TP Regulations: Compliance, "Stay Awake" Issues & Litigation

'*Taxspectives*' by **Afolabi Elebiju** | Originally published in *ThisDay Lawyer, 2nd April 2013, p.12*

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Introduction

Interesting discussions at our November 2012 training, *Transfer Pricing in Nigeria: the New Reality* (see presentation at www.templars-law.com), inspired this piece. Two recent items also contributed: Messrs Osborne and Moscovici's (English & French Finance Ministers') letter that multinationals pay their fair share of taxes and Global Financial Integrity's December 2012 report, *Illicit Financial Flows from Developing Countries: 2001 - 2010* (http://iff.gfintegrity.org/iff2012/2012report.html) placing Nigeria 7th of global listing of illicit outflows, with TP a major contributor to her US$129 billion figure. At February 2013 G20 Finance Ministers' meeting, Germany's Wolfgang Schaube stated: *"the positive effects of globalization must not lead to the [MNCs] artificially shifting their profits and avoiding fair contributions to the tax revenues of our countries."*

Essentially, TP relates to inter-company/divisional pricing arrangements, at which related companies sell services/products to one another. For example, a multinational corporation (MNC) leverages its global procurement to buy input at preferential rates from unrelated vendors/suppliers. Thereafter, series of 'internal sales' occurs (cost plus, at cost or subsidized): sale to manufacturing affiliates, in turn to global marketing, then to respective (resident) subsidiaries. Recharges (e.g. head office/admin costs), split contracts and other tools are deployed towards ensuring that such pricing optimizes (overall Group) tax exposure. MNCs are particularly adept at this cross-border shifting of costs and profits, creating competitive advantage over other sector players, who, like the taxman, are not amused. The TP magnitude can be appreciated from OECD''s 2004 estimate that 60% of international trade is by MNCs, half of that being intra-group transactions.

Illustratively, Starbucks was recently in the news. Its TP strategy (royalties/fees to offshore affiliates) resulted in losses, despite healthy turnover and therefore nil UK corporate tax liability for 3 years. More interesting was customers' revolt that followed disclosure of Starbucks's TP arrangements, prompting their UK CEO to offer £10m tax annually for 2013 and 2014 whether or not they make profit!

In Nigeria, TP schemes have to contend with the basic tenet that every entity is separately taxable. Apart from the absence of group tax relief, pure assignment of 'tax receivables' (credit/losses) to affiliates with taxable positions are not permissible. FIRS typically frown at related party interest-free/concessionary loan interest or uncompetitive' mark-ups; adjusting and "appropriately" taxing them. However, FIRS is happy with 'friendly' foreign loans, as interest expense will not depress Nigerian borrower's taxable profits, assuring Revenue its 'sizable' tax slice. NOTAP scrutinizes fee arrangements with non-resident service providers whilst *CITA* provides that management fee arrangement between Nigerian companies must be approved by the Finance Minister (FIRS review in practice). Excess dividend tax is also a regulatory weapon that is deployable when shareholders' return exceeds tax payable by the business.

Nonetheless (and this trite point bears repeating): tax planning (not evasion) is still a legitimate exercise, and definitely astute tax planners are not to be demonized; they merely challenge the Revenue to step up their own game. The *TP Regulations* (albeit long in coming), is an answer to that challenge.

TP Regs: Objective & Overview

The *TP Regs* seek to: achieve taxation on appropriate basis corresponding to economic activity undertaken in Nigeria; check 'evasion' through under/ overpricing; provision of tax regulatory enforcement ('fighting') tools; create level playing field with MNCs; ensure certainty of Nigerian TP treatment; and obviate double taxation objectives (*Reg 2*). Scope (*Reg 3*), covers transactions between Connected Taxable Persons (CTP) carried out in a manner not consistent with arm's length principle. Anecdotally, "arm's length" is a picture: tax law wants businesses to keep their distance! *Reg 4* prescribe compliance with arm's length (ALP) in transactions between CTPs: *"taxable profits resulting from the transaction(s) must be in a manner consistent with the [ALP]."*

Compliance/Enforcement Issues & Tax Litigation Potential

The tension between "creative" TP compliance by taxpayers and regulatory enforcement of *TP Regs* by FIRS will provide a breeding ground for tax disputes and frequent recourse to the tax objection process (5th *Schedule FIRS Act*). TP Regs' stringent documentation/ disclosure requirement is without prejudice to FIRS' entitlement to request additional information pursuant to audit/review

functions. Underlying this is that the burden of proof that CT terms/conditions are consistent with ALP, is on the taxpayer (*Reg 6(10)*). Whilst impact of TP reporting on *Nigeria's Ease of Paying Taxes* rating is yet to be assessed, given the strategic TP drivers, the increased compliance burden is arguably 'worth the trouble'. Within space constraints, I highlight some potential areas of conflict.

In determining consistency with ALP, applicable TP methods include: *Comparable Uncontrolled Price (CUP); Resale Price; Cost Plus; Transactional Net Margin; Transactional Profit Split*; and any other method prescribed by FIRS. Whilst most appropriate method is a question of circumstances of the relevant transaction, the starting point for FIRS' review is the taxpayer's TP method; there are also circumstances when the taxpayer can use a method different from those listed. Both parties (taxpayer and FIRS) may take divergent views and this would need to be resolved.

Reg 7 allows *Advance Pricing Agreements* (APAs) between CTP and FIRS regarding appropriate criteria for determining CTPs ALP compliance for certain future CTs over a fixed period, provided such APA is consistent with TP Regs. Request for APA must be accompanied by comprehensive information/documentation on activities subject to the APA *(Reg. 10(2))*. Apparently, APA cannot be an avenue to "blindside" the Revenue. FIRS may specify the basis for acceptance, modification or rejection of request: the latter two bear the seeds of tax dispute.

Is the value of APA not limited as it must be within the context of TP Regs, and APA' bindingness suspect because of *Halliburton WA v. FBIR (2006) CLRN 138*? Unless dispute arises, APAs could be beneficial for convenience, certainty and efficiency. *Reg 7(b)(iii)* is indicative of bindingness, subject to consistency of underlying assumptions for the future event(s).

What cause of action and quantum of damages will be available for breach of FIRS' confidentiality obligation regarding trade secrets/commercially sensitive information/documentation provided by taxpayer for negotiating APAs *(Reg 7(10))*? FIRS' process safeguard against unauthorized or negligent disclosure is imperative, especially where damages may not suffice for sufficient sensitive, *"bet the company"* information.

FIRS and taxpayer may also disagree about corresponding adjustments (to avoid double taxation) where DTT provisions are implicated or the application of Comparability Factors provisions. In another vein, provisions for applicability of UN &OECD Tax Documents (*Reg 11*) is helpful for interpretative views from other jurisdictions, capacity leverage for compliance/enforcement by CTPs and FIRS; however, provisions of tax laws prevail in event of inconsistency. Is *Reg. 12(2)* provision making TP Regs superior to other regulatory approvals (e.g. NOTAP on service agreements pursuant to NOTAP Act and Guidelines), not open to challenge? *Reg.13* provision that offences and penalties are as in applicable tax laws is obviously superfluous.

FIRS' various decisions, actions or discretions, e.g. refusal of extension of time within which to comply with request for information; modification or rejection of APA proposals amongst others could trigger disputes. *Reg. 14* charges three-person Decision Review Panel (DRP, 'internal' to FIRS) with responsibility to resolve disputes/controversy arising from implementation of TP Regs. Taxpayers must refer assessment (pursuant to FIRS' adjustment of relevant TR transaction) to DRP within 30 days of receipt or risk the assessment becoming final and conclusive. Can taxpayer seek extension on 'reasonable' grounds?

Where reference was done within time, the decision of DRP is 'final and conclusive' but obviously without prejudice to taxpayer's right of appeal to TAT or FHC. Effectively, reference to DRP is an objection, whilst DRP decision approximates Notice of Refusal to Amend (NORA). It is possible to approach FHC directly (without first appealing to the TAT), e.g. application for judicial review or claim for damages against FIRS.

Conclusion

OECD's *Institutional Approach to Policy Coherence for Development (2004)* recognised that *"attracting FDI… into developing countries is not the end of the game. There is no guarantee that [they] will translate into tax revenues for the countries attracting them."* Thus, a "shine your eye" approach by FIRS can hardly be faulted (even for CTs between resident conglomerates). *"Unless sufficient attention is given to [TP] issues, it is possible that… a developing country will derive little or no revenues from the FDI attracted into its territory."*

Nonetheless, Nigeria needs to keep her eyes on attracting global capital. G20's February 2013 Finance Ministers' communiqué (www.bbc.co.uk/news/business-21481932) that *"we are determined to develop measures to address based erosion and profit shifting, take the necessary collective action and look forward to the comprehensive action plan the OECD will resent to us in July [2013]"* typify that TP is a hot global topic, especially in the global depression. Mr. Moscovici *"we must avoid situations in which some companies use international and domestic law to be taxed nowhere."*

Nigerian TP compliance and enforcement will definitely throw up substantial work for professional advisors including lawyers: advisory services, case evaluation, support/representation with DRP, anticipated increase in (TP related) tax litigation, etc. Undoubtedly, FIRS (all SIRS) too will be busy! The TAT (especially Zones covering the commercial hubs) should also anticipate increased workload, underscoring the imperative for set up of State TATs, as in pre-FIRS Act era.

Hopefully, all these activity will further contribute to ongoing development of Nigerian tax jurisprudence, administration and revenues.

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