidiary of the selling entity.

The Finance Act has introduced amendments to the CGT Act and the VAT Act. The effect of these amendments is that CGT and VAT will no longer be payable upon the sale or transfer of assets during a business reorganisation if:

- the sale or transfer is to a Nigerian company for the purpose of better organisation of that trade, or business or the transfer of its management to Nigeria; and

- the entities are related, i.e. one company has control over the other, or both companies are controlled by some other person, or both companies are members of a recognised group of companies[4] for a minimum period of 365 days prior to the date of the reorganisation.

However, if the transferee subsequently disposes of the assets within 365 days after the date of the transaction, the tax exemptions will be rescinded.

***Planning points**: Opting for an asset acquisition rather than a share acquisition would now be tax neutral. It would involve the following 3-step process- (1) the selling entity will incorporate a wholly-owned subsidiary; (2) the selling entity will transfer the assets to the wholly-owned subsidiary after 365 days; and (3) the selling entity will then sell the subsidiary to the acquirer.*

Where a portfolio company of a private equity fund is the seller, this 3-step process will also be available.

INCENTIVES FOR SMALL BUSINESSES

The Finance Act provides that small businesses (i.e. with a turnover of N25million or less) are exempt from CIT, whilst medium-sized companies (i.e. with a turnover greater than N25million but less than N100 million) are to be taxed at a reduced rate of 20%.

WHT ON DIVIDENDS FROM PETROLEUM PROFITS

Before now, dividends paid out of profits that have been subjected to petroleum profits tax did not suffer WHT. This meant that PE entities with investment in the petroleum industry could receive dividends thereof free of WHT. However, such dividends will now suffer WHT of 10%, although, shareholders that are resident in a country that has a DTA with Nigeria will enjoy a reduced rate of 7.5%.

[4] This is defined in the CGTA as a group of companies as prescribed under the relevant accounting standard.

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The contents of this article are intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances. If you need additional information, please contact taxgroup@aelex.com.

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