Withholding Tax:
The A-Z of Grossing Up

'Taxspectives' by **Afolabi Elebiju** | Originally published in *ThisDay Lawyer, 16th February 2010, p.14*

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Introduction

One recurring point in transactions with withholding tax (WHT) requirement is: should the payer (obliged to deduct WHT from relevant payment), bear the payee's WHT burden by paying the gross amount and yet remit the WHT to the Revenue? Usually, the party insisting that his payment be grossed up, such that he collects the same amount as he would have received if there had been no WHT requirement, is the party in "stronger" bargaining position. A ready illustration is the typical Nigerian landlord and tenant situation - tenant is, for demand/supply reasons, the "weak" party, and who is under pressure to "get the deal done." Grossing-up is also common in lending transactions whilst companies sometimes gross-up compensation by paying personal income taxes on behalf of their expatriate employees/consultants.

Oftentimes, failure to agree whether or not there should be a grossing up provisions in contracts is a deal breaker. This column examines arguments regarding legality, *cum* usefulness, of gross-up provisions and concludes that it should be a matter of business judgement for parties - the tax law should be neutral in the contest.

The Law & Practice

Nigerian tax legislation provides for the WHT system to function as an advance payment of tax upon pain of criminal sanctions for breach. There are essentially *in pari materia* provision in the *Personal Income Tax Act (PITA, sections 69-75), Companies Income Tax Act (CITA, sections 78-84), Petroleum Profits Tax Act (PPTA, sections 56 & 54)*; and the *Federal Inland Revenue Service (Establishment) Act 2007 (FIRSA, sections 30 & 40)*, together with the *WHT Regulations* made pursuant to CITA and PITA respectively.

Parties (e.g. recipients of service) making payments on listed transactions are required to deduct tax on such payments at either 5% or 10% depending on the transaction or status of the payee. WHT can only be deducted from income liable to tax, but is available as credit against future tax liability and potentially entitle taxpayer to refund under *section 23 FIRSA*. The policy underpinning of WHT, apart from facilitating tax collection on a "as you go" basis, is widening the tax net to capture transactions that would have otherwise escaped tax, especially in the informal sector.

In Nigerian real estate transactions, a landlord's lawyer would almost be 'professionally negligent' if the tenancy agreement fails to expressly provide that rent be grossed-up. However, there is no implied requirement that tenants gross-up in the absence of express provision in the lease. Lawyers could, and indeed, leverage on this to help (corporate) tenants vary unfavourably terms of their original lease.

The Arguments: Business and Tax Considerations

'Legality of Gross-Up Clauses in Nigeria', an article in Olaniwun Ajayi LP's seminal collection, *Legal Aspects of Finance in Emerging Markets (2005)* argues that *Regulation 2 CITA (WHT Regulations)* provision that *"a deduction made from a payment shall not be regarded as an additional cost to the contract price as tax due on the payment"*, makes grossing-up illegal to the extent that it shifts the tax burden in breach of the above *Regulation*.

"a deduction made from a payment shall not be regarded as an additional cost to the contract price as tax due on the payment"

This column respectfully argues otherwise: whilst penalties are prescribed for failure to deduct or remit WHT, there are no penalties for grossing-up, notwithstanding the use of "shall" in *Regulation 2.* Thus the absence of penalty makes *Regulation 2* of advisory import for gross-up purposes. Furthermore, *Regulation 5, sections 82 CITA* and *40 FIRSA* as well as *section 74 PITA* (space constrains their reproduction), respectively reinforce the view that Revenue is more interested in substantive offences – failure to deduct/remit WHT – than who bore the burden of WHT remitted.

Given its myriad of responsibilities and limited resources which makes optimisation of efforts imperative, it is understandable that the Revenue's primary concern would be that correct WHT amount come into its coffers. Arguably, remittance is of more practical importance to the Revenue than deduction - because remittance (if at all), follows deduction.

At best, the 'penalty' against grossing-up in *Regulation 2* is that the Revenue may add back the WHT amount to the taxable profits of the payer; but this regulatory response (of disallowed WHT 'expense'), does not make grossing-up illegal. The CA in ***TOTAL v AKINPELU****[2004] 17 NWLR (Pt. 903) 509 at 524* held that having agreed to gross-up, a tenant could not avoid the contractual obligation by relying on WHT statutory provisions: when the WHT is deducted, *"would the full rent agreed upon… have been paid on the premises?"* The Court easily answered this query in the negative.

'The Legality of Gross-Up Clauses' article draws distinction between: (a) phraseology stating that the payee's payment shall not be subject to WHT; and (b) that payer increase the amount payable such that payee would receive the (same) gross amount, even after provision has been made for WHT. Arguably, this distinction supports the views above that grossing-up is not illegal (at least in the latter scenario) because the Revenue ultimately receives WHT from the transaction.

Thirdly is whether, by grossing-up, the payee has received more tax benefit than it is entitled to? In my view, this would be addressed when payee submits its tax returns and reports its entire income at year end. Sometimes, it could be *de minimis.* Otherwise, payee's failure to recognise the gross receipt (payer having paid the WHT) would be tax evasion, and therefore criminal.

In the final analysis, what the payee has enjoyed through the gross-up provision is the time value of money - which could positively impact cash flow, working capital and firm's financial results. However, if payee receives the gross amount, whilst also requiring that payer sends WHT receipts obtained from the Revenue, for use in settling payee's tax liability, this would amount to 'double dipping' and could be fraudulent(especially if payee reports only net amount).

Gross-up clauses particularly provide protection for non-residents against 'external' variables in 'foreign' territories, for example, increase in WHT rates during the tenor of a contract that lacks stabilisation provisions. Notwithstanding the risk of grossed-up WHT being disallowed as part of payer's deductible expenses, payer may still decide to proceed with the arrangement - for example, where the contract will confer some strategic competitive advantage and positively impact bottom-line.

Conclusion

Grossing-up is just another way that counterparties to a deal allocate and mitigate risks: it should be a business decision whether the deal is worth the risk. The tax law should not strengthen the hands of one party against the other at the negotiating table.

Addressing the significant *"inequality of bargaining power"* (*ala Lord Denning*) between landlords and tenants for example, could be done through other policy means - e.g. creation of enabling environment for providing mass housing, expanding access to mortgage financing, etc.

In some jurisdictions (e.g. UK/Canada) properly structured gross up is permissible, although full disclosure is required. Indeed, the Revenue also *"grosses up" when necessary for regulatory reasons (e.g. for estate tax) or disallowing expenses which are added back to profit. Even if we concede that the jury is still out, a positive is that negotiating gross up provides fee earning opportunities to lawyers, depending on whichever way the pendulum of representation tilts." (Olowosile, p.8, http://www.scribd.com/doc/8901648).*

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