



THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

OCTOBER 2021: PROFESSIONAL EXAMINATION

PTE II: FINANCIAL AND TAX ANALYSIS

WEDNESDAY 13TH OCTOBER, 2021

EXAM NO.....

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS.

TIME: 3 HOURS.

1. Debos Exotic Wares Limited (DEWL) was incorporated as a partnership business between Debos Nigeria Limited (DNL) and International House Wares Limited (IHWL) of United Kingdom in March, 2001. DNL holds 60 percent of the share capital of the company while IHWL holds 40 percent.

DEWL has two major product lines, ceramic products and metallic products. The ceramic line consists of table wares such as plates, bowls, cups, mugs, flower vase, etc, while the metallic line includes kitchen wares such as, cooking pots, frying pans, etc. About 70 percent of the production raw materials for these products are imported from United Kingdom and China, while the remaining 30 percent are sourced locally.

The company has two group of customers, the hospitality and retail customers. The hospitality customers are serviced directly by DEWL while the retail customers are serviced by appointed distributions located in each state capital of the country.

Extracts from the company's latest annual financial report is shown below:

Debos Exotic Ware Limited
Extracts from financial statements.

Income statement:		
	2019	2018
	₦'m	₦'m
Revenue	1,245	984
Manufacturing cost	(747)	(523)
Gross profit	498	461
Distribution costs	(93)	(77)
Selling expenses	(229)	(207)
Administrative expenses	(87)	(83)
Operating profit	89	(94)
Finance expenses	(2)	(3)
	87	91
Tax expenses	(22)	(22)
Profit for the year after taxation	<u>65</u>	<u>69</u>

Statement of financial position		
Non-current assets:		
Property, plant and equipment	<u>523</u>	<u>393</u>
Current Assets:		
Inventories	153	135
Account receivables	81	76
Cash and cash equivalents	<u>2</u>	<u>--</u>
	<u>236</u>	<u>211</u>
Current Liabilities:		
Accounts payables	411	319
Bank overdraft	<u>--</u>	<u>2</u>
	<u>411</u>	<u>321</u>
Net current liabilities	(175)	(110)
Net assets	<u>348</u>	<u>283</u>
Equity:		
Ordinary share capital	50	50
Retained earnings	<u>298</u>	<u>233</u>
	<u>348</u>	<u>283</u>

Required:

- (a) Differentiate between accounting analysis and financial statements analysis. (5 Marks)
- (b) Carry out an analysis of the company's financial statements using ratios and comment on the company's performance, efficiency and liquidity. (25 Marks)
- (c) State and explain a strategic tool that can help DEWL to monitor its environments so as to respond strategically to both national and international developments that can affect the company's business. (10 Marks)
- (Total 40 Marks)

SOLUTION TO QUESTION 1

(a) Accounting analysis is mainly concerned with historical data of a company from which stakeholders can have idea about consistency in the company's accounting information system. It reveals the data of business profit, loss, assets, liability, etc. On the other hand, financial statements analysis focuses on the financial performance, cash flow, liquidity, efficiency with which assets are being utilised and the current position of the entity. Financial analysis includes the experienced based process of interpreting and translating the past figures into current future suggestions, actions or activities to achieve the organisation's desired goals.

The purpose of accounting analysis is to adjust the financial statements to reflect the economic reality of the entity before embarking on any financial statements analysis.

(b) Financial statements analysis of Debos Exotic Wares Limited. Using ratios

(i) PERFORMANCE.

	2018	2019
- Gross profit margin: $\frac{\text{Gross profit}}{\text{Revenue}}$	$\frac{461}{984} = 46.85\%$	$\frac{498}{1,245} = 40.00\%$
- Net profit margin: $\frac{\text{Net profit}}{\text{Revenue}}$	$\frac{91}{984} = 9.25\%$	$\frac{87}{1,245} = 6.99\%$
- Returns on capital employed (ROCE): $\frac{\text{EBIT}}{\text{Total assets}}$	$\frac{94}{283} = 33.22\%$	$\frac{89}{348} = 25.57\%$
- Returns on equity (ROE): $\frac{\text{PAT}}{\text{Equity}}$	$\frac{69}{283} = 24.38\%$	$\frac{65}{348} = 18.68\%$

(ii). EFFICIENCY RATIO

	2018	2019
Net assets turnover: $\frac{\text{Revenue}}{\text{Net Asset}}$	$\frac{984}{283}$ 3.47 or 3.5 times	$\frac{1245}{348}$ 3.57 or 3.60 times
Inventory Turnover: $\frac{\text{COGS}}{\text{Average}}$	$\frac{523}{135}$ 3.87 or 3.9 times	$\frac{747}{153}$ 4.88 or 4.9 times
Receivables turnover/Period $\frac{\text{Credit sales or sales}}{\text{Average Acc. Rec.}}$	$\frac{984}{76}$ 12.9 times	$\frac{1245}{81}$ 15.37 or 15.40 times
Or period $\frac{\text{Average Receivable}}{\text{Credit Sales}} \times 365 \text{ days}$	$\frac{76}{984} \times 365$ 28.19 days	$\frac{81}{1245} \times 365$ 23.75 days
Payable turnover/ period $\frac{\text{Credit Purch or Purch}}{\text{Average payable}}$	$\frac{523}{319}$ 1.63 times	$\frac{747}{411}$ 1.83 times
Or period $\frac{\text{Average Payable}}{\text{Credit Purch or Purch}} \times 365 \text{ days}$	$\frac{319}{523} \times 365$ 222.65 days	$\frac{411}{747} \times 365$ 200.82 days

(iii). LIQUIDITY

	2018	2019
- Current ratio:	211/321	236/411
$\frac{\text{Current assets}}{\text{Current Liabilities}}$	= 0.66 : 1.00	= 0.57: 1.00
- Quick ratio / Acid test:	76/321	83/411
$\frac{\text{Current assets} - \text{Inventory}}{\text{Current Liabilities}}$	= 0.24:1.00	= 0.20: 1.0

Comments

- (i). Performance: Although the company has improved on its sales revenue, but profitability has gone down generally. The gross profit margin dropped from 46.85% in 2018 to 40% in 2019. This is an indication that either the cost of manufacture has gone up or the company has to reduce its price to be able to sell.

In the same vein, net profit margin has gone down from 9.25% to 6.99% in 2019. This shows that the company's operating expenses have also gone up.

Returns on capital employed has also gone down from 33.22% in 2018 to 25.57% in 2019. This shows that increase in the company's capital employed in 2019 has not helped the company significantly to improve on its performance. Return on equity also dropped from 24.38% in 2018 to 18.68% in 2019.

- (ii). EFFICIENCY: The company's efficiency remains almost at the same level from 2018 to 2019 as most of the ratio remain almost the same levels for the years. For example, net asset turnover for the two years shows no significant change. Inventory turnover slightly increased from 3.9 times to 4.9 times, but this may be due to the fact that the company has reduced its stock holding, proportionately to the level of sales revenue. Receivable turnover also increases from 12.9 times in 2018 to 15.4 times in 2019 for the same reason as the inventory turnover.

The payable turnover rate remains slightly the same for the two years.

- (iii). LIQUIDITY: The company has liquidity crises, and the operations of the company is being financed by supplier's credit. This cannot continue for a long time. The suppliers may withdraw its support for the company. The current ratio dropped from 0.66:1.00 in 2018 to 0.57: 1.00 in 2019 and likewise, the quick ratio dropped from 0.24:1.00 in 2018 to 0.20:1.00 in 2019.

The company need to inject long term working capital into the business to guarantee its continuing in business. This can be in the form of long term loan or loan notes. The company at present, has no debt capital, as it is wholly financed by equity, so it has capacity to bring in debt capital.

- (c). The tool the company can use to manage its business environment, both nationally and internationally is PESTEL. This shows the factors in the environment that can results in opportunities to the company and or can be a threat to the company's business. PESTEL stands for political factors, economic factors, social factors, technological factors, ecological factors and legal factors in the national or international environment of business. PESTEL analysis is a tool for business strategic planning, market planning and product development.

Political factors: These have to do with the government and its policies. They also have to do with the type of government, whether a democratically elected government or a military dictatorship. Further, they have to do with

the stability of government in the nation. Generally, these are political forces that shape the environment of business.

Economic factors: These are factors that have to do with the government economic policies. They include both the monetary and fiscal policies such as interest rate, exchange rate, balance of payments, tariff and import policies, export, taxation and levies. All these factors affect every business and must be considered when planning the business.

Social factors: These are also known as social – cultural factors, and have to do with the culture of the people in the business environment, their shared belief, attitudes, etc. They also involve the population structure, the age distribution, birth and death rates, the working population, the dependent population, the general health condition of the citizens. These factors always affect market demand and how businesses market their products.

Technological factors: These are the rate of technological changes in the business environment. Today, many technologies are disrupting the way business is being conducted to the extent that some new technologies have killed some industries. Technology has made the world a global village and this has affected the way business is being run, the way products and services are being marketed, etc., every business must continually scan the technological landscape to discover new technology that may impact the business either positively or negatively, so as to proactively prepare for opportunity or ward off threat.

Ecological / Environmental factors: These have to do with the ecology of the environment, air pollution, surface degrading, sustainability, etc. These factors have become important due to the increasing scarcity of materials, pollution targets, doing business as an ethical and sustainable company, carbon foot print targets set by the government. It is generally to make businesses an environmental friendly business. And more and more consumers are demanding that organisations should ensure that products they buy are sourced ethically, and if possible, from a sustainable source.

Legal factors: This has to do with the legal framework existing in the national and international environment. They include, health and safety laws, employment law, companies laws, international rules and legislation, etc. All these affect how business is run, etc.

On the completion of PESTEL analysis, a company will be able to come up with list of opportunities in the environment which it can explore and list of threats to the business which it has to ward off. PESTEL, as a tool, is most of the time used with SWOT analysis

EXAMINER'S REPORT

The question tests candidates' understanding of (a) differences between accounting analysis and financial statements analysis, (b) ratios and interpretation of ratios, and (c) tools for environmental analysis.

Candidate' performance was very poor as less than 10% of the candidates scored 50% of the allocated marks.

The major pitfall of the candidates was lack of understanding of the requirements of the question and also using SWOT for environmental analysis instead of PESTEL that is more appropriate.

Candidates are advised to make use of the institute's study pack and pathfinders and also have a good grasp of all the syllabus areas when preparing for future examinations.

2. The essence of accounting analysis is accounting adjustment.

Required:

Discuss accounting adjustments and the need for it before carrying out financial statements analysis. (15 Marks)

SOLUTION TO QUESTION 2

Accounting adjustments are adjustment made on an entity's accounting figures after carrying out an accounting analysis to correct any accounting distortions identified. The essence of accounting adjustment is to enable the figures in the financial statements reflect the business and economic reality of the entity.

Once the financial analysis has considered the accounting distortions present in the entity's financial statements, the analyst will evaluate whether accounting adjustments are needed to correct the distortions in the financial statements.

Adjustments may be as a result of:

- (i). Accounting policies of the entity do not reflect the underlying economic situation of the entity;
- (ii). The management deliberately decided to distort the entity's performance; and
or
- (iii). The management intends to make the financial statements, comparable over time.

Therefore, adjustments to financial statements are made for the following reasons:

- (i). Accounting standards may not reflect economic reality of the entity;
- (ii). To remove management biases that have been introduced in the preparation of the financial statements, and
- (iii). To make the financial statements comparable across the years or across entities.

EXAMINER'S REPORT

The question tests candidates' knowledge of accounting adjustments before carrying out financial statements analysis.

Candidates' performance was poor as less than 5% of the candidates that attempted the question scored 50% of the marks allocated it.

The candidates common pitfalls were lack of understanding of accounting adjustments and the needs for it.

Candidates are advised to study all aspects of the syllabus when preparing for future examinations of the institute.

3. Most of the multinational enterprises engage in international tax planning so as to reduce their overall tax liabilities.

Required:

Discuss international tax planning, its objectives and strategies. (15 Marks)

SOLUTION TO QUESTION 3

The basic purpose of international tax planning is to exploit differences, gaps and asymmetries in the relevant domestic legal system that create opportunities to reduce, defer or eliminate the multinational enterprises' overall tax liabilities. Many of these asymmetries arise from the fact that, historically, domestic tax rules and bilateral tax treaties have focused primarily on the avoidance of double taxation rather than on preventing base erosion and profit shifting or addressing circumstances where a particular item of income is not taxed anywhere.

According to OECD'S BEPS Action Plan, international tax planning is designed to achieve one or more of the followings:

- (i) Reduction of both corporate tax and withholding tax in the source country;
- (ii) Reduction of tax on any intermediary entities that receive amounts from the entities in the source country; and
- (iii). Reduction of tax on the ultimate parent.

The basic objectives of international tax planning are:

To arrange the affairs of a multinational group of companies such that profits are earned where they are taxed at the lowest possible rates and expenses are incurred where their deduction yields the greatest tax relief.

The commonly used international tax planning strategy is Base Erosion and Profit Shifting (BEPS) strategy. BEPS refers to corporate tax planning strategies used by multinational enterprises to shift profits from higher tax jurisdictions to lower tax jurisdictions thus eroding the tax base of the higher tax jurisdiction. This is done by exploiting the gaps and mismatches in the tax rules. However, it has been observed that intellectual property is usually used as tools for this strategy.

Base erosion is a planning strategy whereby the size of a company's taxable profit is reduced in a country with high tax rate. This is achieved by writing off certain expenses against the profit, so as to reduce the taxable profit.

Profit shifting is a tax planning strategy which is used by a group of companies or a multinational enterprises whereby profit is moved from jurisdiction with high tax rate to jurisdiction with low tax rate.

The essence is to increase the overall after – tax profit that is available to the group shareholders. This strategy uses intra-group payments, such as, royalties, interest, etc, which are tax deductible.

Some of the techniques used by multinationals for base erosion and profit shifting are:

- (i). Intellectual property: Intellectual property, which includes trademarks and technology licensing through transfer pricing. This is done through creation of intellectual property such as patents, trademarks, designs etc in jurisdictions with lower tax rate and then charging companies in the group high royalties for the use of the intellectual property;
- (ii). Thin capitalisation: This is done through setting up of subsidiaries with minimal capital and financing the operation of the subsidiaries through debt from the group company which will in turn charge interests, such interest has different treatments in various jurisdictions but the idea is to reduce group tax liability, if structured correctly; and
- (iii). Hybrid mismatch arrangements: This is possible because of different tax regimes in different jurisdictions which results in unintended effects on double non-taxation. This is normally exploited by companies to reduce tax burden.

EXAMINER'S REPORT

The question tests candidates understanding of multinationals tax planning objectives and strategies.

Candidates' performance was very poor as less than 2% of the candidates scored about 50% of the allocated marks.

The common pitfalls of the candidates were confusing benefits of tax planning with the objectives and strategies of international tax planning.

Candidates are advised to ensure they cover the entire syllabus and make use of the Institute's Study Pack when preparing for future examinations.

4. Companies going into merger and acquisition must carry out due diligence, most especially tax due diligence.

Required:

Discuss what constitute tax due diligence in mergers and acquisitions. (15 Marks)

SOLUTION TO QUESTION 4

The major due diligence issues are tax consequences of the divestment by the seller such as capital allowance recoups and capital gain tax, which may be factored into the pricing of the assets because the buyer is able to claim tax benefits on the amount paid to acquire such assets.

Due to the enormous tax costs of some of these types of transaction, investors often use complex structures to obtain tax reliefs. On asset deals, the historical tax issues

for seller are not too important except to model any incremental costs for changes in compliance after acquisition.

For shares deals, the tax issues are usually complex. This requires a detailed tax due diligence to be undertaken to anticipate and mitigate tax liabilities through indemnities and warranties. Buyers have to understand the attitude of the target entity towards tax compliance, since most tax due diligence issues result from the target's existing approach to tax compliance. This is important in view of the relatively low level of tax compliance in Nigeria, which is partly due to weak tax enforcement on the part of the authorities. It is also useful to evaluate the effectiveness of the tax function, quality of tax personnel, and competency of tax adviser and overall attitude of management to corporate governance assessing potential tax risk.

Assessing compliance challenges: oftentimes, there are challenges around incomplete and poor record keeping by target companies. These businesses are sometimes unable to substantiate their claims of tax compliance, especially filing of returns and remittances of tax liabilities. This stems in part from, the difficulty of obtaining evidence of tax paid both from third parties and tax authorities.

In assessing tax exposures of a target, investors should consider industry – specific issues that may affect the target's tax position. An example of this could be an aggressive industry position on a tax matter or class action on industry -specific issues. A purchaser may also need to evaluate the risk associated with ambiguous tax rules that might create uncertainties in the interpretation and application of tax laws as well as variances between the letters of law and what occurs in practice.

Common risk areas are transaction taxes such as VAT and withholding tax where compliance is generally low or sometimes overlooked by tax payers.

In group situations, transaction taxes on their inter-company transaction are often taken for granted or treated wrongly. There are also non-compliance issues associated with employee taxes (and social security contributions), especially with expatriate staff.

With respect to the acquisition of government – owned enterprises, the need for a thorough due diligence is even more important as most government corporations are not diligent in matters of tax compliance. A common remedy is to seek an indemnity to cover identified and potential tax liabilities as a pre-condition for the acquisition.

When carrying out a tax due diligence on the proposed target, answer to the following specific questions should be sought:

- (i). What is the target's level of tax compliance with respect to companies income tax (CIT), tertiary education tax (TET), capital gain tax (CGT), international technology level and payroll related tax?
- (ii). What are the available tax assets (e.g – unabsorbed capital allowances, unabsorbed tax losses, unutilised WHT credits, etc) on the target book?
- (iii). What is the quantum of non-allowable tax expenses and /or deductions in the target's tax position, e.g filing fees, stamp duties, etc?
- (iv). What are the prospects for the application of the commencement and /or cessation rules post-combination given potential double taxation?

Acquiring party may be able to take advantages of the tax benefits under Nigeria's tax laws in relation to interest payments if it finances the business combinations through loan facilities.

EXAMINER'S REPORT

The question tests candidates' knowledge of tax due diligence in mergers and acquisitions

About 51% of the candidates attempted the question and performance was poor.

The candidates' commonest pitfall was complete lack of understanding of the question.

Candidates are advised to ensure coverage of the sections of the syllabus when preparing for future examinations of the institute.

5. (a) Derivatives are normally used by corporate entities to hedge against risks.

Required:

Discuss the provisions of the Nigeria tax laws on taxation of derivatives.

(10 Marks)

- (b) One of the tools multinational enterprises use in tax planning strategy is intellectual property.

Required:

Discuss how intellectual property can be used as a tax planning strategy.

(5 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 5

- (a). Under the Nigeria tax laws, there are no specific provisions for taxing of derivative transactions. However, the general taxation rules are applicable. And this will require determination whether there is a gain or loss which will be taxable under the Capital Gain Tax Act (CGTA) or Companies Income Tax Act (CITA). As usual, the general rule is that capital gains are taxable under the provisions of CGTA while trading income or losses are taxable under the provisions of CITA.

Under CITA, where it can be established that a company is trading in the underlying assets of a derivative, such as shares, as its usual business and income is derived from such transactions, then the company would be liable to company income tax (CIT) on the profits derived from the transactions. This is in accordance with the Federal Inland Revenue Service (FIRS) position as presented in the FIRS information circular on tax implication of the adoption of the International Financial Reporting Standards (IFRS) in Nigeria, which provides that profits or losses from derivative contracts will be treated under CITA.

Chargeable assets have been defined as fixed assets, debts, options, incorporeal assets and currency other than the Nigerian currency. Therefore, gains arising from disposal of chargeable assets are subject to capital gains tax (CGT) at the rate of 10%.

The CGTA does not give any indication as to how to determine the location of underlying assets in derivative instruments. It can therefore, be logically assumed that the location is determined to be where the rights and obligations relating to the sale of the derivative are tied, if it is tied to Nigeria, it is arguable that the derivative is in Nigeria. Therefore, the gains from the transactions will be expected to be taxable in Nigeria.

Also, where the underlying asset of a derivative is exempted from capital gain tax, the gains from the derivative transaction will also be exempted. An example of this is gains realised from the disposal of Nigeria shares by a company.

Another important implication is that where the derivative is considered to be goods or services, value added tax is payable on the gains, except if the good or service is exempted by the Value Added Tax Act (VATA). It should be noted that "options" are not considered to be goods or services but rather, an incorporeal right, therefore, it would not be subject to VAT. Any premium paid by a company for the right in an option is not liable to VAT.

- (b). Generally, there are two specific tax issues to be considered, apart from the strategic decision of transferring Intellectual Property (IP) to a tax heaven, when considering movement of IP to other jurisdictions. These are:
- (i). The home jurisdiction may treat the transfer as a sale and therefore, consider the capital gains on fair value basis. This will result in an immediate tax obligation; and
 - (ii). The jurisdiction may grant a licence to other companies in other jurisdictions, to use the IP on payment of yearly royalties. Subsequent income received from the IP transfer in form of royalties will be subject to income tax as at when received by the transferee entity.

The above issue however, depends on the tax rules of each jurisdiction where the transfer is taking place.

Multinationals use IP as a form of profit shifting strategy by creating intellectual property in jurisdiction with lower tax rate and charging companies in other jurisdictions royalties for the use of the IP. The purpose is to reduce the overall tax payable by the group.

EXAMINER'S REPORT

The question tests candidates' understanding of the provisions of the Nigeria tax laws on derivatives and how multinationals use intellectual property as a tax planning strategy.

About 50% of the candidates attempted the question, but performance was poor as more than 90% of those that attempted the question scored below 35% of the allocated marks.

The candidates' commonest pitfalls were lack of understanding of the provisions of the Nigeria tax laws on derivatives and how multinationals use intellectual property as a tax planning tool.

Candidates are advised to ensure adequate coverage of all areas of the syllabus when preparing for future examinations.

6. Corporate strategist must carry out an industry analysis when formulating corporate strategies.

Required:

- (a) What is industry analysis? (5 Marks)
- (b) Discuss the basic requirements necessary to perform an effective industry analysis. (10 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 6

- (a). Industry analysis involves observation and analysis of factors such as market behaviours, competitive forces and financial, regulatory, socio- economic and technological trends that influence the domain. Industry analysis delivers insights, into business drivers and key success factors, relevant to the domain. Industry analysis is a business owned activity to assess the existing business environment and its competitive position.

It is one of the preliminary steps in strategic planning. A manager will interpret an industry analysis and combine it with knowledge of existing and emerging technology and managerial issues. Industry analysis capability enhances a manager's involvement in understanding business needs and facilitates a consultative approach in requirements development.

- (b) The following are required to perform an effective industry analysis:
- (i) **Industry research:** Industry research is the acquisition of corporate intelligence on a broad range of issues including macro environment, market and competitive landscape and consumer analysis.
 - (ii) **Information analysis:** Information analysis is the process of discovery and quantification of patterns in industry – specific data and trends. A manager will perform information analysis to interpret macro and mega trends, financial indicators, market growth indicators and influence of technology in sharpening business outcome.
 - (iii) **Industry segmentation:** Industry segmentation is the process of defining and subdividing a large homogenous market into clearly identifiable components having similar needs, wants or demand characteristics. Industry segmentation is driven by factors such as products, target market, geography, demographics, and size of business that constitutes an industry.
 - (iv) **Industry trends:** An assured tendency of a given industry to move in a particular direction over time, has been a primary and rapid disruptive force for managers in the last fifty years making the role of managers very important in signaling industry changes arising from technology trends

EXAMINER'S REPORT

The question tests the candidates' knowledge of industry analysis.

About 80% of the candidates attempted the question and their performance was below average, as majority of the candidates scored less than 30% of the allocated marks.

The commonest pitfalls of the candidates were lack of understanding of industry analysis and the requirements for conducting it.

Candidates are advised to ensure adequate coverage of the syllabus when preparing for future examinations.

7. (a) Business cash flow activities can be divided into three major groups.

Required:

Discuss the activities involved in these three groups.

(6 Marks)

- (b) Dentol Nigeria Limited entered into the following transactions during the year ended December 31, 2019:

	₦'000
Sales to customers for cash	2,500
Purchases of raw materials for cash	1,250
Paid wages and salaries	500
Paid creditors for raw materials purchased on credit	1,300
Received cash from customers	1,500
Received from proceeds of loan notes	5,000
Proceed from new ordinary shares issued during the year	10,000
Received from sales of old plant and machinery	500
Purchased a new plant and machinery	5,000
Paid interest to debenture holders	1,200
Paid dividend to shareholders	2,500

Required:

Classify the above transactions under the three groups of business cash flow activities identified in (a) above.

(9 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 7

- (a). Business cash flow activities consist of operating, financing and investing activities for financial reporting purposes. These three groups of cash flow activities are necessary for the achievement of the overall goals of any business organisation.

Operating activities: These are activities that form part of the day-to-day business activities of an entity. Examples include sales of meals by a

restaurant, provision of services by a consulting firm, manufacturing and sale goods by a manufacturing company, taking of deposits and granting of loan by banks, etc.

Investing activities: These are activities associated with acquisition and disposal of long – term asset. Examples includes purchase of equipment, sales of old plant and machinery.

Financing activities: These are activities related to obtaining or repaying capital. The two primary sources of such funds are owners (shareholders) and creditors. Examples include issuing of equity shares, taking of banks loans and issuing loan notes, etc.

(b) **DENTOL NIGERIA LIMITED**

	₦ ' 000
Operating activities:	
Sales to customers for cash	2,500
Purchase of raw materials for cash	1,250
Wages and Salaries	500
Creditors	1,300
Cash from customers	1,500
Investing activities:	
Sales of old plant and machinery	500
Purchase of new plant and machinery	5,000
Financing activities:	
Proceeds from loan notes	5,000
Proceeds from shares issued	10,000
❖ Interest on loan notes	1,200
❖ Dividends paid to shareholders	2,500

❖ Both items can also be classified under operating activities.

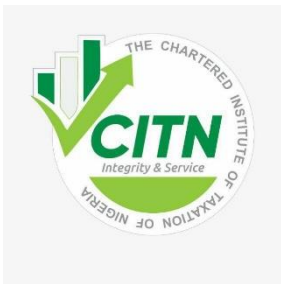
EXAMINER'S REPORT

The question tests the candidates' knowledge of how business cash flow activities can be grouped.

Most of the candidates attempted the question and performance was above average as most of the them that attempted the question scored above 50% of the marks allocated.

The commonest pitfall was candidate's lack of understanding of how to allocate the various business cash flow activities between the three groups.

Candidates are advised to ensure adequate coverage of the syllabus when preparing for future examinations of the institute.



THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

OCTOBER 2021: PROFESSIONAL EXAMINATION

PTE II: INTERNATIONAL TAXATION

TUESDAY 12TH OCTOBER, 2021

EXAM NO.....

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS.

TIME: 3 HOURS.

1. Idofin Ltd and Erinjiyan Ltd, two separate entities, are Nigerian companies doing well in their different sectors within the economy.

The owners of the two companies decided to pool resources together and form a bigger outfit for necessary synergistic benefits. Consequently, a new company, Araromi Ltd, came into existence with a new dynamic management team.

The new company decided to take advantage of free trade within the Economic Community of West African States (ECOWAS) by establishing a branch of its company in Cameroon on October 1st, 2017.

The following were extracted from the consolidated financial statements of Araromi Ltd for the year ended 31/12/2019:

Araromi Ltd

	N'000
Turnover	3,000
Overhead	<u>1,750</u>
	<u>1,250</u>

Included in the overhead are the following:

	Nigeria	Cameroon
	N	N
Depreciation	120,000	310,000
Sales tax	370,000	--
VAT on non-current asset	150,000	--
VAT on revenue expenses	120,000	--
Provision for advertisement	--	<u>610,000</u>
	<u>760,000</u>	<u>920,000</u>

You are informed that:

- (i) Araromi Ltd paid US \$12,500 to the Cameroon tax authority as income tax on business transactions within the period of these financial statements.
- (ii) The net profit for the Cameroon operation was N375,000.

- (iii) The agreed exchange is ₦20 to 1 USD.
- (iv) Capital allowance, Nigeria; ₦90,000, Cameroon; ₦45,000.

Required:

- (a) Describe how double taxation relief is computed for a Nigerian company where there is no double taxation agreement with the other foreign country's tax authority within the commonwealth. (5 Marks)
 - (b) Describe how double taxation relief is computed for a non-Nigerian company doing business in Nigeria where there is no double taxation relief agreement with the other foreign country's tax authority within the commonwealth. (2 Marks)
 - (c) State five challenges facing the international organisations (e.g. OECD) in achieving stated objectives. (3 Marks)
 - (d) Compute the income tax liability of Araromi Ltd after the relief for taxes suffered abroad. (30 Marks)
- (Total 40 Marks)

SOLUTION TO QUESTION 1

- (a) Double taxation relief for a Nigerian company when there is no double taxation agreement with the relevant foreign country's tax authority, the Commonwealth Rate of Tax (CWRT) shall be computed as stated below:

$$\frac{\text{Foreign tax paid}}{\text{Total profit from foreign business}} \times 100\% = x \%$$

The following should be noted:

- (i) Nigerian rate of tax is assumed to be 30%;
 - (ii) Where the CWRT is higher than one-half of Nigerian Rate of Tax (NRT); relief is granted using one-half of NRT. (CWRT > 1/2 NRT; Relief = 1/2 NRT); and
 - (iii) Where one-half of NRT is higher than CWRT; relief is granted using the CWRT (1/2 NRT > CWRT; Relief = CWRT).
- (b) Double taxation relief for a non-Nigerian company doing business in Nigeria shall be computed as follows:
 - (i) Where the CWRT < NRT; Relief = 1/2 CWRT where the commonwealth rate of tax is less than Nigerian rate of tax; Relief = 1/2 CWRT; and
 - (ii) Where the CWRT > NRT; Relief is the amount by which the NRT exceeds one half that of the CWRT [NRT – 1/2 CWRT].
 - (c) Challenges facing international organisations in achieving stated objectives include the following:
 - (i) The structure and operations of these organisations;
 - (ii) The independence of these organisations;
 - (iii) The States can limit or extend their autonomy;
 - (iv) The States from time to time interfere in their activities;
 - (v) The States have enough capacity to restructure or dissolve them; and
 - (vi) They sometimes collide with the sovereignty of a State when they create new structures for regulating cross-border relationships.

(d) **Araromi Ltd**
Computation of Tax Liability
For 2020 Tax Year

	Nigeria	Cameroon	Total
	₦	₦	₦
Net Profit (wi)	875,000	375,000	1,250,000
Add/(Deduct):			
Depreciation	120,000	310,000	430,000
Sales tax	370,000	--	370,000
VAT (Non-current Asset)	150,000	--	150,000
Provision (Advert)	--	610,000	610,000
Adjusted Profit	1,515,000	1,295,000	2,810,000
Capital Allowance	(90,000)	(45,000)	(135,000)
Total Profit	<u>1,425,000</u>	<u>1,250,000</u>	<u>2,675,000</u>
Companies Income Tax @ 30%			802,500
Double Tax Relief (w2)			(187,500)
Net CIT Payable			615,000
TET - 2% of Assessable Profit ($\frac{2}{100} \times \text{₦}2,810,000$)			(56,200)
Total Tax Liability for 2020			<u>671,200</u>

Workings:

(i) Net Profit Computation

	₦
Gross Turnover	3,000,000
Total Overhead	(1,750,000)
Net Profit	<u>1,250,000</u>

Share of Net Profit

	₦
Total Net Profit	1,250,000
Net Profit for Cameroon	(375,000)
Net Profit (Nigerian operations)	<u>875,000</u>

(ii) Conversion to naira = \$12,500 x ₦20

$$= \text{₦}250,000$$

$$\text{CWRT} = \frac{\text{₦}250,000}{\text{₦}1,250,000} \times 100\%$$

$$= 20\%$$

$$\text{One-half of Nig. Rate of Tax} = 30\% \text{ divided by } 2$$

$$= 15\%$$

Relief shall be granted, using the lower of CWRT and $\frac{1}{2}$ NRT; this is 15%

$$\therefore \text{The Relief to Araromi Ltd is } \frac{15}{100} \times \text{₦}1,250,000 = \text{₦}187,500$$

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of double taxation relief for Nigerian and non-Nigerian companies. Additionally, candidates are expected to state the challenges international organisations are facing in their desires to achieve stated objectives.

Above 80% of the candidates attempted the question and the performance was below average. The common pitfalls were the inability of the candidates to correctly identify disallowable expenses, compute commonwealth rate of tax and state the challenges international organisations are facing in order to achieve their desired objectives.

Candidates are advised to read the Institute's Pathfinders, Study Packs and relevant text books when preparing for subsequent examinations.

2. (a) The Income Tax (Country by Country Reporting) (CbCR) Regulations, 2018 came into force in January 2018:
- (i) What are the objectives of the regulations? (3 Marks)
 - (ii) There are basically two compliance filing obligations required of relevant taxpayers: state these filing obligations and the time for filing. (2 Marks)
 - (iii) Non-compliance with The Income Tax (Country by Country Reporting) Regulations, 2018 is met with stiff penalties; state the administrative penalties for failure to meet the compliance obligations in (ii). (4 Marks)
 - (iv) Specified taxpayers are exempted from compliance with the obligations in (ii), on what basis is such exemption given? (1 Mark)
- (b) What are the objectives of regional economic integration? (3 Marks)
- (c) Tax neutrality is a necessary quality for sound and acceptable tax policy, but sometimes, may be counterproductive. Discuss this in line with government interests. (2 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 2

- (a) (i) Objectives of the CbCR regulations are to:
- Provide tax authorities with information about Multinational Enterprises (MNEs) global activities, profits and taxes;
 - Provide tax authorities with information to enhance assessment of international tax avoidance risks;
 - Improve transparency of MNEs in their tax practices; and
 - Prevent tax evasion or avoidance through Base Erosion and Profit Shifting (BEPS).
- (ii) The filing obligations and the time for filing are as follows:
- Filing the CbCR notification should be done by any constituent entity of an MNE group that is resident for tax purpose in Nigeria (including the ultimate parent company) and must notify the FIRS of the entity making the CbCR disclosure on behalf of the group. Notification shall be submitted to the tax

office not later than the last day of the reporting accounting year of the MNE group; and

- The ultimate parent entity of an MNE group must file the CbCR with the Revenue not later than 12 months after the end of the year that relates to the CbCR.

(iii) Administrative penalties for non-compliance with the CbCR are:

(i) Late filings of CbCRs attract a penalty of:

- 1st month – ₦10,000,000; and
- Every month in which the failure continues - ₦1,000,000;

(ii) Incorrect and fake report – ₦10,000,000; and

(iii) Penalty for failure to notify FIRS of the identity and tax residence of the entity within the group that has been charged with the responsibilities to file the CbCR is:

- ₦5,000,000 in the first month; and
- ₦10,000 for every other month the failures continue.

(iv) Taxpayers exempted from filing of CbCR

Where the group (parent entity and constituent entity resident in Nigeria) has a total consolidated revenue of less than one hundred and sixty billion naira (₦160b) in the immediate preceding year, it needs not file CbCR with the Federal Inland Revenue Service.

(b) The objectives of regional economic integration include the:

(i) Strengthening of trade integration and improvement in market efficiency;

(ii) Creation of an enabling environment for private sector development;

(iii) Development of infrastructure programmes in support of economic growth and regional integration;

(iv) Development of strong public sector institutions and good governance;

(v) Improvement of non-economic benefits which include peace and security in the region;

(vi) Reduction of social exclusion and the development of an inclusive civil society;

(vii) Building of environment programmes at the regional level; and

(viii) Strengthening of the region's interaction with other regions of the world.

(c) A neutral tax is one that does not motivate corporate or individual taxpayers to change their behaviour in carrying out economic decisions. Put differently, it does not create incentives for firms or individuals to change their behaviour.

Deviations by government from a neutral tax system could reflect the following benefits:

(i) Increased employment;

(ii) Improvements in less developed areas;

(iii) Attraction of foreign direct investments (FDI);

(iv) Improvement in research and technology;

(v) Improvement of the commercial profitability of investments by making available tax free income within the tax holiday period which is reinvested in the establishment of other industries;

(vi) Facilitates competition in the international capital market; and

(vii) Increases the profit prospects of a new venture and enables a firm to recover its capital costs faster, so that the risks of investments are reduced considerably.

EXAMINER'S REPORT

The question tests candidates' knowledge of the provisions of the Income Tax (Country by Country Reporting) Regulations, 2018, objectives of regional economic integration and the benefits to be derived when a government deviates from a neutral tax system.

About 50% of the candidates attempted the question and the performance was below average. The major pitfalls of the candidates were their poor knowledge of the provisions of the Income Tax (Country by Country Reporting) Regulations, 2018 and the inability to explain the benefits to be derived when a government deviates from neutrality in taxation.

Candidates are advised to familiarise themselves with the provisions of the Income Tax (Country by Country Reporting) Regulations, 2018, the Institute's Study Pack, and Pathfinders.

3. Define the following terms as interpreted in the Nigeria Transfer Pricing regulations and OECD guidelines:
- (a) Global formulary apportionment method (4 Marks)
 - (b) Arm's length principle (4 Marks)
 - (c) Advance Pricing Agreement (2 Marks)
 - (d) Related Party Transactions (3 Marks)
 - (e) Safe Harbour (2 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 3

- (a) "Global formulary apportionment method", also known as unitary taxation, is a method of allocating global profits earned (or loss incurred) by an MNE group on a consolidated basis among the associated enterprises in different countries, using basis of a predetermined formula.

It is an alternative to separate entity accounting, under which a branch or subsidiary within the jurisdiction is accounted for as a separate entity, requiring prices for transactions with other parts of the corporation or group to be assigned according to the arm's length standard commonly used in transfer pricing. In contrast, formulary apportionment attributes the corporation's total worldwide profit (or loss) to each jurisdiction, based on factors such as the proportion of sales, assets or payroll in that jurisdiction.

When applied to a corporate group, formulary apportionment requires combined reporting of the group's results. The parent and all of its subsidiaries are viewed as though they were a single entity (unitary combination), and the method is also known as worldwide unitary taxation. In the US, most states have adopted water's edge combined reporting which restricts the taxable group to just US domestic corporations and excludes "overseas business organization", that is unitary foreign affiliates and foreign parents.

- (b) "Arm's Length Principle" in relation to a controlled transaction means that entities that are related through management, control or capital in their controlled transactions should agree the same terms and conditions which would have been agreed among non-related entities for comparable uncontrolled transactions.

In effect, the arm's length principle would be said to be at play where the relationship (or lack of it), existing between parties to an economic transaction, have not impacted on the prices chargeable or payable by the respective party.

Where parties to a transaction are related or otherwise connected, the transactions must be priced as with those between independent enterprises conducted in similar circumstances. An arm's length price for a transaction is what the price of that transaction would be on the open market.

The arm's length principle provides the basis for taxing income derivable from transactions between associated enterprises in most countries. This principle is further captured in Article 9 of the OECD and UN Model Tax Conventions as well as OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

- (c) An Advance Pricing Agreement is an ahead-of-time agreement between a taxpayer and a tax authority, specifying the appropriate transfer pricing methodology for pricing the transactions of the taxpayer for future years.

The threshold is ₦250,000,000 (two hundred and fifty million naira) per year. The maximum period for the duration of each agreement is three years. Companies can take advantage of this to increase level of certainty on sensitive TP related transactions.

- (d) "Related Party Transaction" is a transaction between connected persons or companies, one of whom has control over the other or persons both of whom are controlled by some other person. Whilst the nature of the related party relationship needs to be disclosed, it is not mandatory to disclose the names of the transacting parties.

- (e) A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and relieves eligible taxpayers from certain obligations otherwise imposed by the general transfer pricing rules in a country. Put differently, safe harbour is defined as circumstances in which the tax authority shall accept the transfer price declared by the taxpayer to be at arm's length.

"Safe Harbour" refers to protection of commercial transactions between connected taxable persons from transfer pricing documentation if:

- (i) Pricing is based on a Nigerian statutory provision; or
- (ii) Pre-approved by the relevant government agencies (for example, NOTAP, DPR, NNPC, CBN, etc). In any event, documentation must be prepared to confirm that approved price is at arm's length.

EXAMINER'S REPORT

The question tests candidates' knowledge of transfer pricing regulations and OECD guidelines. Candidates are expected to specifically define global formulary apportionment method, arm's length principle, advance pricing agreement, related party transactions and safe harbour.

About 60% of the candidates attempted the question and the performance was above average. The common pitfalls of the candidates were their inability to explain advance pricing agreement and safe harbour.

Candidates are advised to read widely before sitting for subsequent examinations.

4. (a) Explain the concept of Double Taxation. (2 Marks)
- (b) List Five (5) countries that have signed agreements with Nigeria for the avoidance of double taxation. (5 Marks)
- (c) List and explain Four (4) purposes of agreement for the avoidance of double taxation. (4 Marks)
- (d) Mention the Two (2) major methods of eliminating Double Taxation. (4 Marks)
(Total 15 Marks)

SOLUTION TO QUESTION 4

- (a) Double Taxation occurs in a situation where an income or profit derived by an individual or an enterprise is subject to tax more than once.

Double taxation can be described in two forms, namely:

- (i) **Juridical double taxation:** This occurs in a situation where an income or a profit is subject to tax in the Source State (that is, the State where the income was derived) and equally subject to tax in the State of Residence.
- (ii) **Economic double taxation is another category of double taxation.** This occurs where an income or part of it is subject to tax in the hands of two individuals in the same country. For example, when income earned by a corporate body is taxed to the company and to its shareholders when distributed as a dividend.
- (b) The following are some countries with active tax treaties with Nigeria:
- (i) United Kingdom;
 - (ii) France;
 - (iii) Belgium;
 - (iv) China;
 - (v) South Africa;
 - (vi) Canada;
 - (vii) Netherland;
 - (viii) Romania;
 - (ix) Pakistan;
 - (x) Italy (only transportation article);
 - (xi) Czech;
 - (xii) Philippines;
 - (xiii) Spain; and
 - (xiv) Slovakia.
- (c) The purposes of double taxation agreement include:
- (i) Clarification of taxing rights of each Contracting State;

- (ii) Fostering cooperation between the Contracting States in respect of exchange of information, non-discrimination in the treatment of non-resident taxpayers in the Source State, etc. The Source State usually treats the non-resident from the treaty partner countries the same way the income or profit of its resident will be taxed;
 - (iii) Elimination of double taxation: The essence of the entire tax treaty is to achieve avoidance of double taxation. As a result, the "modus operandi" of how each type of income will be subject to tax, which of the two Contracting States should have primary taxing right, exclusive taxing right or joint taxing right where applicable, will be comprehensively set out in the tax treaty, in order to achieve the primary aim;
 - (iv) Encouragement of economic cooperation between states;
 - (v) Lowering of compliance cost;
 - (vi) Facilitation of cooperation in exchange of information, assistance in the collection of taxes and dispute resolution; and
 - (vii) Taking advantage of the resultant increase in trade and investment by the two countries.
- (d) The major methods of eliminating double taxation are:
- (i) Exemption method
 - Full exemption; and
 - Exemption with progression method;
 - (ii) Credit method
 - Full credit method; and
 - Ordinary credit method;
 - (iii) Tax sparing credit;
 - (iv) Underlying tax credit; and
 - (v) Participation exemption.

EXAMINER'S REPORT

The question tests candidates' knowledge of the concept of double taxation.

Over 80% of the candidates attempted the question and the performance was average. The commonest pitfall of the candidates was their inability to mention the methods of eliminating double taxation.

Candidates are advised to be abreast of developments in international taxation by reading the Institute's Pathfinders and Study Packs, United Nations and OECD conventions and commentaries in their preparations for future examinations.

5. (a) What do you understand by "*dual residence*". (5 Marks)
- (b) What are the resolution mechanisms available under tax treaty in case of any conflict emanating from dual residence? (10 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 5

(a) **Dual Residence**

This is a situation where a taxpayer is deemed to be resident in the two Contracting States.

A conflict may arise between the two Contracting States on which of the two States has the taxing right over such a taxpayer who maintains dual residence.

Dual residence of a company arises where a company is deemed resident of two Contracting States. The solution in the case of Nigeria is to use the place of incorporation as the residence of such company, while the place of effective management is used in United Kingdom and some other places.

(b) The resolution mechanism put in place to address any conflict arising from dual residence include:

(i) Individuals

The definition of the term "residence" differs from one country to the other. For instance, in Nigeria, the length of stay to qualify a taxpayer as a resident is reckoned within 12-month period (183days). In some countries, for example, USA, a citizen is regarded as resident in the home country whatever the length of stay abroad.

The different definitions of the term "residence" create the problem of dual residence for an individual who is regarded as resident in more than one country.

Where an individual is resident in both Contracting States, then his status shall be determined as follows:

- He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State in which his personal and economic relations are closer (centre of vital interests);
- If the State in which he has his centre of vital interest cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be resident only of the State in which he has a habitual abode;
- If he has an habitual abode in both States or in neither only of them, he shall be deemed to be a resident only of the State of which he is a national; and
- If he is a national of both States or of neither of them, the competent authorities of the contracting States shall settle the question by mutual agreement.

The practice of determining residence in the case of individuals in Nigeria is as follows:

- **The 183-day rule**

A person is considered resident if he is physically present in Nigeria for at least 183 days (including leave and temporary absence) in any 12-month period or serves as a diplomatic agent of Nigeria abroad;

- Regular visitor rule, for example, business visit, 90 + days per year
Any individual who is in Nigeria for some temporary purpose only and not with intent to establish his residence therein and who has not actually resided in Nigeria at one or more times for a period equal in the whole to six months in the year of assessment shall not be treated as a resident in Nigeria;
- Definition of a day (24 hours or part of a day);
- Facts and circumstances of an individual's life, for example, availability of home, center of individual's life, etc; and
- Connecting factors are also taken into consideration and weighed by courts and arbitrators in determining the proper law to apply in deciding a case or dispute.

These factors include:

- Nationality;
- Domicile; and
- Residence;
 - Habitual residence; and
 - Ordinary residence

(ii) **Companies**

- **Place of effective management**

In the case of corporate entities, Nigeria adopts the place of incorporation as the jurisdiction that has the taxing rights in case of dual residence. In the United Kingdom, the place of effective management is considered to have the taxing right.

- **Case-by-case approach (the Mutual Agreement Procedure (MAP) tie-breaker rule)**

Where a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purpose of the convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

In the absence of such agreement stated above, such a person shall not be entitled to any relief or exemption from tax provided by the convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

- **Arbitration**

Where the competent authorities are unable to reach an agreement within two years, the unresolved issues will at the request of the person who presented the case, be solved through arbitration process.

EXAMINER'S REPORT

Candidates are expected to explain 'dual residence' and resolution mechanism put in place to resolve any conflict arising from dual residence.

Over 60% of the candidates attempted the question and the performance was woeful. Most of the candidates were not able to explain the resolution mechanism available under tax treaty in case of any conflict emanating from dual residence.

Candidates are advised to read widely before sitting for future examinations.

6. Explain the following terms:
- (a) Controlled Foreign Company (5 Marks)
 - (b) Elimination of Double Taxation (3 Marks)
 - (c) Treaty Shopping (4 Marks)
 - (d) Reciprocity (3 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 6

(a) Controlled Foreign Company

A controlled foreign company (CFC) is defined as a foreign company that is either directly or indirectly controlled by a resident taxpayer.

In the United States control of the foreign company is defined according to the percentage of shares owned by U.S citizens.

In the United Kingdom, a CFC is a foreign company that is controlled by a UK resident person or persons.

(b) Elimination of double taxation

This is a relief from double taxation of taxpayer's income as a result of dual residence. This refers to the method of reduction of the impact of double taxation on the taxpayer. This can be done by way of inserting provisions for compensation of taxpayer in the event of double taxation in form of tax credit or tax exemption.

In general, the ways to eliminate double taxation include:

- (a) Exempting foreign income from domestic taxation;
 - (b) Granting a credit for foreign taxes;
 - (c) Tax sparing credit;
 - (d) Underlying tax credit; and
 - (e) Participation exemption
- (c) **Treaty shopping** refers to a situation where a person, who is resident in the country (referred to as "home" country) and who earns income or capital gains from another country (referred as "source" or "host" country) is able to benefit from a tax treaty between the source country and another country (referred to as "third" country).

Treaty shopping arises when a person attempts to indirectly access the benefits of a tax treaty between two Contracting States without being a resident of one of those jurisdictions.

In order to curb this act, anti-treaty shopping provisions are included in tax treaties to ensure that only residents and (in some cases) nationals of a Contracting State are entitled to benefits under the tax treaty.

- (d) Reciprocity as provided in Article 8 of the Nigerian agreement for the avoidance of double taxation exists where a Nigerian resident carries on the business of air or sea transportation into a country and the resident of that other country also carries on the same business into Nigeria. In other words, a Nigerian company operating in international traffic carries on its operation into a country, also conducts its operation in international traffic into Nigeria, the tax treatment in such a situation is reciprocal exemption from tax, of profits derived from such operations.

However, in the case of non-reciprocity, incomes derived by the enterprise in the other Contracting State are subject to tax, but at a discounted rate.

EXAMINER'S REPORT

The question tests candidates' knowledge on terminologies in international taxation, for example, controlled foreign company, elimination of double taxation, treaty shopping and reciprocity.

Over 60% of the candidates attempted the question and the performance was below average.

The common pitfalls of the candidates were their inability to explain controlled foreign company and treaty shopping.

Candidates are advised to read the Institute's Study Pack and Pathfinders when preparing for subsequent examinations.

7. (a) What is dual residency and what rule would be applied to resolve dual residency. (5 Marks)
- (b) What are the substantive tests in the specified order that would be used by competent authorities of two Contracting States to resolve dual residency in line with Article 4 of the Model Tax Convention? (10 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 7

(a) Dual Residence

This is a situation where a taxpayer is deemed to be resident in the two Contracting States.

A conflict may arise between the two Contracting States on which of the two States has the taxing right over such a taxpayer who maintains dual residence.

Dual residence of a company arises where a company is deemed resident of two Contracting States. The solution in the case of Nigeria is to use the place of incorporation as the residence of such company, while the place of effective management is used in United Kingdom and some other places.

(b) The resolution mechanism put in place to address any conflict arising from dual residence include:

(i) Individuals

The definition of the term "residence" differs from one country to the other. For instance, in Nigeria, the length of stay to qualify a taxpayer as a resident is reckoned within 12-month period (183days). In some countries, for example, USA, a citizen is regarded as resident in the home country whatever the length of stay abroad.

The different definitions of the term "residence" create the problem of dual residence for an individual who is regarded as resident in more than one country.

Where an individual is resident in both Contracting States, then his status shall be determined as follows:

- He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State in which his personal and economic relations are closer (centre of vital interests);
- If the State in which he has his centre of vital interest cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be resident only of the State in which he has a habitual abode;
- If he has an habitual abode in both States or in neither only of them, he shall be deemed to be a resident only of the State of which he is a national; and
- If he is a national of both States or of neither of them, the competent authorities of the contracting States shall settle the question by mutual agreement.

The practice of determining residence in the case of individuals in Nigeria is as follows:

- The 183-day rule
A person is considered resident if he is physically in Nigeria for at least 183 days (including leave and temporary absence) in any 12-month period or serves as a diplomatic agent of Nigeria abroad;
- Regular visitor rule, for example, business visit, 90 + days per year
Any individual who is in Nigeria for some temporary purpose only and not with intent to establish his residence therein and who has not actually resided in Nigeria at one or more times for a period equal in the whole to six months in the year of assessment shall not be treated as a resident in Nigeria;
- Definition of a day (24 hours or part of a day);
- Facts and circumstances of an individual's life, for example, availability of home, center of individual's life, etc; and
- Connecting factors are also taken into consideration and weighed by courts and arbitrators in determining the proper law to apply in deciding a case or dispute.

These factors include:

- Nationality;
- Domicile; and
- Residence;
 - Habitual residence; and
 - Ordinary residence

(ii) Companies

- **Place of effective management**

In the case of corporate entities, Nigeria adopts the place of incorporation as the jurisdiction that has the taxing rights in case of dual residence. In the United Kingdom, the place of effective management is considered to have the taxing right.

- **Case-by-case approach (the Mutual Agreement Procedure (MAP) tie-breaker rule)**

Where a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purpose of the convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

In the absence of such agreement stated above, such a person shall not be entitled to any relief or exemption from tax provided by the convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

- **Arbitration**

Where the competent authorities are unable to reach an agreement within two years, the unresolved issues will at the request of the person who presented the case, be solved through arbitration process.

EXAMINER'S REPORT

The question tests candidates' knowledge of dual residency and the tests that will be used by Contracting States to resolve any conflict arising from dual residency.

About 20% of the candidates attempted the question and performance was poor. The common pitfall was the inability of most candidates to explain the substantive tests to be used by Contracting States to resolve issues arising from dual residency.

Candidates are advised to read the Institute's Study Packs and Pathfinders in their preparation for future examinations.



THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

OCTOBER 2021: PROFESSIONAL EXAMINATION

PTE II: TAX AUDIT AND INVESTIGATION

TUESDAY 12TH OCTOBER, 2021

EXAM NO.....

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

TIME: 3 HOURS.

1. As a result of dwindling revenue in the Federation Account, taxes have become a veritable source of Internally Generated Revenue (IGR) for most states in Nigeria.

Required:

- (a) List any Two (2) differences between Federal Inland Revenue Service's tax audit and States' Internal Revenue Services' tax audit. (5 Marks)
 - (b) Explain the steps followed by State Internal Revenue Service (SIRS) in carrying out tax audit. (10 Marks)
 - (c) List Ten (10) documents normally requested for by State Internal Revenue Service's officials to enable them carry out tax audit exercise. (10 Marks)
 - (d) State how the eventual liability from the tax audit exercise is normally disposed of. (5 Marks)
 - (e) In tax audit, it is normal for companies to engage the services of tax consultants to handle tax audits on their behalf. State the responsibilities of a company's tax consultant during and after a tax audit exercise by a State Internal Revenue Service. (10 Marks)
- (Total 40 Marks)

SOLUTION TO QUESTION 1

- (a). The difference between Federal Inland Revenue Service tax audit and that of the State's Internal Revenue Service are:
 - (i). The FIRS audit focuses on the tax obligation of incorporated bodies under company income tax, petroleum profit tax, capital gain tax and stamp duties, while the audit of State Internal Revenue Services focuses on the tax obligations of tax payers to the state government where they are resident, under personal income tax, stamp duties, withholding tax and capital gain tax;
 - (ii) The tax audit by FIRS is more broad than that of the state internal revenue which only verifies personal income tax and withholding taxes

- payable on services rendered by individuals and unincorporated businesses.
- (iii) The FIRS cover all companies operating in the country, while state internal revenue audit, covers only individuals resident in a particular state; and
- (iv) State Internal Revenue Service audit coverage do not extend to all the company's transactions, but only to those transactions that have to do with payment of salaries and allowances to staff, directors of the company and payment to consultant that are not limited liability companies.
- (b) The procedures usually followed by the State Internal Revenue Services for tax audit are:
- (i) A letter of notification of audit will be written to the company indicating intention to carry out a tax audit exercise. Attached to the letter is the list of documents required by the team to be made ready;
- (ii) The company / organisation may write to the Internal Revenue Service, seeking another date for the audit, if the date proposed in the letter in (i) above is not convenient to the organisation;
- (iii) The tax audit team will carry out the audit following these procedures:
- Collect all the documents required for the audit, based on the list of requirements for the audit originally sent with the letter of notification;
 - Summarise the individual staff's salaries and allowances based on the organisation's payroll given to the auditors and off payroll payments discovered when going through the payment vouchers;
 - Vouch the organisation's payment vouchers and list all payments for services and suppliers by individual and unincorporated business for the purpose of withholding taxes;
 - Extract from the payment vouchers, off payroll allowances paid to staff, such as travel vacation allowances, medical allowances, dressing allowances, telephone allowances, lunch allowances, etc;
 - Ask for the organisation's rent schedule and note rent paid on staff using the accommodation provided by the organisation;
 - Ask for the organisation's list of vehicles and designation of users;
 - From the above, determine the benefits in kind enjoyed by some of the organisation's staff;
 - Verify pension deductions and their remittances to the appropriate Pension Fund Administrators. Determine the total pension deducted from each staff salaries;
 - Summarise the total salaries paid to all staff, excluding benefits in kind and reconcile with the wages and salaries reported in the financial statement. Any difference represents off payroll payments that have not been captured. Spread this on the individual staff's salary using their basic salaries as the basis of apportionment;
 - Summarise withholdings tax captured under the following headings:
 - Contract and supplies;
 - Professional fee;
 - Directors' fees;
 - Dividend; and
 - Rent and lease rental.
 - Calculate the withholding taxes under each category;

- Calculate the payee payable based on your new calculations of gross pay per staff and pension deducted from staff salaries;
 - Determine the remittance of both payee and withholding taxes by the organisation;
 - Summarise the treasury receipts given to you for payee and withholding taxes remittance;
 - Generate additional liability payable by the organisation;
 - Add 10% penalty and 21% interest to the above to get the total additional tax liability due from the company; and
 - Raise assessment notice on the company based on the above liability.
- (c) The following documents are normally requested by the State Internal Revenue Service tax auditors:
- (i) Payment vouchers, both cash and cheque payment vouchers;
 - (ii) Cheque stubs and bank statements;
 - (iii) Payroll documents with bank instruction letters to credit staff account;
 - (iv) Staff list, together with designation including expatriate;
 - (v) Staff salary structure;
 - (vi) Reconciliation of payroll summary with the general ledger and the financial statements;
 - (vii) General ledger and trial balance;
 - (ix) Petty cash vouchers;
 - (x) Annual audited financial statements and or management accounts;
 - (xi) Schedule of tax remittances and receipts;
 - (xii) List of companies in the group, if it is a group of companies;
 - (xiii) List of contractors and suppliers of the company and their addresses;
 - (xiv) Expatriate quota;
 - (xv) Expatriates' resident permits;
 - (xvi) Rent schedule and names of occupiers together with the rent agreement;
 - (xvii) Staff files;
 - (xviii) Names and addresses of directors and their last tax clearance;
 - (xix) Last tax audit clearance letter;
 - (xx) Schedule of monthly immigration returns;
 - (xxi) Evidence of payment in respect business premises registration / renewal;
 - (xxii) List of motor vehicle and designation of users;
 - (xxiii) Business organisational structure; and
 - (xxiv) Names and addresses of Landlords from whom accommodation is taken for staff and directors.
- (d) Procedures that leads to the final settlement of the liability raised after tax audit are:
- (i) The state internal revenue service will raise a Demand notice on the amount payable and send this to the organisation for settlement;
 - (ii) The organisation will either pay or raise an objection to the liability;
 - (iii) Where there is an objection, the organisation will attach a cheque for the undisputed liability to the letter of objection which will be sent to the internal revenue service;

- (iv) The internal revenue service will arrange for a tax audit reconciliation meeting where the differences will be discussed;
 - (v) The organisation will be required to submit additional documents as a proof of its own position. Where the internal revenue is satisfied, the matter will be resolved and where the revenue is not satisfied, the demand notice remain or issue letter of refusal to amend liability; and
 - (vi) The organisation is now free to appeal to the Tax Appeal Tribunal for adjustment.
- (e) The responsibilities of a tax consultant during and after a tax audit conducted by the state internal revenue service are:
- During**
- (i) Prior to the commencement day of the audit, the company's tax consultant and his team must have carried out a pre-audit check on the company's records and arrive at the likely tax liability. He must have discussed this with the client;
 - (ii) On the first day of the audit, the tax consultant with his staff, will arrive earlier, before the tax auditors' arrival at the company to:
 - Secure and arrange the place the audit will take place;
 - Arrange all documents required for the audit;
 - Receive the audit team on arrival;
 - Arrange a pre-audit meeting with the company's management and the audit team; and
 - Arrange for all other things for a smooth audit e.g logistics.
 - (iii) The company's tax consultant or his staff must be on ground throughout the duration of the audit, to answer any question from the audit team and provide further information the audit team may ask for;
 - (iv) On completion of the audit, the tax consultant will hold an exit meeting with the tax audit team and the company's management in attendance where further clarification could be sought by the audit team from the management regarding their findings, to clear any doubt that may arise, etc;
- AFTER**
- (v) On receipt of the notice of additional tax liability, based on the audit, the company will send this to the tax consultant for advice;
 - (vi) He will study the contents of the notice of additional liability and issues raised so as to take decision;
 - (vii) If the liability is within the expectation of the tax consultant, in the light of the pre-audit exercise he had earlier carried out, he may advise the company to pay the additional liability, which will bring the audit exercise to a close;
 - (viii) Where the liability is more than the expectation of the tax consultant, he will first discuss his observation with management and later write a letter of objection to the liability to the state internal revenue service within the stipulated time, stating with evidence his basis of objection and attaching:
 - His own computation of the additional liability if any; and
 - A cheque for the tax liability, as computed by the consultant; (ie undisputed tax liability, if any);
 - (ix) The tax consultant will liaise with the state internal revenue to fix a date for the reconciliation of the two liabilities, i.e the revenue's liability and

- the one computed by the consultant. This meeting is called, tax reconciliation committee (TARC);
- (x) If the disagreement is resolved, during the meeting the tax consultant and the representative of the state internal revenue service will sign the agreement, computation and liability which will now form the basis of a raised liability from the revenue service to the company;
 - (xi) On receipt of the notice of revised liability, the consultant will advise the company to pay the balance liability, i.e, the difference between the new liability and the one paid earlier with the notice of objection. This will bring the audit exercise to a close and the tax consultant will liaise with the state internal revenue service to collect a letter of clearance to the company. This letter will indicate that the company has settled its liability to the state up to the date the audit covered;
 - (xi) If the company and the consultant are still not in agreement with the tax liability, the tax consultant will write a letter of objection again to the state internal revenue service, enclosing additional evidence to help the revenue service to reverse the liability;
 - (xii) There will be another TARC meeting to resolve the dispute and for the revenue service to revise the liability;
 - (xiii) If the matter could not be resolved at the TARC meeting, then the company consultant will advise the company to apply to Tax Appeal Tribunal for its settlement;
 - (xiv) If either party is still not satisfied with the decision of the Tax Appeal Tribunal, the party can approach the Federal High Court for settlement;
 - (xv) If either party is not satisfied with the ruling of the Federal High Court, such party can proceed to the Court of Appeal; and if either party is not satisfied with the court of Appeal's decision, such party can go ahead to the supreme court. The decision of the supreme court is final on the dispute.

Examiner's Report

The question tests candidates' understanding of tax Audit.

Candidates demonstrated good knowledge of the question and performance was above average.

The commonest pitfall was their inability to correctly list the documents being requested for by State Internal Revenue officials.

Candidates are advised to pay more attention to all area of the syllabus for better performance in future examination.

Well attempted and performance is above average

2. Chief Tope Adelaja (the Babalaje of Somolu, Lagos) who recently retired as a Principal of one of the Federal Government Colleges, decided to set up a limited liability company in July 2018. He prepared his company's accounts at the end of December each year, however, he did not prepare any accounts in December 2018. He prepared the accounts up to December 2019 for the first 18 months of trading to be filed with the

relevant tax authority. After finalising the accounts, the Accountant informed Chief Adelaja that the accounts need to be audited by an appointed statutory auditor before the tax returns can be filed with tax authority.

At the same time, he received a letter from the Ikeja Micro and Small Tax Office of the Federal Inland Revenue Service (FIRS) that the tax office would like to visit the company for a routine tax audit.

Chief Adelaja is now confused about the various audits. He has approached you as a tax professional, to enlighten him on the various audits.

Required:

In a columinal format, discuss the similarities and differences between statutory audit and tax audit. (15 Marks)

SOLUTION TO QUESTION 2

The difference and similarities between statutory audit and tax audit are;

	Statutory Audit	Tax Audit
i. Law / statute	Required under the Companies and Allied Matters Act 2020	Required by the various provisions in the revenue laws.
ii. Opinion	The auditor is required to form an independent opinion and report thereon as to the truth and fairness of the financial statements	The auditor is required to form an opinion as to whether taxpayer has complied with the provision of the tax laws, and if not, do determine the additional liability.
iii. Period / Timing	Statutory audit is required to be carried out on a yearly basis	Frequency of tax audit is determined by the management of the relevant tax authority but not more than six years backward.
iv. Appointment	The statutory auditor is appointed annually by the shareholders of the company at every Annual General Meeting (AGM)	Tax auditors are picked among the staff of the relevant tax authority carrying out the audit.
vi. Duties and Right	They are guided by CAMA and Accounting and Auditing standards	They are guided by the relevant tax laws.
vii. Qualification	He must be a qualified Accountant and must have practicing license of any of the two recognised accounting bodies in Nigeria.	There is no provision for any qualification of tax auditor in the tax laws.

viii. Reporting	He reports to members (shareholder) of the company.	He reports to the relevant tax authority,
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SIMILARITIES

Both statutory audit and tax Audit;

- i. Must write post audit report based on the finding during the audit exercise.
- ii. Are executed / carried up by knowledgeable person/professional person with experience in the field of Accountancy, Audit and Taxation;
- iii. Involve requesting for documents/information or additional document / information to be worked on and this form the basis of their opinion / report. Or both ensures they gather appropriate / relevant/ sufficient documentary evidence and information to use;
- iv. Make use of similar methods in gathering audit evidence (e.g inspection, observation, enquiries, external confirmation, re-calculation /re- casting, analytical procedure etc);
- v. Evoke existing laws and guiding laws / provisions/ policies and check for compliance or otherwise;
- vi. Do post – audit meeting so as to inform tax payer their findings, areas for additional information and / or document; and
- vii. Keep records / documents as evidence and / or working papers for future reference.

Examiner's Report

The question tests candidates' knowledge of differences and similarities between statutory audit and tax audit.

Candidates' performance was average as most candidates failed to recognise similarities and paid more attention to differences between the two.

Candidates are advised to ensure that they cover all aspects of the syllabus when preparing for future examinations.

3. One of the techniques available for tax officials that enable them discover at a glance, whether or not a company is window dressing its accounts with a view of reducing tax liabilities, is financial statements ratios analysis.

Required:

- (a) Discuss ratios analysis as a technique for analytical review in tax audit planning. (7 Marks)
 - (b) Give Two (2) examples each of the following ratios:
 - (i) Liquidity ratios;
 - (ii) Efficiency or activity ratios;
 - (iii) Profitability ratios; and
 - (iv) Leverage ratios. (8 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 3

- (a) A ratio is the arithmetic relationship between two figures in a set of financial statements. It can be presented in a number of forms as follows:
- as a percentage, where figure is divided by another and multiplied by 100;
 - as a fraction where one figure is divided by another;
 - as a period of time where one figure is divided by another by number of months or days in a year; and
 - as a proportion by setting one figure to a unit, 1, showing the other figure as a relative value of 1.

It is often necessary to interpret a set of financial statements in order to identify the strengths and weaknesses of a company and highlight any underlying trends in its operations. One method of interpreting a company's financial statements is by the use of ratios analysis. It involves comparison of one figure with another to produce a ratio, and assessing whether the ratio indicates a strength or a weakness in the company's affairs. The key to obtaining meaningful information from ratios analysis is by comparing ratios of two or more periods for the same company, or compare one company's ratio with those of another company and or those of the industry average.

In determining, assessing and evaluating areas of risk that the tax auditor should focus on during audit, ratio analysis is used to identify those areas. Therefore, tax auditors should be able to use ratio analysis to make a qualitative assessment of the company's operating results and financial position to identify areas that may require detailed analysis or probing further during the field tax audit exercise.

The ratios will be evaluated with the following tax evasion tendencies of the tax payers in mind:

- (i). Understatement of turnover / income;
- (ii). Overstatement of expenses;
- (iii). Undervaluation of inventories;
- (iv). Creation and maintenance of secret reserves;
- (v). Undisclosed / omission of income;
- (vi). Fictitious expenses; and
- (vii) Artificial transactions

(b). Examples of ratios are as follows;

(i). **Liquidity ratio**

- **Working capital ratio / current ratio:**

This measures a company's ability to meet its short term financial obligations out of its current asset. It is calculated as follows:

$$\frac{\text{Current assets}}{\text{Current liability}}$$

- **Quick assets ratio / acid test:**

It measures the company's ability to meet its short term financial obligations out of current assets less inventories. It is calculated as follows:

$$\frac{\text{current asset less inventory}}{\text{Current liabilities}}$$

(ii). **Efficiency / activity ratio**

- **Asset turnover:**
Measures the efficiency with which the company's assets are used to generate sales revenue. It is calculated as follows:

$$\frac{\text{Sales}}{\text{Net assets}} = \frac{\text{Sales}}{\text{Capital employed}}$$

- **Inventory holding period:**
It measures the average number of days which elapse between acquiring an item of inventory and selling or using that item. It is calculated as follows:

$$\frac{\text{average inventory}}{\text{Cost of sales}} \times \frac{365 \text{ days}}{1}$$

- **Trade receivables collection period:**
It measures the average number of days which elapse between making a credit sale and receiving payment from the customer. It is calculated as follows:

$$\frac{\text{Average trade receivable}}{\text{Credit sales}} \times \frac{365 \text{ days}}{1}$$

- **Trade payables payment period:**
It measures the average number of days which elapse between the date a credit purchase and the date in which payment is made to the suppliers. The ratio is calculated as follows:

$$\frac{\text{Average trade payables}}{\text{Credit purchase}} \times \frac{365 \text{ days}}{1}$$

(iii) **Profitability ratio:**

- **Returns on Capital Employed (ROCE):**
It expresses the company's profit as a percentage of the amount of capital invested in the company. It is calculated as follows:

$$\frac{\text{Profit before long-term interest and tax}}{\text{Capital Employed}}$$

- **Return on Equity (ROE):**
It concentrates on the company's ordinary shareholders and compares their capital with the amount of profits which has been earned on their behalf. It is calculated as follows:

$$\frac{\text{Profit after interest, tax and performance dividend}}{\text{Ordinary share capital and reserve.}}$$

- **Gross profit margin:**

It expresses a company's gross profit as a percentage of its sales revenue. It is calculated as follows

$$\frac{\text{Gross profit}}{\text{Sales Revenue}} \times 100$$

- **Net Profit margin:** It expresses a company's profit as a percentage of its sales revenue. It is calculated as follows:

$$\frac{\text{Profit}}{\text{Sales Revenue}} \times 100$$

(iv) **Leverage ratio:**

- **Capital Gearing ratio:**

It measures the extent to which a company's long – term funds have been provided by lender. It is usually calculated as follows:

$$\frac{\text{Preference share capital plus non – current liability}}{\text{Total share capital and reserves plus non current liability}}$$

- **Interest cover:** it is a measure of the number of times that the interest payable for an accounting period could have been paid out of the available profits. It is calculated as follows:

$$\frac{\text{Profit before interest and tax}}{\text{Interest paid}}$$

Examiner's Report

The question tests candidates' knowledge on accounting ratios and use of accounting ratios in audit procedures.

Candidates' performance was poor and they demonstrated inability to explain the various ratios.

Candidates are advised to ensure they cover all aspects of the syllabus when preparing for future examinations.

4. The sole objective of an audit is for the auditor to express an opinion, in form of a report, on a company's financial statements. However, whether for a statutory audit or tax audit, for the auditor to arrive at a conclusion which will form the basis of his opinion, he needs to gather sufficient and appropriate evidence.

Required:

- (a) Explain briefly, audit evidence. (5 Marks)
- (b) Explain the concept, "sufficient and appropriate" evidence. (5 Marks)
- (c) Explain any Five (5) methods the auditor normally use in gathering audit evidence. (5 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 4

- (a). Audit evidence consists of information and data that can be verified, relevant to the matter under consideration and which can influence the condition in arriving at the conclusions on which the audit opinion is based. Audit evidence has three qualities, these are:
- reliability;
 - relevance; and
 - sufficiency.

Audit evidence includes all the information contained in the accounting and other records forming basis of the financial statements. It is important that the auditor obtain reliable, credible and sufficient evidence to substantiate the results of the tax audit.

There are three basic issues regarding audit evidence, these are:

- The auditor must obtain evidence to support financial statements assertions;
 - The evidence obtained by the auditor must be sufficient and appropriate; and
 - The auditor must evaluate and documents evidence sufficiently.
- (b). According to ISA 500, there should be sufficient and appropriate audit evidence for the auditor to be able to draw reasonable conclusion on which to base his audit opinion. This means that auditor should obtain enough reliable evidence upon which he can draw reasonable conclusions to form an opinion on the financial statements which he has audited.

Sufficiency and appropriateness of audit evidence are interrelated and both apply to test of controls and substantive procedures. Sufficiency is the measure of the quantity of audit evidence while appropriateness refers to the measure of quality or reliability of the audit evidence.

Factors that may influence the sufficiency of audit evidence are:

- i. Materiality of the item being tested;
- ii. Level of audit risk involved;
- iii. Persuasiveness of the audit evidence obtained;
- iv. Population of the item- how large the item is;
- v. Client's accounting and internal control system, and
- vi. Client's financial condition.

However, the auditor is expected to exercise judgement on what he considers to be sufficient, relevant and reliable evidence.

In order words, subjectivity and experience of auditor can be a strong determinant of sufficiency and appropriateness.

- (c). The methods the auditor normally use in gathering evidence are :
- i. **Inspection:** This could be inspection of assets in the accounting records which form basis of the financial statements. This inspection

will provide confirmation for the existence of the assets, gives evidence of valuation but does not confirm rights and obligation.

It could also be inspection of documents related to the items entered into the accounting records, this provides evidence that the asset exist or that the transaction or event occurred. It also gives proof of completeness.

- ii. **Observation:** This is the auditor watching procedure being performed, for example the auditor watching the inventory count or payment of wages to worker.
- iii. **Enquires:** These involve seeking information from knowledgeable person, insider or external, to the entity under audit. The auditor, however, is to evaluate responses to the inquires and corroborate them with other evidence. The auditor may obtain written responses to any of the enquiries, if necessary.
- iv. **External confirmation:** This is seeking confirmation from another source, external to the entity, of details in the client's accounting records, such as, confirmation of bank balance from the bank directly or confirmation of receivable balances from the client's customers directly.
- vi. **Recalculation:** This is checking the arithmetic accuracy of the client's accounting records, an example is adding up the client's year end trade receivable or recalculating the age analysis of the client's year – end receivables.
- vii. **Cross checking work done:** This is the auditor's independent execution of procedures or control originally performed by the client, for example, performing the age analysis of client's year – end receivable balance
- viii. **Analytical procedures:** These consist of evaluation of financial information or comparison of financial and / or non – financial data for possible relationships and investigating unexpected fluctuation. Example of analysis procedures include comparison of previous years 's financial statement with the current year.

Examiner's Report

This question tests candidates' knowledge of audit evidence and how auditors gather audit evidence.

Candidates' performance was poor as they demonstrated little understanding of audit evidence.

Candidates are advised to read wide and cover all aspects of the syllabus when preparing for future examinations.

5. Generally, there are two types of audit usually employed by the tax authority. These are desk audit and field audit.

Required:

- (a) Discuss briefly desk audit and field audit. (5 Marks)

- (b) Describe the step by step procedures involved in carrying out a field audit.
(10 Marks)
(Total 15 Marks)

SOLUTION TO QUESTION 5

- (a). i. **Desk audit:** This is a form of audit that is usually conducted in the tax office, outside the premises of the tax payers being audited. It is normally conducted without the knowledge of the tax payer. The tax officials will examine the tax returns filed by the tax payer and the accounts submitted with the returns. This can also be compared with the tax payer's previous returns. The tax officials can issue queriers to the tax payer based on the audit. It can also ask for more information or submission of some documents.
- ii. **Field audit:** This audit is normally conducted in the premises of the tax payer. It is usually more comprehensive and gives the tax auditor opportunity to examine all relevant documents, records, accounts, schedule, etc. It thus enables the auditor to ask for explanation or more information directly from the representatives of the company.
- (b). The step by step procedures involve in carrying out a field audit are:
- i. Selection of taxpayer to be audited
The tax payer to be audited is selected based on some criteria, such as; routine audit plan, random sampling, third party information, risk profiling, tax refund claims, referrals resulting from desk examination, non-filing of tax returns, etc;
 - ii. Preliminary review of the taxpayer's file
This will enable the tax auditors to collect relevant information about the tax payer, tax payment records of the taxpayer, including VAT and WHT would be collected, the taxpayer's financial statements will be analysed and areas of interest to the auditor would be noted. Other relevant information about the taxpayer and its industry will be collected and documented;
 - iii. Preparation of the audit plan
This is the outline of the work to be done, and the member of staff that would be involved, including the time frame for the audit;
 - iv. Sending notification to the taxpayer
A letter will be sent to the taxpayer to inform the taxpayer about the audit. The letter will state the scope of the audit, the officers that will carry out the audit and the duration of the audit. List of documents needed will be attached to the letter;
 - v. Pre- audit meeting
This meeting is normally held in the premises of the taxpayer on the day the audit is to commence, between the audit team and the representatives of the taxpayer. The purpose of the meeting is to introduce members of the audit team, check the documents that will be needed for the audit and to solicit for cooperation;
 - vi. Conducting the actual audit
This is where the field works take place. It includes examination of the books, records and accounts of the taxpayer. It may also include the physical

examination of assets of the taxpayer. Minutes of the taxpayer board and management meeting will also be examined and documented where needed. The auditor can also ask for explanation from the taxpayer's staff on various relevant issues to the audit;

vii. Post Audit meeting

This is usually carried out in the premises of the taxpayer as soon as the audit is completed. The team leader will thank the taxpayer for the cooperation enjoyed during the audit and will further seek clarification on issues that could not be resolved during examination of the taxpayer's records;

viii. Interim Report

Each of the team members will prepare their reports and discuss it with the team leader who will consolidate the reports and submit it to the management;

ix. Reconciliation meetings

This is a meeting between the auditors, taxpayer's representatives and the management of the tax authority to resolve all outstanding matter relating to the audit; and

x. Final report

After the reconciliation meeting, the auditors will write their final report and submit to management. Where there is need to raise additional assessment on the taxpayer, based on the audit, this will be done after the final audit report is submitted.

Examiner's Report

The question tests candidates' understanding of desk and field audit, and step involved in field audit.

Performance was very good.

6. Tax audit and tax investigations are the weapons available to tax authorities to check underpayment of taxes and criminal tax evasions.

Required:

- (a) Define tax audit and tax investigation. (5 Marks)
- (b) List Five (5) objectives of tax audit. (5 Marks)
- (c) List Five (5) objectives of tax investigation. (5 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 6

- (a) Tax audit is the process of verifying any matter relating to gains or incomes of a person, group of persons or corporate organisation on any matter that has to do with the entries in any book, records, accounts documents or returns as the relevant tax authority may specify from time to time.

Tax investigation is a comprehensive specific and in-depth examination of the books, records, documents information and all activities of a taxpayer in order to determine the truth of the matter. It is usually a follow up of specific issues

emanating from tax audit usually carried out by tax authority in order to recover tax undercharged or unpaid in the previous years where the tax authority has reliable evidence or reasonable suspicion that the tax payer has committed tax fraud or evasion.

- (b). The objective of tax audit are to:
- i. Determine whether or not the taxpayer have complied with relevant tax laws, if not, take necessary actions in line with the tax laws;
 - ii. Discover if there is any existence of tax fraud and therefore, recommend for tax investigation;
 - iii. Discourage tax evasion thereby enhancing higher tax compliance;
 - iv. Provide ways of educating tax payers on various aspects of the tax laws;
 - v. Encourage voluntary compliance with the tax laws and regulations;
 - vi. Create taxpayers' awareness of their right and responsibilities under the provision of the tax laws and regulation;
 - vii. Determine whether or not the tax computations filed with the tax office are in agreement with the underlying records of the taxpayer;
 - viii. Determine whether or not adequate accounting books and records are maintained for the purpose of determining the tax payable by the taxpayer or whether there is no tax liability; and
 - ix. Ascertain taxpayer's proper tax liability.
- (c). The objectives of tax investigation are to:
- i. Detect tax evasion and other breaches of the tax laws;
 - ii. Determine and recover the tax loss resulting from the breach;
 - iii. Identify and apply the penalties / sanctions imposed by law for the breach;
 - iv. Trace and locate the offender;
 - v. Provide sufficient evidence of the breach;
 - vi. Identify avoidance and recommend changes to processes, system and tax law;
 - vii. Serve as a veritable resource for tax information and monitoring;
 - viii. Identify cases involving tax fraud and obtain evidence for possible prosecution of the culprits;
 - x. Reduce fiscal crime and its normal effects within the community; and
 - xi. Collect /recover unpaid taxes / generate revenue; and
 - xii. Do additional indept audit of identified / specific area of the business record and or information

Examiner's Report

The question tests candidate' knowledge of tax audit and tax investigation together with their objectives.

Candidates performance was poor

The commonest pitfall was that they could not separate the objectives of tax audit from that of tax investigation.

Candidates are advised to ensure that they prepare adequately for future examinations.

7. Discuss fully the provisions of the FIRS Establishment Act, 2007 on tax audit and investigation. (15 Marks)

SOLUTION TO QUESTION 7

The Federal Inland Revenue Service (established Act) 2007 gives the power of investigation to the Federal Inland Revenue Service (FIRS) in section 35 which states in sub sections 1 and 2 that "the Service shall employ special Purpose Tax Officers to assist any relevant law enforcement agency in the investigation of any offence under this Act notwithstanding, anything to the contrary in any other enactment or law, the service shall have the power to investigate or cause investigation to be conducted to ascertain any violation of any tax law whether or not such violation has been reported to the service"

Sub section 2 state further, "if the provisions of any other law, including the enactments in the First schedule are inconsistent with the provision of this Act, the provision of this Act shall prevail and the provision of the other law shall to the extent of the inconsistency void".

Sub section 3 further provides that: "in conducting any investigation under subsection (2) of this section, the service may cause investigation to be conducted into the properties of any person if it appears to the Service that the life style of the person and extent of the properties are not justified by his source of income"

In section 25, sub section 1, the Act provides that: " the Service shall have power to administer all the enactment listed in the first schedule to this Act and any other enactment or law on taxation in respect of which the National Assembly may confer power on the Service".

And section 68 states that: "Notwithstanding the provisions of this Act, the relevant provisions of all existing enactments including but not limited to, the law in the First Schedule shall be received with such modifications as to bring them into conformity with the provisions of this Act"

The implication of the above is that the Service has power of audit, verification and investigation in respect of all the enactments in the First schedule.

The enactments in the First schedule are:

- i. Company Income Tax Act, LFN 2004, as amended;
- ii. Petroleum Profit Tax Act, LFN 2004, as amended;
- iii. Personal Income Tax Act, LFN 2004 as amended;
- iv. Capital Gain Tax Act, LFN 2004 as amended;
- v. Value Added Tax Ac, LFN as amended;
- vi. Taxes and Levies (Approved List for collection Act);
- vii. All regulations, proclamation, government notices and rules issued in terms of these legislation;

- viii. Any other law for the assessment, collection and accounting of revenue accruable to the government of the Federation as may be made by National Assembly from time to time or regulation incidental to the laws, confirming any power, duty and obligation on the Service;
- ix. Enactment or laws imposing taxes and levies within the Federal Capital Territory; and
- x. Enactment or laws imposing collection of taxes, fees and levies collected by other government agencies and companies including signature bonus, pipeline fees, penalty for gas flared, depot levies and licences, fees for Oil Exploration Licenced (OEL), Oil mining licence (OML) Oil Production licence (OPL), royalties, rents (productive and non- productive), fees for licences to operate drilling rigs, fees for oil pipeline licence, haulage fees and all such fee prevalent in the oil industry but not limited to the above list.

Examiner's Report

The question test candidates' knowledge of the provisions of the Federal Inland Revenue Service (Established) Act, on tax audit and investigation.

Performance was very poor as most of the candidates that attempted the question demonstrated lack of understanding of the provisions.

Candidates are advised to ensure that they prepare adequately and make use of the Institute's study packs and pathfinders of previous diets for better performance in future examinations.



THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

OCTOBER 2021: PROFESSIONAL EXAMINATION

PTE II: INCOME TAX FOR SPECIALISED BUSINESS

WEDNESDAY 13TH OCTOBER, 2021

EXAM NO.....

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS.

TIME: 3 HOURS.

1. Peoples Trust Bank Plc is a commercial bank providing private and business banking products to small and medium enterprises.

The extract of the Statement of Comprehensive Income for the year ended 31 December, 2015 is as follows:

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER, 2015

	₦
Interest income	102,168,772,000
Interest expense (10% paid to other Nigeria banks)	<u>(48,820,676,800)</u>
Net interest income	53,348,095,200
Impairment charge/write back on specific financial assets	<u>6,006,572,800</u>
Net interest income	59,354,668,000
Fees and commission	21,116,158,400
Fees and commission expenses	--
Net realised gains on investment securities	1,408,310,400
Net foreign income/(loss)	4,588,649,600
Other operating income	11,022,661,600
Loss on disposal of a subsidiary	(403,458,400)
Fair value gain on investment property	3,880,228,800
Write back/(impairment) charge on non-financial assets	(658,545,600)
Personnel expenses	(20,750,254,400)
Operating lease expenses	(1,018,418,400)
Depreciation and amortisation	(6,224,165,600)
Other operating expenses	<u>(47,223,517,600)</u>
Profit before tax	25,092,316,800
Income tax expense	<u>(4,122,841,600)</u>
Profit for the year	<u>20,969,475,200</u>

Other information

Included in the interest income are income earned from	
Bonds issued by corporate entity	382,440,043
Bonds issued by FGN	61,952,747
Bonds FGN trading	74,098,050

FMBN bonds	42,706,781
State government bonds	213,769,207
Included in the interest expenses are:	
Euro bond capitalised expenses	4,852,000
Interest expense -wht	173,368,800
Loss on trading in corporate bonds	4,113,328,800
Included in the personnel expenses	
Provision for defined benefit plan	731,161,600
Other expenses	
Provision for litigation	381,669,600
Contribution to approved pension scheme	200,573,906
Revaluation deficits	527,802,400
Loan loss provision on specific loan and advances	5,388,873,141
Impairment allowance on disposal of investments	820,748,800
Rent- office premise	691,638,400
Rent- residential	88,519,200
Consultancy, professional, management fees	4,586,455,734
Repairs and maintenance	9,627,089,600
Directors overseas training (sponsored by one of the subsidiaries)	80,000,000

The bank has the following policies;

Collateral policies

It is the bank's policy that all credit exposures are secured

Authority limit on credits for loan approvals

Board of Directors	₦200billion
Management Credit Committee	₦10billion

Approval limits of principal officers

Officers	Approval limits
Group Managing Director	₦200million
Group Deputy Managing Director	₦150million
Group Executive Director	₦75million

Continuous professional development

It is the bank's policy that the Directors undergo continuous professional development in order to improve their performance. Such courses are to be held in Nigeria.

A credit facility approved by the GMD alone in the sum of NG ₦300m, which has remained bad at the end of the year. The loan has been written off to the loan loss account. The collateral provided could only produce NG ₦180m.

The Board of Directors proposed and paid dividend of 78 kobo each on the issued share capital of 18,306,335,126 ordinary shares of 50k each as at 31 December 2015. Withholding tax will be deducted at the time of payment. All shareholders are taxpayers resident in Nigeria.

DONATIONS

The bank made contributions to charitable and non-charitable organisation to the tune of NG ₦240m. Details are as follows;

Beneficiary	Purpose	Amount (₦)
Bankers committee	Terror fund	200,000,000
O. B. Williams Foundations	Foundations	16,000,000
Nigeria Immigration Service	Renovation of office	12,800,000
Betcom Limited	Donations	12,000,000
		240,000,000

The capital allowance schedule for the period is as follows

Brought forward	26,646,051,714
Current	9,981,929,659

Included in other operating incomes are:

Cash management charges	313,080,000
Rental income	246,887,200
Other income	79,503,076

Included in fees and commission are:

Verve income	788,728,000
Visa income	167,610

The following assets were also acquired by the bank from Nigeria suppliers:

	₦
Lease holds improvements and building	5,319,562,400
Computer hardware	1,019,671,540
Furniture and fittings	3,077,020,800
Motor vehicles	1,096,590,400

(a) You are required to prepare:

- (i) tax computations of the Peoples Bank Trust Plc, based on the above information in line with the provisions of CITA and other legislation.
- (ii) VAT and withholding tax liabilities.

Give reason for taxing or exempting any items you judge not too obvious.
(35 Marks)

- (b) The Finance Act 2020 provides for several amendments to the tax laws with the aim of deepening the tax administration, encourage the growth of small and medium businesses as well as provide clarity to certain provisions of the tax laws. In view of the above, you are required to:

- (i) Discuss the amendment of Section 19 of Companies Income Tax Act as it relates to Tax on Dividend distributed by Banks to it's shareholders.

(4 Marks)

- (ii) States VAT rates for vatable income earned by Banks and other Financial Institutions.

(1 Mark)

(Total 40 Marks)

SOLUTION TO QUESTION 1

(a) (i) **People Trust Bank Plc**

Tax Computation for the 2016 year of Assessments

	₦	₦
Net profits before tax		25,092,316,800
Add Back: Disallowable Expenses:		
Depreciation and amortisation	6,224,165,600	
Loss on disposal of subsidiary	403,458,400	
Impairment charge on non-financial assets	658,545,600	
EURO bond capitalised expenses	4,852,000	
Interest expense – WHT	173,368,800	
Loss on trading in bond	4,113,328,800	
Provision for litigation	381,669,600	
Provision for defined benefit plan	731,161,600	
Revaluation deficits	527,802,400	
Impairments allowance on disposal of investments	820,748,800	
Directors' oversea training – Third party expense	80,000,000	
Disallowable Donations:		
O. B. Williams Foundations	16,000,000	
Betcom Ltd.	12,000,000	
Disallowed bad debt (see working 1)	<u>120,000,000</u>	
		<u>14,267,101,600</u>
Adjusted Profits		39,359,418,400
Less: Non-Taxable Income:		
Fair value gain on investment property		<u>3,880,228,800</u>
		35,479,189,600
Exempted Incomes		
Bonds issued by corporate entity	382,440,043	
Bonds issued by FGN (AFS)	61,952,747	
Bonds FGN trading	74,098,050	
FMBN bonds	42,706,781	
State government bonds	<u>213,769,207</u>	
		<u>774,966,828</u>
Assessable Profits		34,704,222,772
Less: Capital allowances:		
Brought forward	26,646,051,714	
Current	<u>9,981,929,659</u>	
Total	36,627,981,373	
Relieved capital allowance (2/3)	<u>24,418,654,249</u>	<u>24,418,654,249</u>
Capital Allowance Carried Forward	12,209,327,124	
Total Profits		10,285,568,523
Companies income tax @ 30%		3,085,670,557
Tertiary education tax @ 2% of assessable profits		694,084,455.44

		₦
Dividend paid (see working 2)		14,278,941,399
Tax @ 30%		4,283,682,420
As per tax computation		3,085,670,557
Difference to be paid		1,198,011,863
Working 1		
Bad debts		300,000,000
Disallowed amount		<u>180,000,000</u>
		<u>120,000,000</u>
Working 2 – Dividends Paid		
0.78 x 18,306,335,126 = 14,278,941,399		

(ii) Computation of Value Added Tax

Year of accounts	2015
	₦
Cash management charges	313,080,000
Rental income	246,887,200
Verve income	788,728,000
Visa income	167,610
Other income	79,503,076
Total vatable sales	1,428,365,886
Less: Non vatable sales	--
Net vatable sales	<u>1,428,365,886</u>
Output tax @ 5%	71,418,294
Less: Input VAT verified	--
VAT payable	<u>71,418,294</u>

Computation of Withholding Tax

Year of accounts	2015
	₦
Interest expenses (see working 3)	43,938,609,120
Dividend paid (see working 2)	14,278,941,399
Rent – Residentials	<u>88,519,200</u>
	<u>58,306,069,719</u>
Withholding tax @ 10%	5,830,606,972
Consultancy Professional Management Fees	4,586,455,734
Rent – Office premises	<u>691,638,400</u>
Total	<u>5,278,094,134</u>
Less: VAT @ 5%	263,904,707
Total net of VAT	5,014,189,427
Less: WHT Tax @ 10%	501,418,943

Other's asset acquisition:	
Lease hold improvement and building	5,319,562,400
Computer hardware	1,019,671,540
Furniture & fittings	3,077,020,800
Motor vehicles	1,096,590,400
Total	10,512,845,140
Less: VAT @ 5%	525,642,257
Amount incurred less VAT	9,987,202,883
Less: WHT @ 5%	499,360,144
	<u>9,487,842,739</u>

Total WHT Liabilities (5,830,606,972 + 501,418,943 + 499,360,144)
= 6,831,386,059

Summary of Tax Liabilities

Year of Assessments	2016	
Year of Accounts	2015	
		₦
1. Income tax	4,283,682,420	
2. Education tax	694,084,455	
3. Value added tax	71,418,294	
4. Withholding tax	6,831,386,059	
	11,880,571,228	

Working 3

Interest expenses	48,820,676,800
Non-interbank portion (90%)	43,938,609,120

- (b) (i) The finance act 2020 amends section 19 of companies income tax by providing exceptions to excess dividend tax.

Prior to the amendments, where a company or bank pays dividend in excess of its taxable profits, such dividend is subjected to companies income tax @ 30% by the tax authority.

There was no consideration as to whether or not the income from which such dividend is paid have been taxed before now or whether the underlying income is altogether exempted from tax.

Based on the 2020 Finance Act amendment, dividends are paid out of retained earnings of a company, provided that the dividends are paid out of profits that have been subjected to tax under Companies Income Tax Act, shall be exempted from tax under section 19 of CITA.

- (ii) VAT rates for vatiable incomes earned by Banks and other financial institution is 7.5% effective February, 2020 calendar year.

EXAMINER'S REPORT

The question tests candidate's knowledge on:

Computation of taxes for a bank in line with the provisions of CITA and other legislation. It also requires candidates to compute VAT and WHT.

The amendment to section 19 of CITA as it relates to tax on dividend distributed by Banks to its shareholders. It also requires candidates to state VAT rates for vatable income earned by Banks and other Financial Institutions.

Performance was poor as more than 90% of the candidates that attempted the questions displayed poor understanding of the concept tested.

Candidate's common pitfalls were their inability to determine allowable and disallowable expenses as well as their knowledge gap in Finance Act, 2020.

Candidates are be advised to read wide and update their knowledge with relevant amended laws like Finance Act; CAMA; CITA; PPTA; PIAT; etc. They should also make effort to attend CITN accredited study centres spread across the country.

2. Company A and Company B are both Nigerian companies, and both manufacture flexible plastic packaging.

The accounting year end of both companies is 31 December.

Company A would like to acquire the entire business of company B. Company B is willing to sell the business, so the two companies are jointly taking advice on the tax consequences of the proposed transaction.

The assets that are encompassed by the business and which are to be transferred are the manufacturing plant and machinery, land & buildings, and trade receivables.

- (a) You are required to draft a report to the two companies jointly, setting out six of the tax issues that can arise from the proposed transaction. (6 Marks)
- (b) Would your advice be different if both companies A and B were wholly owned subsidiaries of X Plc? If so, list the points that would or could change. (7 Marks)
- (c) If company B is put into liquidation after the transaction, how does this possibly affect your advice? (2 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 2

(a)

ABC Tax Professional Services
33, Asokoro Crescent, Ikeja Lagos.

The Managing Director,
Company A Ltd; Company B Ltd

Dear Sirs,

ACQUISITION OF COMPANY B BY COMPANY A

Our previous discussions on the above subject matter refers.

As regards the transactions, the following are the tax issues that can arise on the proposal:

- Need to inform FIRS of the transaction;
- 'B' will be ceasing business, so the company's trading, profit for the last 3 years will be treated on cessation basis. (Assumption is that the company's accounts relates to years before the introduction of Finance Act, 2019;
- Assets will be disclosed to calculate balancing adjustments. If balancing charge, this will increase as tax liability;
- Company 'A' will not be commencing a new business as this seems to be an extension of the existing business it operates;
- Company 'A' will be able to claim capital allowances on assets, including initial allowance and investment allowances;
- Company 'A' claim to allowances on industrial building will be limited to their original costs to 'B' or its present disclosure;
- Company 'B' will have to charge VAT on sale of trading assets. 'A' cannot claim this as input tax;
- 'A' will not be able to claim bad debt relief for any business which realises less than they paid for them;
- Governor's consent fee to be paid on transactions of land; and
- If 'B' issues any asset for more than original costs (including goodwill), this will be subject to capital gains tax at first or the gain.

You are free to contact us for further clarification on any of the issues raised above.

Managing Partner

For ABC Professional Service

- (a) This makes the two companies part of a group. So can seek direction under S.29(a) CITA.
- No cessation rules.
 - No balancing adjustments.
 - 'A' will take over assets for tax purposes at tax written down value.
 - No tax on transaction.
 - No VAT on transaction.

- (b) If 'B' is put into liquidation, WHT on dividend during liquidation will be on amount including any capital profits being distributed. So, this would include gains or profit made on selling assets and business to 'A'.

EXAMINER'S REPORT

The question tests candidate's knowledge on acquisition of a company by another. The two companies are Nigerian companies. The question was sub-divided into 3 parts to test candidates' knowledge of:

- (i) Tax issues that could arise as a result of such transaction.
- (ii) If the two companies are subsidiaries of another company.
- (iii) On the effect of the company being acquired having no transaction.

About 85% of the candidates attempted the question but a fairly large number of the candidates understand part (1) while parts (ii) and (iii) were not understood.

Candidates' commonest pitfall was that they failed to bring out the tax issues arising from the acquisition but treated the question as normal tax issues.

Candidates are advised to direct their attention more to the practical application of tax laws and principles rather than just having general knowledge of the subjects.

3. The More You Look Ltd has decided to form one or more entities to operate in an export processing or free trade zone regulated by NEPZA, and conduct new businesses there. Each new business will require an investment of US\$ 2 million.

One business will be to operate a tank farm and associated jetties, mooring facilities, etc. This business will import low pour fuel oil (LPFO), store it, and sell it to customers. Of the total sales, 60% will be to other entities operating approved activities in the free trade zone, and the remaining 40% of sales will be exported to customers in other West African countries.

The other business will manufacture plastic artificial hair, for extensions, wigs, "weaves" etc. The raw material will be imported from China. Of the total sales, 30% will be exported to customers in other West African countries; 10% will be sold to customers operating approved activities in the FTZ, and 60% will be sold to customers in the Nigerian customs territory.

Required:

- (a) List Three (3) existing general free trade (or export processing) zones in Nigeria. (3 Marks)
- (b) List Three (3) benefits of being an approved enterprise in a free trade zone (FTZ). (3 Marks)
- (c) Determine whether each of these two businesses will qualify as approved enterprises, with reasons. (4 Marks)

- (d) If the hair manufacturing business only sold 24% of total sales to customers in the customs territory, would this change its eligibility for approved activity status? (1 Mark)
- (e) In the circumstances in part (d) above, would the entity be required to pay companies income tax in Nigeria? If so, on what portion of its profits? (2 Marks)
- (f) If sales are made to customers in the customs territory, will there be VAT on the sales? If so, how will it be collected? (2 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 3

- (a) These are the free trade zones in Nigeria:
- Calabar;
 - Kano;
 - Tinapa;
 - Snake Island;
 - Lekki;
 - Maigatari;
 - Ladol;
 - Ogun Guangdong;
 - NAHCO;
 - ALSCON;
 - Oil & Gas Free Trade Zone; and
 - Bindu FTZ.
- (b)
- Laws pertaining to taxes, duties and foreign exchange shall not apply.
 - Foreign capital investment can be repatriated at any time with capital appreciation.
 - Profits and dividends earned by foreign individuals can be remitted.
 - No import or export licences required.
 - Up to 25% of production can be sold into customs territory, subject to valid permit on payment of duties.
 - Rent free land at construction phase
 - Up to 100% foreign ownership
 - Foreign managers and qualified personnel can be employed
- (c)
- | | | |
|--------------------|---|--|
| Tank Farm | - | Qualified |
| | - | Investment > \$500,000 |
| | - | Partly warehousing, partly transshipment |
| Hair Manufacturing | - | Does not Qualify |
| | - | Manufacturing partly for sales |
| | - | 75% for Nigerian Customs Territory |
- (d) Sales less than 25% in customs territory. Manufacturing and qualified.
- (e)
- It is subject to income tax on portion of incomes from sales to Nigeria.
 - 76% exported, so 24% taxation on Nigerian business.

- (f) No VAT does apply.
- To be paid at time goods pass through boundary into customs, territory by persons importing them.

EXAMINER'S REPORT

The question tests taxation of companies operating within the Free Trade Zones which are regulated by NEPZA the six (6) questions that test good understanding of the purpose, implementation and qualification /disqualifications of existing/new proposals coming to the zone.

About 90% of the candidates attempted the question and about 60% of them appears to understand the question and hence performed well.

Candidates are advised to read wide and update themselves on issues bothering on free trade zones, when preparing for future examinations.

4. BankCo. operates a Nigerian bank. In the year ended 31 December 2018, it earned interest income of ₦150million; and fees of ₦25million. It also received ₦20million as dividends from Nigerian unit trusts, and earned profits of ₦10million from trading Nigerian government bonds.

Included in interest earned was ₦20million of interest on Nigerian Treasury Bills, and ₦10million of interest on agricultural loans. All loans to agricultural customers had an interest rate lower than base rate at the time of inception of the loan, and had a moratorium of at least 18 months.

The bank paid ₦80million interest on deposits. Of this, ₦50million was paid to other Nigerian banks, and a further ₦5million to the Bank of Industry on a loan that was taken on condition that it would be used to fund loans to agricultural customers.

The bank incurred other operating costs of ₦40million.

The bank made a gain of ₦10million on disposal of shares in another listed company, acquired two (2) years earlier. The bank bought these shares with the expectation of making a profit on them, as part of its banking business.

There were no other costs or income items. The bank declared and paid a dividend of ₦50million in the year.

Required

Compute Companies Income Tax (CIT) for BankCo, and
Compute withholding tax to be paid by BankCo.

Ignore Tertiary Education Trust Fund Tax (TET), and minimum tax. Assume that there were no capital allowances due. Assume also that all shareholders and all deposit holders are Nigerian residents.

All operating costs were fees for professional, consulting or technical services.

(15 Marks)

SOLUTION TO QUESTION 4

BankCo.

Computation of Companies Income Tax for the 2019 Year of Assessment

	₦million	₦million
Income		
Interest income		150
Fees income		25
Dividends income		20
Profit from Govt. Bonds		10
Gain on SME shares		<u>10</u>
		215
Costs		
Interest paid	80	
Operating costs	<u>40</u>	<u>120</u>
Profit		<u>95</u>
Taxable Income		
Profit for the year		95
Disallowable costs: Payment to BOI		5
Earned Incomes:		
- Unit trust dividends		(20)
- Bond trading profit		(10)
- Treasury bills interest		(20)
- Agric loans interest		<u>(10)</u>
Taxable profit		40
Companies Income Tax @ 30%)		12
Dividend paid		50
Tax on dividend paid @ 30%		15

Dividend paid is in excess of taxable profit, hence dividend was taxed @ 30% = ₦15m.

	₦million	₦million
WHT Payable		
Interest paid	80	
Less interbank	(55)	25
WHT @ 10%		2.5
Operating cost	40	
WHT @ 10%		4
Dividend paid	50	
WHT @ 10%	5	
Less WHT paid on unit trusts	(2)	<u>3</u>
Withholding tax		<u>9.5</u>

EXAMINER'S REPORT

The question tests candidate's ability to compute company income tax and WHT. About 70% of the candidates attempted the question and performance was poor.

The common pitfalls were that, many candidates lacked understanding of the question and many did not aggregate the income from all sources to enable them determine allowable and disallowable expenses.

Candidates are advised to study wide and make use of the Institute's Study Pack and Pathfinder for future examinations.

5. (a) (i) Set out Three (3) characteristics of a unit trust scheme. (3 Marks)
- (ii) Under which income tax act does a unit trust pay tax? (1 Mark)
- (iii) A unit trust typically earns dividends and interest, and makes capital gains on disposal of investments. It would also typically pay management fees to its manager, and audit fees.

For example, a unit trust earned	N'million
Capital gain on sale of shares	2
Dividends from Nigerian companies	10
Interest	5
And	
Paid management fees and audit fees (VAT inclusive)	3
Declared a distribution	12

Describe the tax treatment of each line of income, costs and distribution. Ignore VAT. (8 Marks)

- (b) If an individual could own either units in a unit trust, or the underlying investments (i.e., those that the unit trust has invested in), which method would lead to the higher overall tax cost for that individual? Give reasons. (3 Marks)
(Total 15 Marks)

SOLUTION TO QUESTION 5

- (a) (i) A unit trust is an investment scheme and:
- A unit trust is a trust;
 - Members or public hold units or participation rights;
 - Investors investing in unit trusts have ownership in the trust assets;
 - Each unit trust scheme comes with distinct set of investment objective;
 - Unit trust is managed by a fund manager, who maintains the trust and tries to improve profit level; and
 - It is an investment pooling arrangement.

(ii) Companies Income Tax Act 2004 as amended.

(iii) Dividends: These are franked investment income. Have suffered 10% withholding tax as a final tax.

Interests: Taxable at CIT rate or 30% and TET or 2%. But have suffered 10% withholding tax which can be used as credit.

Management and audit fees paid – Tax deductible. Unit trust to deduct WHT @ 15%.

Distribution disallowed – Not tax deductible. Treated as dividend paid by a company to deduct withholding tax at 15%. But can credit WHT suffered on

franked investment incomes against this capital gains on sales of shares exempted from capital gains tax, not subject to companies income tax.

- (b) - Individual owning shares – Suffered withholding tax at 10% as final tax.
- Individual earning interest – Suffered withholding tax at 10% as final tax.
- Individual disposing shares is exempted from capital gains tax.
- Section 23(n) of CITA tax imposed on Unit trust distributions from franked investments income and from capital gains. Direct investment by individual does not suffer this.
- Individual pays less tax if invests in underlying assets directly.
- However, Section 9 of the Finance Act 2019 has deleted Section 23(n) of CITA, therefore a unit trust is not expected to deduct withholding tax upon distribution of dividends, which have been subject to withholding tax to its beneficiaries.

EXAMINER'S REPORT

The question tests candidate's knowledge about Unit Trust Investments business.

It is sub-divided into:

- (a) (i) Characteristics of a unit trust scheme
 - (ii) Knowledge of the income tax act that governs the scheme
 - (iii) Knowledge of tax treatment of each line of income, cost and distribution.
- (b) Knowledge about method that would lead to a higher overall tax cost for an individual with reasons.

About 70% of candidates attempted the question but only few candidates demonstrated good understanding of the question's requirements.

Common pitfalls for candidates were:

- Low knowledge of the requirement of the question; and
- Poor knowledge and understanding of the operations of unit trust investments scheme.

Candidates are advised to read wide and research more on the topic of Unit Trust Investments when preparing for future examinations.

6. (a) List Five (5) organs of government involved in the administration of the Pioneer Status Incentive and state a role performed by each of the organs. (10 Marks)
- (b) State Six (6) conditions for the extension of a pioneer status grant. (3 Marks)
- (c) Briefly define the following terms in line with the Industrial Development (Income Tax Relief) Act.
- (i) Old Trade or Business
 - (ii) By-Product

(2 Marks)
(Total 15 Marks)

SOLUTION TO QUESTION 6

- (a) (i) Federal Executive Council (FEC)
The FEC is responsible for the amendment of the list of pioneer industries and pioneer products (pioneer list) from time to time under the direction of the President.
- (ii) Federal Ministry of Industry, Trade and Investment (FMITI). The Minister of Industry, Trade and Investments is responsible for specifying the mode of application for the pioneer status incentive.
- (iii) Nigeria Investments Promotion Council (NIPC)
On the delegated authorities of the Minister of Industry, Trade and Investments, NIPC is responsible for processing pioneer status incentive applications and cancelling pioneer certificates if the provisions of the IDA and other guidelines are contravened. On the delegated authority of the President, NIPC is responsible for approving and extending pioneer period and issuance of pioneer certificates.
- (iv) Industrial Inspectorate Division of the Federal Ministry of Industry, Trade and Investments. The Industrial Inspectorate Department is responsible for certifying the "production day".
- (iv) Federal Inland Revenue Service (FIRS)
The FIRS is responsible for giving effect to the pioneer status incentive granted any company and issuance certificate of qualifying expenditure to beneficiaries.
- (b) Conditions for the extension of Pioneer Status Incentive
- (i) Application must be in writing to the Nigeria Investments Promotion Council.
- (ii) The application must reach the NIPC not later than one month after the expiration of the initial tax relief period.
- (iii) The particular of all capital expenditure incurred by the company by that date.
- (iv) NIPC must be satisfied as to the rate of expansion, standard of efficiency and the level of development of the companies.
- (v) NIPC must be satisfied as to the use of local raw materials and the training and development of Nigerian personnel.
- (vi) The relative importance of the industry to the economy of the nation.
- (vii) Any other condition as may be prescribed by the Minister of Finance.
- (c) (i) Old Trade or Business
This refers to the trade or business of a pioneer company during its tax relief period which either ceases within the period or is deemed to cease at the end of the period permissible.
- (ii) By Product
This refers to any goods or services so described in any pioneer certificate being goods or services necessarily or ordinarily produced in the course of producing a pioneer product.

EXAMINER'S REPORT

The question tests candidates' knowledge on pioneer status in the following areas:

- (a) The organs of Government involved in its administration;
- (b) The conditions for its extension; and
- (c) Definition of old Trade Business and By-product under the Industrial Development (Income Tax Relief) Act.

About 90% of the candidates attempted the question. Performance was just fair as 50% of candidates did well in part (a) while the performance in part (b) and (c) were woeful.

Candidates' common pitfalls were their lack of knowledge of the organs of Government involved in the administration of pioneer status and conditions for the extension of pioneer status.

Candidates are advised to read wide and ensure they obtain relevant books and materials that will further enhance their knowledge when preparing for future examinations.

7. Oloibiri Oil and Gas Company Ltd was awarded OPL 251 in 2010 to explore and produce oil and gas on a sole risk basis in a deep offshore water area of 800 meters.

Following the discovery of crude oil in November 2016, the Block (OPL 251) was converted to OML 618 on a production sharing contract basis by the Department of Petroleum Resources (DPR). The company is the holder and operator of a production sharing contract arrangement with two (2) other companies in OML 618 block.

Due to the viability of the oil Block, the Federal Government in October, 2020 wrote the company to inform them of its intention to exercise Back-in-Right in OML 618 from January 2021 fiscal year.

In the first week of February 2021, the company directed its tax department to prepare its 2020 actual petroleum profits tax returns ahead of the filing deadline date.

Extracted below is the company's data for that purpose:

- (1) Monthly petroleum profit tax payable on estimate \$5m.
- (2) Production – Brass Blend 9,000,000 barrels
Lifting – Brass Blend 9,500,000 barrels
- (3) Cost oil = \$250m

Other relevant information:

- (a) Included in the cost oil was Royalty oil; Tertiary Education tax of \$2.5m and Donation to Ikoyi club of \$15m.
- (b) The financial statement of the company also shows that it made a profit of \$70,000,000 and dividend distributed to its shareholders in 2019 financial year was \$42,000,000.

Note also:

- (i) All crude oil produced were exported.
- (ii) The company did not revise its estimate in 2020 and have paid up to the 12th installment.

Required:

- (a) Explain briefly the term of Back-in-Right in the upstream sector of the oil and gas industry. (2 Marks)
 - (b) State the royalty rates for crude oil production in the deep offshore and inland basis operations as provided in the Deep Offshore Amendment Act 2019. (5 Marks)
 - (c) Compute royalty payable from OML 618 to the Federal Government pursuant to Deep Offshore (Amendment) Act, 2019. (3 Marks)
 - (d) Compute withholding tax from dividend paid to the shareholders of Oloibiri Oil and Gas Company Ltd. pursuant to 2019 Finance Act amendment of section 60 of Petroleum Profits Tax Act (PPTA). You are to assume that 90% of its equity shares is held by a company who resides and have its operation in Netherland and 10% of the shares of the company are held by Nigerian shareholders. (5 Marks)
- (Total 15 Marks)

SOLUTION TO QUESTION 7

- (a) Back-in-Right are oil and gas terms that allows the assignor (usually the government) to acquire an equity participation once a commercial discovery have been made in the oil and gas asset without participating in the risk of exploration.

The licence holder is mandated by the policy to relinquish a certain percentage up to 50% of its equity participation in the license to the Federal Government or the assignor of the license.

- (b) Royalty rates for deep offshore operation as provided in the deep offshore (Amendment) Act, 2019 thus:
 - (i) Royalty by volume
Royalty on chargeable value of crude oil
In areas greater than 200 meters
Water depth – 10%
 - (ii) Royalty by price
 - From US \$0 and up to US \$20 per barrel - 0%
 - Above US \$20 and up to US \$60 per barrel - 2.5%
 - Above US \$60 and up to US \$100 per barrel - 4%
 - Above US \$100 and up to US \$150 per barrel - 8%
 - Above US \$150 - 10%

- (c) Oloibiri Oil and Gas Company Ltd.
Computation of Royalty Payable in OML 618 for 2019 Accounting Year

Royalty by Volume		\$
Production (Brass Blend)	9,000,000 barrels/day	
Average price	\$55	
Chargeable value	\$495,000,000	
Royalty @ 10% of chargeable value		49,500,000
Royalty by Price		
Production (Brass Blend)	9,000,000 barrels/day	
Average price	\$55	
Chargeable value	\$495,000,000	
Royalty rate for increase that exceeds \$20 and up to \$60 = 2.5%		
Royalty by Price @ 2.5%		12,375,000
Chargeable value		
Total royalty payable		61,875,000

- (d) Pursuant to Finance Act 2019 (Amendment) Oil and Gas Companies are to now pay WHT on dividend distributed to its shareholders.
- Nigeria has a "Double Tax Agreement with Netherland, hence the WHT rate = 7.5%.
 - WHT rate for Nigerian Shareholders = 10%

Computation of WHT on Dividend Distributed to Oloibiri Oil and Gas Company Shareholders in 2019.

	US \$
(a) Netherland shareholders	
\$42,000,000 x 90% x 7.5%	2,835,000
(b) Nigerian shareholders	
\$42,000,000 x 10% x 10%	<u>420,000</u>
Total WHT on dividend distributed	<u>3,255,000</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of the oil and gas sector as it relates to the following:

- (a) Explanation of the term 'Back – in - Right-' in the upstream sector of the oil and gas industry;
- (b) Royalty rates for crude oil production in the deep offshore and inland basis;
- (c) Computation of royalty payable; and
- (d) Computation of WHT from dividend paid to shareholders. Less than 40% of the candidates attempted the question out of which about 10% understood the question. Only about 4 candidates attempted 7 (a).

Candidates generally did not understand the question, hence few candidates attempted it.

Candidates' common pitfalls include:

- (a) Inability to understand/define Back – in – Right;
- (b) Lack of knowledge on Royalty rate both in volume and in price; and
- (c) Inability to compute Royalty payable.

Candidates are advised to prepare adequately for future examinations and make use of the Institute's Study Pack and Pathfinder.

