MODULE 2

GENERAL PRINCIPLES OF TAX

OUTLINE

- Personal Income Tax.
- Companies Income Tax.
- Basis of Assessment.
- Commencement and cessation/change of accounting date.
- Capital Allowances.
- International Transactions.
- Tax distortion under inflationary conditions.

Personal Income Tax

Personal income tax is payable by self-employed and employed individuals to the relevant State Board of Internal Revenue.

- Tax has three distinct characteristics:
- It is a compulsory levy
- It is imposed by an organ of government; and
- It is for public purposes.

Person(s) Liable to pay tax

The following person(s) are liable to pay tax on the income earned in a year of assessment:

i. Employed and self-employed individuals;
ii. Itinerant workers;
iii. Families;
iv. Trustees.

- **Income chargeable to tax**

  Every chargeable person shall pay tax in each year of assessment on all sources of income made in and outside Nigeria, whether or not the income made outside Nigeria has been subjected to foreign tax or not. Such foreign tax shall be available for set-off against the Nigerian Tax.

  Income of an individual chargeable to tax can be categorised into:

a) Earned income; and

b) Unearned income.

Earned Income

This is income from trade, business, profession, vocation or employment carried on or exercised by a person, and a pension derived by him in respect of a previous employment

Section 3 of PITA lists the following s chargeable earned income:

i. Gains or profits from trade, business, profession or vocation. This may arise from trade carried on for a period of one year or less in a year of assessment.

ii. Salary, wages, fees, allowances, gains or profit from employment including:

   a) Compensation

   b) Bonuses

c) Premium

d) Benefits

e) Other prerequisites allowed, given or granted by any person to employee. For example, if an employee receives gifts or tips from a customer, it is deemed to be income arising from employment and is chargeable to income tax.

iii. Gains or profits including premiums arising from the grant of rights for the use or occupation of any property.

iv. Pension, charge or annuity.

v. Any profits, gains or other payment not defined in the above categories.

Unearned income

This is income from investments not relating to reward for personal services rendered. It includes:

i) dividends;

ii) discounts on lending instruments;

iii.) rent;

iv) royalties, etc

- **Introduction of Consolidated Relief Allowance by PITA Amendment Act 2011.**

  The amendment Act, 2011, scrapped the old relief system and increased relief for all taxable persons. Thus, all reliefs are combined into the Consolidated Relief Allowance (CRA) which is turn combines all previous reliefs such as leave, meal, housing, utility, transport allowance, etc., into a single relief of N200,000 subject to a minimum tax of 1% of gross income (whichever is higher) plus 20% of gross income.

Companies Income Tax

- Companies income tax is a tax imposed on the profits of companies. Section 105(1) of CITA 2004 defines a company as "any company or corporation (other than a corporation sole) established by or under any law in force in Nigeria or elsewhere."

  Companies income tax is payable for each year of assessment on the profits of any company accruing in, derived from, brought into or received in Nigeria.

Minimum Tax

Individuals:

Minimum tax is payable at 1% where the total income is not more than ₦30,000.

Companies:

Where a company's turnover is N500,000 or below and the company has been in business for a minimum of four calendar years, the minimum tax to be levied and paid shall be:

- 0.5 percent of gross profits; or
- 0.5 percent of net assets; or
- 0.25 percent of paid up capital; or
- 0.25 percent of turnover of the company for the year.

Whichever is the highest.

Where the company's turnover exceeds ₦500,000. The minimum tax will still be calculated as stated above plus 0.125 percent of turnover in excess of ₦500,000

- **Minimum Tax Conditions that are applicable in the computation:**

  Individuals:

  This is applicable where:

  - the taxpayer has no taxable income because of larger personal relief.
  - taxable income produces tax payable lower than 1% of the income.
  - earned income does not exceed ₦30,000

  Companies:

  A company is chargeable to a minimum tax if in any year of assessment the ascertainment of total assessable profits from all sources of a company results in:

  - a loss; or
  - no tax payable; or
  - tax payable which is less than the minimum tax.

- **Example**

  Dapo Limited has the following details for the year ended 31st December, 2015:

	₦
Gross profit	20,000,000
Net assets	50,000,000
Acquired Net assets in the year	15,000,000
Paid up share capital	35,000,000
Turnover	80,000,000
Net profit	8,000,000

Notes;

(i) The turnover is understated by ₦10,000,000

(ii) Gross profit has a constant relationship with turnover.

(iii) Acquired net assets in the year included ₦2,000,000 assets in the previous year.

Required:

Compute the minimum Tax payable by Dapo Limited for the year ended 31st December, 2015.

DAPO LIMITED

Computation of Minimum Tax Payable for 2015 Year of Assessment

		₦	₦
(i)	At turnover of N500,000		
The highest of:			
(a)	0.5% of N22,500,000	112,500	112,500
(b)	0.5% of N13,000,000	65,000	
(c)	0.25% of N35,000,000	87,500	
(d)	0.25% of N500,000	1,250	
(ii)	At turnover in excess of ₦500,000		
Add:			
0,125% of (₦90,000,000- ₦500,000)			111,875
Minimum Tax Liability			224,375

Basis of Assessment

- Prior to 1980, the Nigerian government fiscal year used to run from 1st April of a particular year to 31st March of the following year. In 1980 the federal government changed its fiscal year to correspond with the calendar year. Its fiscal year now runs from 1st January to 31st December of the same year. The fiscal year is also referred to as the year of assessment or tax year for tax purpose.
- The normal basis of assessment of a company's profits from trade or business is the preceding year basis. This implies that the assessable profits of any company for each year of assessment are the profits of the year immediately preceding the year of assessment.
- The basis period is an accounting period whose profit is used for determining the tax assessment of a particular year of assessment.

Commencement and cessation, change of accounting date

- **Commencement.**

  Where a company commences to carry on a trade or business, its assessable profits from the trade or business for the first three years of assessment are ascertained as follows:

  First Year of Assessment

  The assessable profits shall be the profits of that year of commencement i.e. actual profits from the date of commencement to 31st December of the same year.

  Second Year of Assessment

  The assessable profits shall be the amount of the profits of one year from the date of commencement of the business i.e. the first twelve months from the date of commencement.

  Third Year of Assessment

  The assessable profits shall be the profits of the year immediately preceding the third year of assessment. The assessment is based on the profits of the normal accounting period of twelve months ending in the year preceding the year of assessment.

Mr. Dick commenced business on the 1st of October 2008 making up accounts to 30 June of every year. The following results were extracted from his books:

	₦
Period to 30/6/2009	840,000
Year ended 30/6/2010	900,000
Year ended 30/6/2011	200,000
Year ended 30/6/2012	400,000

Capital expenditure were incurred as follows:

Date of purchase	Item Cost	₦
January 2008	Lorry	150,000
August 2008	Plant	800,000
May 2009	Building	240,000
September 2009	Motor vehicle	200,000
June 2000	Furniture	35,000
December 2000	Equipment	65,000

You are required to compute:

a. The normal assessments

b. The revised assessments based on taxpayer's election

c. The relevant years in which the capital expenditure incurred will be treated for the purpose of capital allowances.

MR. DICK

a. Computation of basis Period for Assessable Profit for Normal Assessments

Tax Year	Basis Period	Assessable Profit
		₦
2008	1/10/2008 – 31/12/2008	280,000
2009	1/10/2008 – 30/09/2009	1,065,000
2010	1/10/2008 – 30/09/2009	1,065,000

(b) Computation of Basis Period for Assessable Profit for Revised Assessments.

Tax Year	Basis Period	Assessable Profit
		₦
2008	1/10/2008 – 31/12/2008	280,000
2009	1/01/2009 – 31/12/2009	1,010,000
2010	1/01/2010 – 31/12/2010	550,000

Advise: Mr. King would exercise his election right to be assessed on actual year basis in the second and third years of assessment.

(c) Basis for the Computation of Capital Allowance

Tax Year	Basis Period for Ass. Profit	Basis Period for Cap. Expenditure	QCE
2008	1/10/2008 – 31/12/2008	1/10/2008 – 31/12/2008	Lorry, Plant
2009	1/10/2008 – 30/09/2009	1/01/2009 – 30/09/2009	Building, Motor Vehicle
2010	1/10/2008 – 30/09/2009		
2011	1/07/2009 – 30/06/2010	1/10/2009 – 30/06/2010	Furniture
2012	1/07/2010 – 30/06/2011	1/07/2010 – 30/06/2011	Equipment
2013	1/07/2011 – 30/06/2012	1/07/2011 – 30/06/2012	

Workings:

a. Normal Assessments.

2008 Tax Year				₦
1/10/2008 – 31/12/2008	=	3/12 x ₦840,000	=	280,000

2009 Tax Year				
1/10/2008 – 30/06/2009	=			840,000
1/07/2009 – 30/09/2009	=	3/12 x ₦900,000	=	225,000
				1,065,000

b. Revised Assessment- Actual Year basis

2008 Tax Year

	₦
1/10/2008 – 31/12/2008 = 3/12 x ₦840,000	280,000

2009 Tax Year

1/01/2009 – 30/06/2009 =	6/9 x ₦840,000	=	560,000
1/07/2009 – 31/12/2009 =	6/12 x ₦900,000	=	450,000
			1,010,000

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- 2010 Tax Year

1/01/2010 – 30/06/2010 =	6/12 x ₦900,000	=	450,000
1/07/2010 – 31/12/2010 =	6/12 x ₦200,000	=	100,000
			550,000

Cessation

- Where an individual permanently ceases to carry on a business, trade or profession., his assessable income for the year he ceases to trade and the year preceding the year of cessation will be raised as follows:

  Year of Cessation (Ultimate Year):

  Trading profits from 1 January to the date of cessation. The assessment will be raised for the period on actual year basis.

  Year before the Year of cessation (Penultimate Year):

  The assessable income will be computed using two basis of assessment:

a) The trading profit made during the normal accounting year end preceding the penultimate year.

b) The actual trading profit made between January and December of the penultimate year.

Illustration

Mr. Joel has been running his business in the name of JJ Enterprises for several years. A limited liability company (Outsourcing Enterprise Limited) in the same trade was desirous of expanding its own market share. It therefore decided to make an attractive offer to the proprietor of Joshua Enterprises. The proprietor is keen to accept the offer because of its attractiveness. The sale is scheduled to take place at a mutually agreed date. The following details are made available:

	₦
Adjusted profit for the year ended 30/09/2011	800,000
Adjusted profit for the year ended 30/09/2012	2,400,000
Adjusted profit for the year ended 30/09/2013	3,600,000

The estimated profits for the year to September 30, 2014 and that for the period to January 31, 2015 have been given as follows:

Year ended 30/09/2014	4,300,000
3 Months to 31/12/2014	600,000
1 Month to 31/01/2015	100,000

Required:

Advise the proprietor of Joshua Enterprises on whether to dispose of its business to 31st December, 2014 or on 31st January, 2015. Support your answer with relevant computations.

Solution

JJ Enterprises

(a) Computation of Basis Period for Assessable Profit for Cessation on 31st December, 2014.

	Normal Assessment		Revised Assessment	
Tax Year	Basis Period	Ass. Profit	Basis Period	Ass. Profit
		₦		₦
2013	1/10/2011 – 30/09/2012	2,400,000	1/01/2013 – 31/12/2013	3,775,000
2014	1/01/2014 – 31/12/2014	600,000		

(b) Computation of Basis Period for Assessable Profit for Cessation on 31st January,2015

	Normal Assessment		Revised Assessment	
Tax Year	Basis Period	Ass. Profit	Basis Period	Ass. Profit
		₦		₦
2014	1/10/2012 – 30/09/2013	3,600,000	1/01/2014 – 31/12/2014	3,825,000
2015	1/01/2015 – 31/01/2015	100,000		

- Advise:

  Joshua is advised to cease operation of its business on 31st January, 2015 because of the possibility of lower tax liability.

Workings:

a. Cessation on 31st December, 2014

2013 Revised			₦
1/01/2013 – 30/09/2013	=	9/12 x ₦3,600,000 =	2,700,000
1/10/2013 – 31/12/2013	=	3/12 x ₦4,300,000 =	1,075,000
			3,775,000

b. Cessation on 31st January, 2015

2014 Revised:			₦
1/01/2014 – 30/09/2014	=	9/12 x ₦4,300,000	3,225,000
1/10/2014 – 31/12/2014	=		600,000
			3,825,000

Change of Accounting Date

- An individual has the right to make up the accounts of his business to a particular month in a year of assessment. Such accounting date must be supplied to SIRS. Whenever the accounting date is changed, it will affect the tax return of the individual.

  The SIRS will re-compute his assessable income for three years starting from the year in which the individual fails to make up his to the old date.

  The SIRS will compute assessable income for three years of assessment based on old and new accounting date.

  SIRS will choose the accounting period that gives the highest assessable income to assess the individual for the threes years.

Illustration

Strong Construction Ltd has been operating in Nigeria for many years and prepares its accounts to 31st December of every year. The controlling company for all the affiliates worldwide which has its registered office in Japan had also been preparing its accounts to 31st December of every year until 2009, when it decided at its Board meeting that all other affiliated companies worldwide must summit copies of their 12 months audited accounts two months before 31st December of every year beginning from 2009.

There are two alternatives the Board of Directors of Rock Construction Nigeria Limited is contemplating:

To prepare the accounts for the year ended within 2010, to end in:

a) June 2010 or

b) September 2010

As a Tax Consultant, your advise is sought, so as to ascertain the financial year-end that would minimize the assessable profits on which tax is payable for those periods. The following information was provided:

	₦
Net Profit per accounts for year ended 31/12/2008	20,000,000
Net Profit per accounts for year ended 31/12/2009	50,000,000
Net Profit per accounts for year ended 31/12/2010	60,000,000
Net Profit per accounts for year ended 31/12/2011	70,000,000

- Other information in respect of the accounts for the year ended 31st December are as follows:

	2008	2009	2010	2011
	₦	₦	₦	₦
Depreciation charged	2,000,000	5,000,000	5,500,000	7,000,000
Loss of Sales of Assets included	-	-	500,000	-

Required:

Show the computations on the new accounting year-end which the Nigeria Company should adopt.

Solution

STRONG CONSTRUCTION LTD

OPTION A: USE 30TH JUNE

Tax Year	Basis Period	Assessable Profit
		₦
2010	1/07/2008 – 30/06/2009	38,500,000
2011	1/07/2009 – 30/06/2010	60,500,000
2012	1/07/2010 – 30/06/2011	71,500,000
		170,500,000

OPTION B: USE OF 30TH SEPTEMBER

Tax Year	Basis Period	Assessable Profit
		₦
2010	1/10/2008 – 30/09/2009	46,750,000
2011	1/10/2009 – 30/09/2010	63,250,000
2012	1/10/2010 – 30/09/2011	74,250,000
		184,250,000

Workings:

A. Computation of Adjusted Profit

	2008	2009	2010	2011
	₦ '000	₦ '000	₦ '000	₦ '000
Net profit reported	20,000	50,000,	60,000	70,000
Add depreciation	2,000,	5,000	5,500	7,000
Loss on sale of asset	0	0	500	0
Adjusted Net Profit	22,000,	55,000	66,000	77,000

B. Option A Computation

2010		₦
1/07/2008 – 31/12/2008	= 6/12 x ₦22,000,000 =	11,000,000
1/01/2009 – 30/06/2009	= 6/12 x ₦55,000,000 =	27,500,000
		38,500,000

2011		
1/07/2009 – 31/12/2009	= 6/12 x ₦55,000,000 =	27,500,000
1/01/2010 – 30/06/2010	= 6/12 x ₦66,000,000 =	33,000,000
		60,500,000

2012

1/07/2010 – 31/12/2010 = 6/12 x ₦66,000,000 = 33,000,000

1/01/2011 – 30/06/2011 = 6/12 x ₦77,000,000 = 38,500,000

71,500,000

C. Option B Computation

2010:

1/10/2008 – 31/12/2008 = 3/12 x ₦22,000,000 = 5,500,000

1/01/2009 – 30/09/2009 = 9/12 x ₦55,000,000 = 38,500,000

44,000,000

2011:

1/10/2009 – 31/12/2009 = 3/12 x ₦55,000,000 = 13,750,000

1/01/2010 – 30/09/2010 = 9/12 x ₦66,000,000 = 49,500,000

63,250,000

2012:

1/10/2010 – 31/12/2010 = 3/12 x ₦66,000,000 = 16,500,000

1/012/011 – 30/09/2011 = 9/12 x ₦77,000,000 = 57,750,000

74,250,000

Capital Allowances

Capital allowance is granted in lieu of depreciation charged on assets utilized in businesses. Whereas depreciation is based on the accounting policy of the taxpayer, capital allowance is computed on qualifying capital expenditures at fixed rated per the provisions of the relevant tax law.

Capital allowance is claimed on qualifying capital expenditure (QCE) under the following conditions:

- the qualifying capital expenditure must be owned by the taxpayer as at the end of the basis period;
- the qualifying capital expenditure must be "in use" as at the end of the basis period;
- the qualifying capital expenditure must be used for the purpose of the trade or business of the tax payer;
- where the value of the qualifying capital expenditure is not less than N500,000, an acceptance certificate must be obtained from the inspectorate division of the Federal Ministry of Industries.

There are basically four types of capital allowances:

- Initial Allowance: This is claimed on the qualifying capital expenditure only once and generally in the year of first year.
- Annual Allowance: This is claimed on straight line basis over the estimated tax life of the qualifying capital expenditure.
- Investment Allowance: This is claimed only once for specific assets (Plant and equipment). This is an additional allowance for certain capital expenditure. It is an incentive.
- Balance Adjustments: This may be a balancing allowance or a balancing charge. This will arise when a qualifying capital expenditure is disposed. The sale proceed on disposal is compared with the tax written down value of the capital expenditure. If the sales proceed exceeds the tax written down value, a balancing charge is obtained where as the reverse results in balancing allowance.

International Transactions

- Nigeria is a part of the global economy in which she partakes in transactions such as exchange of goods and services, movement of persons and capital or disposal of capital assets across national frontiers. The trade in goods is usually in the form of sale or purchase of raw materials, semi-finished and finished goods and spare parts. Services traded in may include, consultancy, technical, professional and management services. Capital flows are investments in equity, loans, technology and know-how. Persons also move across the borders to provide employment services. Movable and immovable assets held across the borders may also be disposed of. For these transactions, there are compensating outflows in the forms of payments, dividends, interests, royalties, rents, employment remuneration and capital gains. These trans-border transactions have far-reaching implications for the taxpayer, the government and the tax administration.
- The concept of permanent establishment (PE) is key in the determination of a non-resident's liability to Nigerian tax system.

- **Turnkey projects**

  Section 13(2) of CITA provides that a person without a fixed base or a dependent agent in Nigeria can still be deemed to have a PE in Nigeria in respect of its business if:

  “that trade or business or activity involves a single transact for surveys, deliveries, installations or construction.”

  In such a case, such a turnkey project would constitute a PE in Nigeria and the contractor would be liable to tax in respect of the executed contract.

- **Multinational Enterprises (MNES)**

  The term “Multinational Enterprises” is defined as “groups of associated enterprises operating across national frontiers”. These enterprises have become powerful in terms of the sizes of the world trade, investment and finance they control.

  The growth is attributed to the support of international organizations like the World Bank, the International Monetary Fund (IMF) and the World Trade Organisation (WTO).

  Both the Nigeria tax laws and the tax treaties give prominent attention to MNEs. Under section 22(1)(b) of CITA, internal trading between associated companies is to be regarded as “artificial or fictitious” if not made at arm’s length.

- The tax authority is empowered to set aside the transaction and to take measures to counter the arbitrariness which is capable of reducing tax liability. Similarly, Section 29(9) of CITA, provides for mergers and acquisitions within or by associated companies. Where they occur, the commencement and cessation clauses would not be apply to such arrangement but rather, the new outfit would be treated as a going concern. The assets of the new outfit would be deemed to have been sold or transferred at written-down value of such assets and the assets would not be qualify for initial allowance in the calculation of company's capital allowances.

  In terms of section 29(10) of CITA, where an MNE incorporates a subsidiary in Nigeria to carry on a business not materially different from its business, the applicable conditions are the same as those that apply mergers and acquisitions. However, the subsidiary would be allowed to utilise and carry forward the losses incurred by the parent company before the incorporation.

- **TRANSFER PRICING**

  Transfer pricing refers to the pricing of transfers between associated enterprises. Such transfers could take several forms:

i. Transfer of goods raw materials, semi-finished goods, spare parts and finished products
ii. Transfer of services banking, technical and management services, finance and legal services
iii. Transfer of intangible items trademarks, copyrights, patents and intangibles in manufacturing, oil drilling, marketing, software.

Tax distortion under inflationary conditions

- Inflation increases the nominal value of an asset while there is no equal increase in the real value. Thus, under inflationary periods, any increase in the value of an asset should not be subject to capital gains tax since there is no gain. However, sometimes the money value of an asset may appreciate thus giving rise to some capital gains which may be taxable., for example, holders of corporate shares and urban real estate who sell or transfer them with beneficial gains. This does not apply to holders of bonds and fixed assets who will be adversely affected by inflation. Hence, it would make sense to tax capital gains on holders of corporate and real estate during inflation with the exemption of those holding bonds and fixed assets to ensure equity in taxation. An inflation allowance should be granted to companies which acquire additional assets or replace old assets during inflationary periods so as to cover losses due to the cost of acquiring new assets against old replaced assets.

Review Questions

1. Discuss the concept of transfer pricing, turnkey projects and Multinational enterprises indicating their tax implications.
2. Mention ten profits of companies exempted from companies income tax under section 23 of CITA and discuss what is meant by interest deemed to be derived from Nigeria?
3. Explain with relevant examples the three reasons that cause abnormality in the basis period of business.
4. Minimum tax rules relate to companies and individuals:
   (a) Examine the bases of its computation for both companies and individuals.
   (b) Explain the conditions surrounding their computation.

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