Seun Adu

PwC's Transfer Pricing Series

Transfer Pricing and the Trojan horse in the 2019 Finance Bill

> The amendments to section 27 will come as good news to many taxpayers. It will however be bad news or a mixed bag for some others. For now, the main casualties are taxpayers whose businesses are driven by the exploitation of IP and who must make payments to related parties for the rights to use the IP.

You have heard the story before. Greece and Troy are at war. For ten years, the Greeks surround the city of Troy but find no way to breach its walls. Tired of not making progress, the Greeks decide to stop working hard and start working smart. They pretend to abandon the war and leave a gift in honour of the Trojans. The Trojans wake up to find there are no Greeks trying to tear down their city walls and no Greek ships anywhere in sight: just a mighty wooden horse; a parting gift from the Greeks.

Delighted, they pull the wooden horse into the city and throw a big party to celebrate their victory. What they do not know is that there are Greek warriors hiding in the belly of the wooden horse. When the city goes to sleep, the Greek warriors climb out, open the city gates from the inside, and let the rest of the Greek army in. The Greeks catch the Trojans unawares and win the war.

For the casual observer, the proposed deletion of Sections 27g, 27h, and 27i of the Companies Income Tax Act (CITA) and the introduction of a new section 27g are welcome gifts from the government; a victory for taxpayers. You only need to look a little closer to realise there might be a Trojan horse right in the middle of the party.

Why it is great that the Sections 27g, h, and i will go

There are at least three reasons why the proposed deletions are great.

Section 27h requires taxpayers to get the approval of the Minister of Finance to be eligible for a tax deduction for management services. In practice, the FIRS uses the approval of the National Office for Technology Acquisition and Promotion (NOTAP) as a proxy for the Minister's approval. Similarly section 27i gives the FIRS the discretion to determine whether or not any expense incurred outside Nigeria is allowable. This discretion is often hinged on the availability of a NOTAP approval for transactions that required such approvals.

The problem with relying on NOTAP's approval is that the prices approved by NOTAP do not necessarily reflect any of the key principles relevant for evaluating the deductibility of an expense for tax purposes. For example NOTAP can refuse to give an approval even where it is clear that the expense is a valid business expense. In addition, NOTAP often caps the approved fees for the transaction to an amount that does not reflect market prices or the arm's length principle.

The second reason why the proposed deletions are good is the fact that if one is to follow the law strictly, then every person paying a management service fee, regardless of the amount, to a company (including an unrelated party) outside Nigeria would have to approach the Minister of Finance to get an approval. In addition, based on Section 27g, anyone that incurs expenses incidental to earning a management fee, must obtain the approval of the Minister. Experience has shown that these provisions are impractical and are arguably not the best use of the Minister's time and resources.

Finally, Section 27i gives the FIRS the discretion to allow or disallow expenses incurred outside Nigeria without setting the parameters for exercising this discretion. This could lead to abuse.

The deletion of these sections suggests a deliberate move away from the use of arbitrary rules in limiting tax deductions for expenses incurred outside Nigeria.

What the new Section 27(g) says and why it is almost a good deal

The new Section 27(g) focuses on transactions between related parties. It does not place any restrictions on charges for transactions with independent parties. This is good because in general, there is limited room for abuse when companies deal with independent parties.

This section provides that transactions between related parties will not be deductible for tax purposes except they are consistent with the TP Regulations.

Since the overarching theme of the TP Regulations is for related parties to price their transactions in line with the arm's length principle, it effectively makes compliance with the arm's length principle a primary condition for the tax deductibility of expenses incurred in transactions between related parties.

Surely, this has to be a good thing. You no longer have to worry that arbitrary price caps from NOTAP will determine whether or not you get a tax deduction for your related party expenses. You only need to concern yourself with applying the arm's length principle in line with global standards, right?

The problem with the new provision

You underestimate the full impact of the new provision if you assume that the pricing rules prescribed in the TP Regulations are (and will always be) consistent with the arm's length principle. This is the problem.

If arbitrary rules to limit the tax deductibility of payments to related parties are introduced through the TP Regulations, they will have the full backing of the CITA even if they are not in line with the arm's length principle. This will in effect take us back to the very problem we thought we had got rid of.

The 2018 TP Regulations have at least one significant provision that does not follow the arm's length standard (or any globally agreed standard); and there is no guarantee that there won't be more in the future.

In particular, the 2018 TP Regulations provide that, even when you can show that the price you have paid for the rights to use an intangible (let us call this a royalty) is a market price, you will not be allowed to deduct any amount in excess of 5% of the Earnings Before Interest, Tax, Depreciation and Armotisation plus the Royalty (EBITDAR) relating to the business for which the intangible right was used. The percentage (5%) and profit measure (EBITDAR) applied appear to be arbitrary and do not reflect what independent parties will agree to in all situations. This provision has significant implications for businesses that are heavily driven by intellectual property rights.

If you take the proposed changes out of the equation, one could have challenged this EBITDAR cap on the basis that it is not consistent with the arm's length principle as specified in the CITA. The passing into law of the new Section 27(g) will effectively invalidate this argument.

Conclusion

The proposed amendments to section 27 will come as good news to many taxpayers. It will however be bad news or a mixed bag for some others. For now, the main casualties are taxpayers whose businesses are driven by the exploitation of IP and who must make payments to related parties for the rights to use the IP. The disallowed amounts in excess of the EBITDAR cap will go to increase their cost of doing business in Nigeria.

The requirement to comply with the TP Regulations as a pre-condition for obtaining tax deductibility for related party charges is good only to the extent that the TP Regulations themselves contain rules that are not arbitrary and do not discriminate against valid and properly priced business charges.

The proposed changes will solve many problems but will also re-introduce others. One fix for this new problem is for the lawmakers to make compliance with the "arm's length principle" the condition for the deductibility of intercompany charges. The alternative is to, like they have done with CITA, get rid of arbitrary restrictions in the TP Regulations otherwise the proposed change re-introduces the same problem it seeks to fix, at least for royalties.

Seun Adu is a Partner and Transfer Pricing Leader at PwC Nigeria. He is a regular writer and public speaker on tax and transfer pricing matters.

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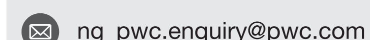
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