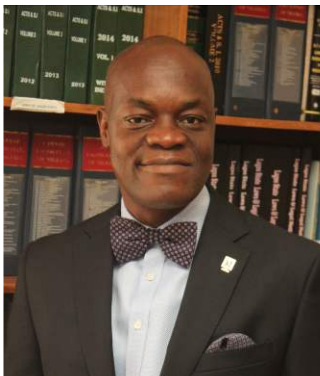
March 2020

Thought Leadership | *Afolabi Elebiju*

Nigeria's Finance Act 2020 Tax Amendments - Should the Oil and Gas Sector Be Nervous?

Introduction

The Federal Government (FG) recorded a notable achievement on January 13th 2020 when President Buhari signed the ***Finance Act No. 1 of 2020*** (albeit wrongly self-described as ***Finance Act 2019***) into law. Further commendation would be earned if the FG keeps its word that henceforth, a Finance Bill embodying proposed tax legislative changes "on an ongoing basis", will accompany every annual Budget proposal. The last time that such happened was under the military; no civilian administration has attempted to do so since Nigeria's return to democratic governance in 1999.



a.elebiju@lelawlegal.com

Obviously, the ***Finance Act 2020 (FA 2020)*** has significantly transformed Nigerian tax landscape by enshrining many long sought for amendments, such as easing up the erstwhile prejudicial excess dividends tax (EDT) and minimum tax provisions – potentially improving Nigeria's investment attractiveness. (As an aside, this author contributed his own quota to the EDT advocacy through three articles: ***'Oando Plc v FIRS: Excess Dividends Tax Revisited'***, *ThisDay Lawyer, 07.10.2014, p. 12*; ***'Excess Dividends Tax: The Unfinished Business'***, *ThisDay Lawyer, 26.11.2013, p. 7*; and ***'Rethinking Nigeria's Excess Dividends Tax'***, *ThisDay Lawyer, 20.11.2011, p. vii*).

Another positive development is the introduction of *preferential companies income tax (CIT) rates* (at 0% and 20% compared to 30% regular rate) for "*small*" and "*medium-sized*" companies; and *Value Added Tax (VAT) compliance obligations exemption* for "small companies" with N25 million turnover or less. Clearly, these are "*good optics*", from ease of doing business perspectives. It is also gladdening that the ***FA 2020*** has introduced provisions seeking to bring Nigerian tax jurisprudence apace with current business realities - such as the digital economy - by revising Nigeria's permanent establishment rules.

Finance Act 2020: A Mixed Grill?

A sector like agriculture ("*agricultural production*") just got more favourable tax treatment (potential cumulative 8 year tax holidays (for new businesses?) *vide* ***section 9 FA 2020*** (introducing ***new 23(1)(1C) CITA***)). Insurance industry's disadvantaged tax toga has been removed: ***sections 5*** and ***6 FA 2020***. Real Estate Investment Trusts (REITS) have now formally received a new lease of life: ***section 9(a) FA 2020 (new section 23(1)(s) CITA).*** However, some others particularly the Nigerian oil and gas industry may feel hard done by, *vide* the new ***FA 2020*** provisions.

This article will discuss industry impacting tax changes, which coupled with provisions of the recently enacted ***Deep Offshore and Inland Basin (Production Sharing Contracts) (Amendment) Act 2019 (PSCAA)*** may constrain Nigeria's still strategic oil and gas sector. Such could potentially render Nigeria less competitive in attracting global capital to develop new oil and gas projects. For reasons of space, we will discuss the ***PSCAA*** in a subsequent article.

Removal of Withholding Tax (WHT) Exemption on Upstream Dividends

Starting with the obvious one: ***section 24 FA 2020*** has now repealed ***section 60 Petroleum Profits Tax Act, Cap. P13, Laws of the Federation of Nigeria (LFN) 2004, (PPTA)*** that exempted upstream dividends from withholding tax (WHT), unlike 'regular' dividends. The 10% additional tax exposure (or 7.5% for shareholders resident in a country having double taxation treaty (DTT) with Nigeria), will definitely impact project economics, for example, the financial modelling of upstream assets investors/acquirers during the recent assets divestiture by IOCs. It is now definitely a factor in assessing prospective deals, and in deciding whether or not to invest.

Upstream operators have now, by virtue of the ***FA 2020*** provision an additional WHT compliance obligation – to deduct WHT from dividends paid to shareholders. Whilst WHT deduction and remittance is an after ***PPTA*** tax event, failure to do so will expose the upstream investee company to applicable sanctions in ***section 40 Federal Inland Revenue Service (Establishment) Act, Cap. F36, LFN 2004 (FIRS Act).*** In this author's view, the combined effect of ***sections 40*** and ***68(2) FIRS Act*** has displaced the more onerous sanction in ***section 54 PPTA*** (the ***FIRS Act*** was later in time and ***section 68 FIRS Act*** is a 'supremacy provision').

Another implication of the new applicability of WHT to upstream dividends is the likelihood that such variation will trigger the stabilisation clause provisions of relevant PSCs, which envisaged that contractors will be restored to their prior state ('equilibrium') *if any change in law, rule, regulation or policy negatively affects contractor take under the PSCs.* The circularity challenges this will bring is better imagined: NNPC whilst being contractually bound to give effect to the stabilisation clause, lacks (legal) capacity to consummate/achieve such result. Although not applicable to the upstream space, new ***section 27(1)(l) CITA*** (*vide* ***section 11 FA 2020***) now penalises taxpayers, to discourage them from bearing the tax burden of any third party. To the extent that stabilisation seeks to render nugatory FG's intent to increase its resource take through tax legislation, stabilisation is arguably 'quixotic'.

PSC contractors aggrieved with their reduced take may launch stabilisation arbitration claims, because the FG (through its statutory agency, the NNPC) contractually committed to give effect to stabilisation. If IOCs are successful, could they seek to enforce such award outside Nigeria or use such to 'negotiate'? Will Nigeria's approach to dealing with the fallouts not affect our perception in the global investment community?

Thin Capitalisation Requirements

FA 2020's new rules against thin capitalisation could also be disconcerting for industry players contemplating capital intensive projects, given that global industry practice is to have an 'optimal' equity-debt capital mix. ***Section 25 FA 2020*** introducing new ***Seventh Schedule CITA*** curtails interest deductions on loans from "*foreign connected persons*" (related party *via* ownership or control tests). Allowable foreign related party interest expense must not be above ***30% of EBITDA***, whilst the interest expense cannot be carried forward for more than five (5) years, totalling maximum six (6) years of deductibility.

This thin capitalisation requirement discourages foreign related party debt financing in favour of equity on the two fronts, limiting: (a) the amount of allowable tax expense; and (b) length (period of deductions) - such that any amounts above the thresholds will be added to the taxable profits of the Nigerian borrower. In addition, the Nigerian borrower in breach of this rule will be liable to 10% penalty and interest at CBN's minimum rediscount rate plus spread to be determined by the Minister on any adjustments made by the FIRS relating to excess interest charged during the year.

Whilst the foregoing changes are meant to facilitate incremental collections to the public fisc, their 'unintended' impact is also worthy of reflection. These provisions will impact large scale long term downstream and midstream project financing.

Being ***CITA***-related, the thin capitalisation requirements in ***FA 2020*** referenced above, do not apply to upstream players: it is ***PPTA's*** deductibility rules in ***sections 10 (and 13) PPTA*** (rather than ***CITA's***) that apply to upstream companies. Whilst conceding that ***FA 2020*** did not make express carve-outs for upstream sector as it did for banking and insurance, the latter was because they are taxable under ***CITA***.

Otherwise, FG's recognition of the cash-intensive nature of upstream operations would more likely than not, have also made it to provide an upstream sector exception. Finally, if the intention was to tinker with ***PPTA's*** deductibility rules vide thin capitalisation, the draftsman would have done so expressly, (a la ***section 24 FA 2020*** and repealed ***section 60 PPTA).*** It is trite that tax legislation are strictly construed, clearly the purport of ***FA 2020*** excess interest provision was not to repeal or curtail ***section 10(1)(g) PPTA's*** benchmark for deductibility of related party foreign loans.

Unintended Effects?

Whilst the foregoing changes are meant to facilitate incremental collections to the public *fisc*, their 'unintended' impact is also worthy of reflection. These provisions will impact large scale long term downstream and midstream project financing. Related party foreign debt may, more often than not, be inescapable because the Nigerian

project company, not being listed abroad may be unable to get favourable financing terms.

With the advent of these provisions, such financings already have spanners thrown into their works, and many will accordingly need to be restructured. There is a possibility that some projects may be at risk if no near-term alternative (but compliant) arrangements can be crafted to replace erstwhile financing structures. Will promoters now be forced to list their Nigerian operations in order to attract international capital that will sidestep the thin capitalisation provisions?

The foregoing may find illustration in Nigerian LNG (NLNG) Limited's Train 7 development; the announcement of its Final Investment Decision (FID) was recently welcomed with fanfare. However, the ***FA 2020*** excess interest provisions threatens the equity and shareholder loan financing model of NLNG (given that NNPC is the only Nigerian shareholder of NLNG). That would be quite a contrast to the enactment of ***NLNG (Fiscal Incentives, Guarantees and Assurances) Act, Cap. N87, LFN 2004*** that prescribed (with retrospective operation), special investment incentives which kick started Nigeria's stellar returns LNG story and other positive spill over effects. NLNG, in order to shield itself, may consider alternative arrangements such as utilising its cash reserves, scaling down shareholder loan component of debt financing, or deferring payment of dividends for some time. This last option will also affect government revenues as NLNG dividends have of late been a huge chunk of the Federation's income.

Will this not have a chilling effect on proposed projects for example under the *Gas Flare Commercialisation Programme* or other large scale projects? Instructively, other proposed LNG projects in Nigeria notably Brass LNG and Olokola LNG have either not taken off or been called off! Imagine a Mozambique that came late to the LNG party attracting more LNG investment than Nigeria with ambitions to overtake Nigeria on LNG investment, even before the entry of ***FA 2020***!

It is also noteworthy that under the new ***Third Schedule CITA*** (*vide* ***section 23 FA 2020***), the maximum WHT exemption on foreign loan interest income is now 70%, instead of the erstwhile 100% exemption. The lower WHT exemption rates may further discourage foreign lenders to the entire oil and gas industry; lenders to upstream players are not excluded, since taxation of foreign interest income (irrespective of sector) is governed by ***CITA***.

Transfer Pricing Regulations

One would have thought that ***section 11 FA*** provision (new ***section 27(1)(g) CITA***) on strict compliance with ***Transfer Pricing Regulations 2018 (TP Regulations)*** is now mandatory should suffice to meet any mischief that anti-thin capitalisation rule is meant to achieve. Related parties should not be published for engaging in transactions that are at arm's length; since tax law should focus on substance rather than form, what is important is that the terms are competitive (that is comparable to, or in line with market trends), not that the lender for example is a connected party. The ***TP Regulations*** (and enabling provisions of tax legislation, here ***section 22 CITA***) have sufficient anti-avoidance teeth to discourage aggressive tax planning. The question we therefore ask is the excess interest expense provisions not an overkill when considering projects that are not easily amenable to third party financing, especially because of heightened project risk?

The foregoing concerns is even reinforced by the fact that prior to ***FA 2020***, Nigerian tax jurisprudence has firmly settled the principle that competitiveness of related party loans was the key driver - once the loans were *"wholly, exclusively, necessarily and reasonably incurred"* for purposes of generating taxable profits: ***section 24 CITA***. Persuasive comparison can be made with ***section 10(1)(g) PPTA's*** stipulated of the London Inter-Bank Offer Rate (LIBOR) as the comparative benchmark, for upstream related party loans. See further, the author's April 2012 joint article (with Atinuke Agboluaje), '***Rethinking Deductibility of Interest on Affiliate Loans by Upstream Companies under Nigeria's Petroleum Profits Tax Act (PPTA)', 1 TLJN, pp.15-32.*** Any upstream doubts have also been settled by subsequent case law.

Conclusion

The avowed intention to enact tax legislative amendments to keep pace with business realities brings to mind the long delayed ***Petroleum Industry Bill***. The deleterious effects of the uncertainty that has hampered investments in Nigeria's oil and gas sector as a result of non-passage of the PIB has been well documented elsewhere. Nigeria needs to recognise that daily, the band of competitors to our investment dollars are increasing: more and more countries are joining the oil and gas producers club.

The FG must ensure that Nigeria is not unwittingly demarking herself as a veritable destination for oil and gas investment in Africa. It is respectfully submitted that upstream impact assessment of the ***FA 2020*** amendments should be conducted in due course, and if found to be negative, corrective action should be taken in ***FA 2021*** and subsequent legislation.

LeLaw Disclaimer:

Thank you for reading this article. Although we hope you find it informative, please note that same is not legal advice and must not be construed as such. However, if you have any enquiries, please contact the author, Afolabi Elebiju at a.elebiju@lelawlegal.com ***OR*** *info@lelawlegal.com.*