Nigeria issues guidelines on significant economic presence for foreign companies

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Introduction

Physical presence in traditional service delivery is easy to monitor. Under this system, a tax authority can determine whether a non-resident person is taxable in a country based on factors such as fixed base, turnkey project, and dependent agent. Fairly straight-forward. All went well until the digital era jumped into the spotlight.

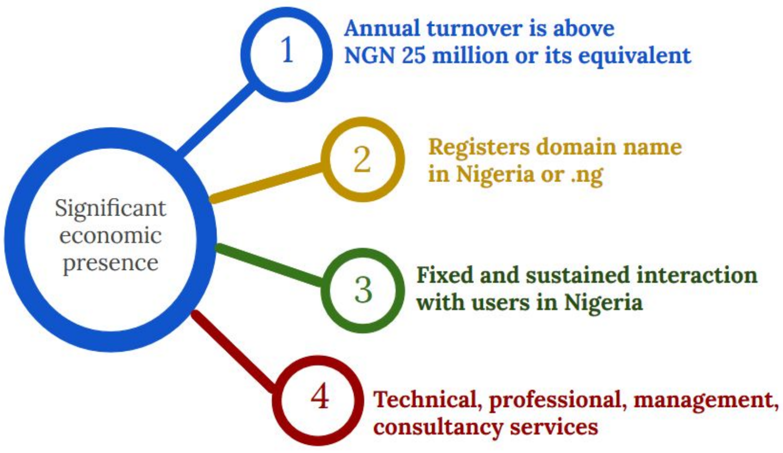
If there is one factor that has changed the way most businesses operate in a foreign market, it is technology. With the aid of technology, companies can provide services to consumers in another country without physically crossing the borders. International trade comes along with benefits as well as costs. There are more revenue, consumer base, a higher profit margin, and the likelihood that a business pays no tax on foreign operations. Therefore, policies on the taxation of multinational enterprises must consider technology. These policies may not be available in local tax laws.

Significant economic presence in Nigeria

In 2019, the Organisation of Economic Cooperation for Development proposed two pillars that will guide countries on the taxation of the digital economy. Emphasis is on Pillar One as it examines how to re-distribute the taxing rights using user participation, marketing intangibles, and significant economic presence (SEP). The SEP model explores how technology enables enterprises to operate fully in an offshore economy without having a physical presence. As a result, the user base or continuous marketing activities of a foreign company using digital technology are examples of factors that can create SEP.

Nigeria introduced the rule on significant economic presence in the Finance Act 2019. The Act contains amendments to seven tax laws, including companies income tax act (CITA).

Section 13 of CITA 2004, as amended, shows the new basis that will make a non-resident company (NRC) taxable in Nigeria. Henceforth, the Nigerian tax authority will test whether a foreign company has a significant economic presence. The effective date of the Finance Act was 13 January 2020. Furthermore, the Finance Minister has published a Gazette on Companies Income Tax (Significant Economic Presence) Order 2020. The Gazette provides additional details on the scope, threshold of, and activities exempt from SEP in Nigeria.



Conditions for significant economic presence in Nigeria

Foreign companies covered under SEP in Nigeria

A foreign company operating in Nigeria will have a significant economic presence under the following.

1. It derives an annual revenue of above NGN25 million (or Naira equivalent) from -
   - services to users in Nigeria such as digital contents, online affiliation, data collection on the usage of websites or applications, or
   - taxable goods or services that are delivered either directly or indirectly through digital channels to Nigeria. Examples of digital channels are e-commerce, social media, online video, data sharing platforms, and similar activities conducted through satellite.

The threshold for annual turnover is inclusive of all activities of connected persons in the accounting year.

2. It registers a website address in Nigeria or uses Nigerian domain name.

3. It has a fixed and constant communication with users in Nigeria. For instance, where a business adjusts its online brand to attract persons in Nigeria or raises bills in local currency.

Nevertheless, Nigeria shall treat a foreign company covered under a multilateral agreement in line with that agreement. The provisions will apply from the effective date of the consensus arrangement in Nigeria.

4. A foreign company that carries on trade or business in the form of technical, professional, management, or consultancy services will have SEP on income or payments from a person in Nigeria. Where this is the sole source of income for an NRC without SEP, then withholding tax is the final tax.

It is not all payments to a foreign company that will create SEP. Transactions exempt are amounts paid to an employee under an employment contract, receipts from and payments to an educational institution, and sums paid by a foreign-fixed base of a Nigerian company.

Effective date and definition of profits

While the Gazette has a commencement date of 3 February 2020, the document was available to the public on 29 May 2020. The Federal Inland Revenue Service (FIRS) may issue a notice to guide taxpayers on the effective date.

Even though the Gazette contains more details on activities that can create SEP in Nigeria, the definition of taxable profits is uncertain. A couple of questions on how the tax authority will determine profits attributable to the operations in Nigeria are below.

1. Will companies pay income tax on revenue or profits? If profits, what is the basis for determining taxable profits?

2. Will the tax authority apply deemed profit as a flat percentage of the global turnover for all companies?

3. Is profit calculated as a ratio of local revenue to worldwide revenue, or will the tax authority weigh other parameters like assets and employees?

4. Will the tax authority insist on collecting the audited financial accounts for the Nigerian operations?

Furthermore, the NGN25million threshold means that any (foreign) medium and large business with a significant economic presence will enter the tax net. Consequently, more foreign companies may have tax obligations in Nigeria.

Need for collaboration

Let's move from the unknown to the known. It is usual for a company to report global income in the country where it has a head office. A revised approach, therefore, is where the SEP rule has an extra layer that allows the jurisdiction in which the NRC has headquarters to allocate revenue and expenses to other countries where a person is tax resident. Countries should discard political and economic issues in this arrangement. Mutual cooperation and collaboration among tax authorities in different jurisdictions will be essential.

Closing remarks

It is interesting to see that the Nigerian tax law is moving in line with global tax practices. More interesting to observe how FIRS intends to track the new group of taxable persons. As events unfold, the tax authority may need to fine-tune its approach. A traditional tax administration will not be ideal for online NRCs in Nigeria. Nigerian tax authority must have a strong "tax-technology" presence if it wants to generate taxes from the digital economy. However, the challenges of SEP can reduce through the collaboration of tax authorities in various jurisdictions.

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