Key Highlights of the Newly Issued Transfer Pricing Regulations 2018.

In the exercise of its rule-making authority under its enabling legislation,[1] the Board of the Federal Inland Revenue Service (**"FIRS"**) has issued the Income Tax (Transfer Pricing) Regulations 2018 (the **"2018 Regulations"**). The 2018 Regulations revokes and replaces the Income Tax (Transfer Pricing) Regulations 2012 (the "**2012 Regulations**") which hitherto governed regulations over transfer pricing in Nigeria. The 2018 Regulations fairly incorporate the current international trends in the regulation of transfer pricing and is designed to guarantee greater compliance with the transfer pricing regime in Nigeria. This would in turn increase Nigeria's tax revenue and reduce tax evasion occasioned through the underpricing or overpricing of related party transactions.

This client alert is aimed at highlighting the headline changes introduced by the 2018 Regulations. In line with our tradition of keeping our clients apprised of any changes in the law that may impact on their businesses and commercial undertakings, we have provided summaries of the key changes introduced by the new transfer pricing regime.

[1] Section 61 Federal Inland Revenue Service (Establishment) Act 2007

Scope and purpose

The new regime applies to both foreign and domestic controlled transactions between "*connected persons*",[2] not "*connected taxable persons*" as was the case under the 2012 Regulations. The definition of connected persons under the 2018 Regulations is extremely wide such that where one person can control and/or influence the financial, operational, or commercial decisions of another person, they would be deemed to be connected persons. Also, any third person who can influence and/or control the financial, commercial, or operational decisions of the two connected persons, would also be deemed to be connected with them.[3] Further, any person deemed to be connected to another under the federal tax legislations in Nigeria,[4] or under the model tax convention and transfer pricing guidelines of the United Nations (UN) or the Organization for Economic Co-operation and Development (OECD), or under any double tax treaty executed between Nigeria and another country, shall be deemed to be connected persons under the 2018 Regulations.[5]

This wide definition of connected person may have some unintended consequences for the providers of credit. It is common place to have overbearing lenders who exercise a great deal of influence and/or control over the financial, commercial and operational decisions of those to whom they have advanced credit. Whilst it is unclear whether the FIRS intended to import the "potential lender shadow-director liability" into the transfer pricing regime and to treat such creditors as connected persons; we advise our clients to deal at arm's length with persons to whom they have advanced credit, to avoid possible liabilities under the new transfer pricing regime.

Potential double taxation for importers

In relation to imported goods and services, the FIRS now has the power to reject the reported value on which the customs duty was assessed, notwithstanding the fact that the reported value had been accepted and acted upon by a competent agency of government.[6] The FIRS may reject such value and substitute it with its own estimates for the purposes of confirming compliance with the arm's length principle and assessing the tax liability of the importer.

Besides creating a conflict between two agencies of government, this new power of the FIRS may lead to double taxation of the affected importers.

Deemed transfer prices for commodity imports and exports.

In any controlled transaction for the import or export of commodities, if the agreed price is higher than the "quoted price" (for imports) or lower than the quoted price (for exports), then the transfer price under the new regime would be the quoted price on the date of the transaction. For exported goods which were resold by the offshore connected person to an unrelated third party at a price higher than the quoted price, that higher price would be deemed to be the transfer price for determining the offshore connected party's tax liability in Nigeria. However, where the taxable person in Nigeria (in the case of imports or exports) or the offshore connected person provides evidence showing that the price was consistent with the arm's length principle,

[2] Regulation 3(1), 2018 Regulations
[3] Regulation 12(1), 2018 Regulations
[4] Regulation 12(2)(a) – (d), 2018 Regulations
[5] Regulation 12(2)(e) & (f), 2018 Regulations
[6] Regulation 5(8), 2018 Regulations

then the FIRS may accept the price used by the connected persons.[7]

The quoted price is the stated price of the commodity on an international or domestic commodities exchange or from governmental price-setting agencies which is used by unrelated parties in uncontrolled transactions.[8]

Intragroup services

The fees charged by service providers for providing services to connected persons, especially within a corporate group would now be subjected to heightened transfer pricing scrutiny. Under the new regime, such service fees would only be deemed consistent with the arm's length principle if and only if: (i) they are charged for service actually rendered; (ii) the provision of the service has economic or commercial value to the recipient; (iii) if it were an uncontrolled comparable transaction between independent parties, the recipient would still be willing to pay the same amount for the provision of the service.[9]

Exploitation of intangible assets between connected persons

The full consideration or royalty paid for any transfer of a right in an intangible asset (such as software leases and licenses over intellectual property or other arrangements which gives retains ownership of the intangible asset in one party and gives the other party only a right to use) between connected persons would no longer be recognized as allowable expenses for tax deduction. Under the new regime, the portion of the consideration allowable for tax deduction as expenses is capped at 5% of the earnings before interest, tax, depreciation, and amortization (EBITDA) arising from the exploitation of the intangible asset.[10]

Note that the 2018 Regulations make a carve-out for outright assignments/sales of the intangible asset between connected persons. Where the transfer was an outright assignment/sale, the full consideration would be allowed for tax deduction as expenses.[11]

The difference in treatment between outright assignments and leases/licenses is that while the expenses in the former are recognized for tax deduction only once

New transfer pricing disclosure obligations and associated penalties for non-compliance

A new suite of disclosure obligations have been imposed on connected persons. They include:

(a) Each connected person in Nigeria must make a transfer pricing declaration of all its connected/related entities within and outside Nigeria within the earliest of eighteen (18) months from the date of its incorporation or six (6) months after the end of the accounting year.[12] A failure to comply with this disclosure obligation attracts a penalty of ₦ 10 million (approximately US$ 28, 000) and ₦ 10, 000.00 (approximately US$ 28) for each day in which the default continues.[13]

(b) Each connected person must make an updated transfer pricing declaration within six (6) months from the end of any accounting year in which any of the following occurs:

(i) The merger of the declarant with any company whether intra-group or with an unconnected entity;

[7] Regulation 5(9)(a) & (b), 2018 Regulations
[8] Regulation 27, 2018 Regulations
[9] Regulation 6(1), 2018 Regulations
[10] Regulation 7(5), 2018 Regulations
[11] Ibid.
[12] Regulation 13(1)(2) & (3), 2018 Regulations
[13] Regulation 13(8), 2018 Regulations

(ii) The merger of the declarant's parent with an unconnected person;
(iii) The merger or acquisition of the declarant by an unconnected person
(iv) An acquisition of up to 20% of the declarant's parent by an unconnected person;
(v) An acquisition of up to 20% of the declarant by unconnected persons;
(vi) Any sale or acquisition of the declarant's subsidiary; and
(vii) Any other change in the structure or arrangement (i.e. change of ownership) in the declarant which would impact on the determination whether it is connected to some other person or not.

A failure to comply with these disclosure obligations attracts a fine of ₦ 25, 000.00 (approximately US$70) for each day in which the default continues.[14]

(c) Every connected person must notify the FIRS whenever a new director is appointed, or an existing director retires.[15] A failure to comply with this disclosure obligation attracts a fine of ₦ 25, 000.00 (approximately US$70) for each day in which the default continues.[16]

(d) Each connected person shall disclose all controlled transactions to which it is a party within the earliest of eighteen (18) months from the date of its incorporation or six (6) months after the end of the accounting year.[17] Failure to comply with this disclosure obligation attracts a fine of ₦ 10 million (approximately US$ 28, 000) or one (1%) percent of the controlled transaction not disclosed or incorrectly disclosed, whichever is higher. For non-disclosure, there is an additional fine of ₦ 10, 000 (approximately US$ 28) for each day in which the default continues.[18]

(e) Each connected person must prepare documentation containing such information and data that may be required by the FIRS in verifying whether the controlled transactions of that person were consistent with the arm's length principle. This documentation must be prepared before the due date for the filing of the income tax returns for the year in which the transaction took place. However, this documentation can only be made available to the FIRS within twenty-one (21) days from the date the FIRS serves a written request for them on the connected person.[19] A failure to comply with this obligation attracts a fine of ₦ 10 million (approximately US$ 28, 000) or one (1%) percent of all controlled transactions, whichever is higher, and an additional fine of ₦ 10, 000 (approximately US$ 28) for each day in which the default continues.[20]

Note that where the total value of a connected person's controlled transactions is less than ₦ 300 million (approximately US$ 900, 000.00), it may elect not to maintain the documentation above. However, if the FIRS makes a written demand for the documentation, the connected person must prepare and file them within 90 days from the date of the request.[21]

[14] Regulation 13(7), 2018 Regulations
[15] Regulation 13(6), 2018 Regulations
[16] Regulation 13(7), 2018 Regulations
[17] Regulation 14(1), (2) & (3), 2018 Regulations
[18] Regulation 14(4) & (5), 2018 Regulations
[19] Regulation 16(1) – (4), 2018 Regulations
[20] Regulation 16(5), 2018 Regulations
[21] Regulation 17(3), 2018 Regulations

Disputed assessments

A tax payer who has an objection to an assessment made under the 2018 Regulations can no longer approach the Decision Review Panel for review. Such a tax payer can only lodge its objection with FIRS within 30days from the date on which it received the assessment. Under the 2018 Regulations, the head of the FIRS' transfer pricing unit has a discretion whether or not to refer a tax payer's objection to the Decision Review Panel. This does not sufficiently protect tax payers since there is the potential risk that the head of the transfer pricing unit may refuse to refer the objection to the panel for review.

Conclusion

The recurring theme in the 2018 Regulations is the FIRS' desire to compel compliance with the transfer pricing regime and huge penal sanctions have been prescribed to guarantee this. We expect our clients and other affected market participants to ensure that they are fully compliant with the new regime and to regularize their positions if necessary.

The market is still trying to fully grasp the exact extent and implications of the new regime and issues are very likely to arise in the future, such as the wide definition of connected person. We expect the FIRS to provide some clarifications on the commencement date and the definition of "commencement." Some clarity is also required around the potential double taxation that may occur if the FIRS rejects a price/value reported to and accepted by the Nigerian Customs Service and on which import duties and other levies were assessed and paid at the port of entry. Further, the 5% of EBITDA cap on tax deductible expenses accruing from the exploitation of intangibles rights under a lease or licensing arrangement may operate against the core of the arm's length principle as it may lead to underpricing. In our opinion, the new rules governing objections to disputed assessments do not provide adequate protection to the tax payer. However, such a tax payer may have to obtain an order of mandamus to compel the referral of his objection to the Decision Review Panel.

While the partial exclusion of entities with less than N300 million in total controlled transaction value would lighten the compliance burden on qualifying entities, affected tax payers may need to increase their budgetary allocations for compliance costs. This is particularly so for corporate groups since each connected entity must separately meets its compliance obligations under the new regime.

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