



# **WTS** Tax Update for the Digital Economy

**Nigeria: The significant economic presence order 2020**

## EXECUTIVE SUMMARY

The concept of digital services taxation is fast becoming a global trend and has been a subject of discussion by the OECD through its Base Erosion and Profit Shifting (BEPS) Project, with several ongoing proposal talks with member countries.

Nigeria like some countries has taken steps ahead of the OECD in taxing its digital economy. Nigeria's approach to this has been to first amend its Companies Income Tax Act by expanding the tax base for non-resident entities to include companies carrying on digital activities in Nigeria, and tax liability for these companies is dependent on a minimum derived turnover of 25 Million Naira (64,320 USD). This is described in the Companies Income Tax Act as Significant Economic Presence (SEP), and outlines the framework for digital services taxation in Nigeria.

Regardless, it is expected that companies captured by the expansion of the tax base, that is, companies carrying out digital activities in Nigeria, are to file their tax returns with the Federal Inland Revenue Service (FIRS) annually, and to also indicate the income derived from Nigeria in their financial statement. Where they have met the minimum threshold of 25 Million Naira or its equivalent, these companies are expected to pay tax in accordance with the tax rate provided by the Companies Income Tax Act (as amended by the Finance Act), that is, 20% of income derived where taxable income is between 25,000,000 Naira and 100,000,000 Naira, and 30% tax rate where above 100,000,000 Naira.

Positively, this introduction is likely to increase revenue for the Nigerian government with little impact on indigenous businesses since the focus is on non-resident companies without a fixed base in Nigeria. Additionally, it is envisaged that non-resident digital services companies will establish a fixed base in Nigeria to ensure proper accountability and to avoid the rigors of complying with the new tax requirements.

It is worth mentioning that there are currently no anti-double taxation treaties with respect to digital taxation in Nigeria. Hopefully, countries of non-resident companies with significant economic presence in Nigeria will someday commence negotiations for tax relief treaties on digital activities in Nigeria.

In light of the foregoing, the Minister of Finance, by the powers vested on the office, has passed the Companies Income Tax (Significant Economic Presence) Order 2020 ("the Order"), which provides in details Nigeria's approach to digital services taxation.

This article shall therefore focus on the following:

- The principle of significant economic presence as contained in the Order,
- Application of the Order including the exemptions,
- Our commentaries on the implementation of the Order.

## INTRODUCTION

Global tax policies have admitted to the disruptive introduction of digital services taxation as existing tax rules such as, the arm's length principle and principle of physical presence may not be able to accommodate the peculiarity of digital activities. To this end, the OECD has come up with a few proposals on how digital activities may be taxed. Notwithstanding the OECD's ongoing proposal talks, countries like France and India have taken proactive steps to tax its digital economy. Most recently, Nigeria also took steps to tax its digital economy: as opposed to the principle of physical presence, companies which carry out digital activities are to be taxed by their significant economic presence.

## SIGNIFICANT ECONOMIC PRESENCE UNDER THE FINANCE ACT, 2019

In amending the Companies Income Tax, Act, ("CITA")<sup>1</sup>,

<sup>1</sup> Section 13 (2) of the Companies Income Tax, Act, CAP C20 Laws of the Federation of Nigeria, 2004. This provision provides for the definition of Nigerian companies for the purpose of taxation under the Companies Income Tax, Act. Following the amendment by the Finance Act, Nigerian companies may be classified thus;

- a) Where such company has a fixed base in Nigeria to the extent that the profit or income may be attributable to the fixed base.
- b) In the absence of a fixed base, habitually carries on trade or conduct business through a representative acting as agent of the NRC and profit accrued may be attributed to this agency.
- c) If the NRC executes a single contract for surveys, installation, construction, deliveries and in the case of digital service, has significant economic presence. Profits from such contract are subjected to income tax.
- d) Transactions between related parties subjected to the application of the arm's length principle by the tax authorities.
- e) Execution of professional, consultancy, management services outside Nigeria to a person resident in Nigeria.

the Finance Act, by virtue of its Section 4,<sup>2</sup> expanded the companies that will be considered taxable by widening its scope to companies that carry on digital activities without physical presence, and foreign companies providing technical, management, consultancy or professional services to a Nigerian resident.

The Finance Act notes that such companies shall only be taxed to the extent that they have significant economic presence and profits may be attributed to their activities.

Notably, the Finance Act failed to define the term “significant economic presence”, consequent upon which, the Minister of Finance released the Companies Income Tax (SEP) Order, 2020 “The Order” which defines how the concept of significant economic presence (SEP) shall apply in Nigeria.

#### APPLICATION OF THE ORDER

The application of the Order takes a two-lane approach. It applies to companies by their activity and by their revenue raised from the Nigerian economy. The Order spells out the activities constituting “significant economic presence” for tax purposes.<sup>3</sup>

These activities can be classified accordingly:

**1. Digital Service Providers:** These are non-resident companies who derive N25 Million Naira (64, 320 USD) annual gross turnover or its equivalent in other currencies from any or combination of the following digital activities:

- Streaming or downloading services of digital contents (e.g. movies, videos, music, applications, games and e-books) to people in Nigeria;
- Transmission of data collected about Nigerian users generated from users’ activities on websites or mobile applications;
- Provides goods or services through a digital platform to Nigeria;
- Provision of intermediation services through digital platforms, websites or other online applications that link suppliers and customers in Nigeria;

- Use of a Nigerian domain name (i.e. .ng) or registration of a website address in Nigeria; or
- Having a purposeful and sustained interaction with persons in Nigeria by customizing its digital page or platform to target persons in Nigeria, including reflecting the prices of its products or services in Nigerian currency or providing options for billing or payment in Nigerian currency. It should be noted that, the Order does not define the term “purposeful and sustained interaction”.

**2. Provision of technical, professional, management, or consultancy services to Nigerian customers:** The Order provides that a foreign company providing technical, professional, management or consultancy services shall have SEP in Nigeria in any accounting year where it earns any income, or receives any payment from a person resident in Nigeria, or a fixed base or agent of a foreign company in Nigeria.<sup>4</sup>

This position is similar with the UN model on rules guiding income taxation of services through permanent establishment, with noteworthy differences. A combined reading of Articles 5, 7 and 9 of the UN model speculates that for the purpose of income taxation of services through a permanent establishment within a contracting state, such services must have continued for a period of 183 days, and where such service is between related parties, the arm’s length rule shall apply to such service. However, Nigeria’s position is that such income is taxable regardless of whether the service rendered is continuous.

Conclusively, the Finance Act reaffirms that income generally derived from Nigeria not covered by Section 13 of CITA are to be taxed using the withholding tax rate applicable to such income.

**3. SEP and activities carried out by connected persons:** The Order further states that for the purpose of determining threshold, activities carried out by connected persons shall be aggregated to determine the gross sum of income earned.

The Order also defines “connected persons” as follows:<sup>5</sup>

<sup>2</sup> The Finance Act was enacted with the purpose of amending the several tax laws in Nigeria. The laws affected by the Finance Act are the Companies Income Tax, Act, Value Added Tax, Act, Stamp Duties Act, Capital Gains Tax, Act, Personal Income Tax, Act and the Petroleum Profit Tax Act.

<sup>3</sup> Section 1 of the Companies Income Tax (Significant Economic Presence) Order, 2020.

<sup>4</sup> Section 2 (1) (a -b) of the Companies Income Tax (SEP) Order 2020

<sup>5</sup> Section 1 (5) of the Companies Income Tax (SEP) Order 2020

- persons that are "associates" as defined in the Companies and Allied Matters Act, Cap C20, LFN 2004 (as amended) [CAMA];
- or persons that are business associates in any form, such that one person participates directly or indirectly in the management, control or in the capital of the other, or the same person or persons participate directly or indirectly in the management, control or in the capital of both enterprises. The definition given above appears to be an abridged version of the definition of who a connected person is under the Income Tax (Transfer Pricing) Regulation, 2018 ("the regulation"). The regulation defines connected persons thus, persons are deemed connected where one person has the ability to control or influence the other person in making financial, commercial or operational decisions, or there is a third person who has the ability to control or influence both persons in making financial, commercial, or operational decisions. The Regulation further adopted the definitions of "connected persons" by the several tax legislations; Companies Income Tax Act, Petroleum Profit Tax Act, Capital Gain Tax Act, the OECD manual and UN guidelines etc.

#### EXEMPTION FROM APPLICATION OF SEP

The Order exempts the activities of the following foreign companies from constituting SEP in Nigeria:

- any foreign company covered by an existing tax treaty, multilateral agreement or consensus agreement to address tax challenges arising from the digitalization of the economy. That is, where Nigeria has an existing anti-double taxation treaty on digital taxation with another country, the Order will not apply to companies of such countries who derive income from digital service covered by the Order in Nigeria.
- any foreign company making any payment, where the payment, is made:
  1. to its employee under a contract of employment or;
  2. for teaching in an educational institution or for teaching by an educational institution or;
  3. by a foreign fixed base of a Nigerian company

#### DEFINITION OF TERMS

The Order provides clarifications on the definition of the following services contained in S. 13 (2) (c) & (e) of CITA. They include:

- "services of a technical nature" refer to specialized services such as advertising, training or provision of personnel other than those involved in the provision of professional, management and consultancy services.
- "any other electronic or wireless apparatus" is defined to include digital or related activities carried on through satellite

#### COMMENTARIES

1. It is our observation that the Order has retroactive effect as it is deemed to have been made on the 3rd of February, 2020. The implication of this is that, companies affected by the Order are expected to commence compliance from the said date, alongside other amendments made by the Finance Act.
2. Also, the clarity of mode of implementing the Order against non-resident companies that render technical, management and consultancy services without a physical presence was not extended to digital service providers. There are no clear provisions in the Order as to how the SEP rule will be administered especially as it relates to digital service providers. As, such, the implementation and enforcement of the Order is a concern. It is hoped that as further progress is made with taxing the digital service sector in Nigeria, the tax authorities will provide further informative circulars to address this concern.
3. The question of ascertaining profits attributable to the Nigerian economy will be a challenge for tax authorities as often time the income of foreign companies are calculated by their gross income without specifying how much is generated from a particular jurisdiction. While there are suggestions that consumer base may help in ascertaining this, it is not clear and certain which approach the Nigerian tax authorities will apply in ascertaining attributable profit. Furthermore, there is a difficulty in applying the transfer pricing principles. The regulation restricts itself to physical service and income that are determinable. The Order suggests the use of taxation on derived gross income from Nigeria of up to 25 million Naira or its equivalent in other currencies. The regulation does not contemplate digital service. Note that the determination of income derived from digital activities in Nigeria is what determines chiefly whether a foreign company will be taxed under the Order.

4. Following the 2015 directive by the FIRS that non-resident companies should file their returns on actual income basis. The Order should have given guidance as to whether qualifying non-resident companies should file their returns on actual or deemed income basis.<sup>6</sup>

Based on international norms, the provisions of a Double Tax Treaty (DTT) override local tax laws. As such, the provisions of the Order, being an extension of CITA:

1. cannot apply to companies based in countries with which Nigeria has an existing anti-double taxation treaty on digital taxation. As stated above, Nigeria does not have such treaty arrangement with any country.
2. On the issue of ownership of or control of the electronic or wireless apparatus such as receivers, satellite and connected servers, the Order remains silent. This is a notable oversight considering the complex nature of the supply chain of digital services which involve the use of satellites and related equipment.
3. The definition of "connected persons" as contained in the Order is not as expansive as its definition in Paragraph 6(a) of the Seventh Schedule of CITA which includes any person under common control, ownership or management, any person not connected but receives implicit or explicit guarantee or deposit for a debt and any related party as described in the Income Tax (Transfer Pricing) Regulations, 2018. This disparity may result in dispute between the FIRS and taxpayers.

## CONCLUSION

The concept of digital services taxation is the new trend in the global tax space, and it is expected that modifications will be made continuously to arrive at practical ways of implementing the provisions of the Order in Nigeria. Clearly this approach will create a level of equilibrium amongst countries where digital activities are carried out, profits are realized and yet no tax is levied. Nigeria has demonstrated its intention to shrink this tax leakage and we can only hope it gets it right and leads the pace of digital services taxation in Africa.

Taxpayers are therefore advised to analyze their transactions in line with the provisions of the Order and CITA to ensure that they stay compliant and avoid unnecessary exposure to tax penalties.

<sup>6</sup> Section 30 of the CITA authorizes tax authorities to charge a fair and reasonable percentage as taxable profit on turnover that cannot be ascertained. By practice, the tax authorities in Nigeria charge NRC on 20% of their total turnover as income derived in Nigeria. This income is what is referred to as deemed income. The implication of this is usually that either the tax payer or the tax authorities may be short changing themselves by paying taxes based on deemed income. To this end, the tax authorities have hinted that returns should be filed based on their actual income as against deemed income.

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