THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

APRIL 2023 PATHFINDER FOR PTE II

PTE II: TAX AUDIT AND INVESTIGATION

TUESDAY APRIL 18, 2023 **EXAMNO.....................**

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS. **TIME: 3 HOURS**

1. You are the Team leader in charge of the tax audit of Sangotel Nigeria Plc, based in Apapa Industrial Estate, Lagos State. In preparation for the audit, you are required to prepare an audit plan, however, before the preparation of the audit plan you need to carry out some specific steps and have some documents and information.
   You have extracted the following from year 2022 financial statements of the company:

Statement of financial position extract

	2022	2021
	₦000	₦000
Property, plant and equipment	32,560	31,850
Receivables:		
Trade	3,600	2,150
Other	250	200
Inventories:		
Raw materials	1,200	870
Work-in-progress	350	450
Finished goods	1,860	1,610
Current liabilities:		
Trade payables	2,060	1,470
Other payables	500	450

Statement of comprehensive income extracts

	2022	2021
	₦000	**₦000**
Revenue	43,150	40,750
Cost of sales	(29,180)	(29,040)
Gross profit	13,970	11,710
Depreciation and loss on sales of property, plant and equipment	(3,450)	(2,010)
Other expenses	(2,340)	(2,280)
Profit before tax	8,180	7,420

Required:

a. Discuss the steps you are to take before preparing the audit plan memorandum. 10 marks

b. State and explain the importance of specific documents/information you must have in your tax audit file as part of your preliminary plan for the audit. 6 marks

c. From the financial statements extracts, prepare the following ratios:
   i. Gross profit ratio
   ii. Net profit ratio
   iii. Inventory turnover
   iv. Receivables collection period (days). 8 Marks

d. Comment briefly on each of the above ratios you have calculated. 6 marks

e. Set out further information that you would request from the financial controller when you are on the field audit to clarify the situation with regards to:
   i. Property, plant and equipment,
   ii. Trade receivables and
   iii. Inventory. 10 Marks

Total (40 Marks)

Solution to Question One

a.

❖ A detailed understanding of the taxpayer is the first step. This is done by extracting the following basic information from the taxpayer's Permanent Note Jacket file (PNJ). A background information questionnaire form containing the following questions could be used for this purpose:
- Name of the company;
- Registered address;
- Date of commencement of business;
- Date of registration;

- Taxpayer identification number (TIN);
- Nature of business;
- Accounting year end;
- Particulars of the Directors
- External auditors/tax consultants and their addresses;
- Bankers and their addresses;
- Solicitors and secretaries;
- Litigation details (if any)
- Associated companies and their addresses; and
- Period covered during the last audit or investigation exercise (where applicable).

❖ Preliminary review of tax files

Open Tax audit files (Folders)

Once the decision to audit a taxpayer is taken, the first step is to set up the appropriate Tax audit folders or files. This is because every step taken in the audit process must be properly documented and the resulting working paper must be referenced, reviewed as appropriate and filed. Note that, setting up of the working papers and folders must be done electronically, if physical, hard copy is required, print from the electronic version. In this regard, the cover page should consist of:

➢ Name of Taxpayer;
➢ Taxpayer Identification Number (TIN);
➢ Registered Address;
➢ Telephone Number(s);
➢ E-mail address(es);
➢ Name of the Managing Director; and
➢ Years of assessment to be covered by the exercise.

❖ Preliminary Activities and Review

- Audit team to acquaint themselves with background information of the taxpayer to be audited.
- Preparation of risk profiling of the taxpayer
- Preparation of audit checklist to be used in respect of each taxpayer to ensure that all necessary areas of audit activities are covered
- Design interview format for the taxpayer
- Assign specific duties to audit team members.

❖ Taxpayer's History

- Establish the reason for the audit and review the team leader's note with respect to issues to be addressed.
- Review the taxpayers file for information with respect to its tax compliance history
- Obtain from all the tax office departments/units the existing information on the taxpayer to be audited.

❖ Previous year Audit File

- Review previous years audit files where the taxpayer had previously been audited. Know the type of audit done, the purpose and scope of work done, findings and conclusions and outstanding issues yet to be resolved (if any).
- Prepare a brief summary of the highlights of the audit. All unresolved/disputed issues are addressed during the current audit.
- Call the taxpayer on phone to obtain an update on the schedules he is supposed to provide during the audit if possible, ask the taxpayer to send them to the tax office

before the date of commencement of field audit. The schedules must be available not later than the date of the pre-audit meeting.

b. The following documents must be in tax audit file as part of the preliminary plan for the audit:
   i. Tax Audit check list: This is to be used during the audit exercise to ensure that a thorough job is done
      - It ensures that tax audit exercise is undertaken systematically and not in a haphazard manner.
      - It makes the audit work to be faster, orderly and properly completed
      - It ensures tick off of activity performed as the work progresses until the audit exercise is completed
   ii. Audit programme: This is a schedule of work expected to be performed on each item of the tax audit check list.
      - It facilitates tax audit supervision and control, providing senior members of the audit team the information and knowledge regarding the progress of the work done.,
      - it provides details of the work which the team leader requires individual members of the team to perform.
      - it provides information as to how much of the audit work has been completed as at a particular date and how much is outstanding.
      - it ensures continuity in the audit work because, should there be a change in the personnel constituting the audit team the new member will be able to see at a glance the outstanding work to be done.
      - it is a time management tool.

c. Ratios

	2022	**2021**
Gross profit ratio i.e GP x 100 Revenue	13,970/43,150 X 100 32.4%	11,710/40,750 X100 28.7%
Net profit ratio i.e Net Profit x 100 Revenue	8,180/43,150 X 100 19.0%	7,420/40,750 X 100 18.2%
Inventory turnover i.e Cost of sales inventory	29,180/3410 8.6 times	29,040/2930 9.9 times
Receivable collection Period i.e Trade Receivable x 365 Revenue	3,600/43,150 X 365 30 days	2,150/40,750 X 365 19 days

d. Comments

i. Gross profit ratio shows that the company has improved on the gross profit on revenue in 2022 due to efficient manufacturing/sourcing of materials.

ii. Net profit ratio has also slightly increased in 2022, which shows that the company has managed its operating expenses during the year efficiently and effectively.

iii. Inventory turnover has slightly reduced in 2022, which may be due to increase in inventory holding.

iv. Receivable collection period has deteriorated from 19 days in 2021 to 30 days in 2022. This shows that the company has either increase the credit period it extended to its customers or has not follow up collections from customers effectively during 2022 and this will affect business cash flow.

e. Further information

Property, plant and equipment

i. An explanation for the increase in Net Book Value (NBV) and depreciation/loss on disposals.
ii. Confirmation of the accounting policy for depreciation to ensure it is consistent with the previous year.
iii. The company's policy for reviewing useful lives to ensure they are reasonable (especially where assets have been sold at a loss).
iv. A detailed analysis of movements on Property, Plant and Equipment (PPE) during the year, including details of additions and disposals and depreciation charges.
v. Whether any assets are recorded at a valuation as opposed to cost.
vi. The split of the expense between depreciation and loss on disposal of property, plant and equipment.
vii. Any own work capitalised.
viii. Documentary evidence to support any acquisition and or disposal.
ix. Non – Current Asset Acceptance certificate.

Trade receivables

i. An explanation for the increase in the trade receivables collection period.
ii. Details of any significant new customers during the year and information on their credit ratings.
iii. An analysis of bad debts written off and the allowance for receivables.
iv. An age analysis of receivables.
v. Details of post year end cash receipts.

Inventory

i. Explanations for the movements in raw materials, work in progress and finished goods and for the overall increase in inventory.
ii. Details of any adjustment required to physical inventory records as a result of the year end count.
iii. Details of post year-end sales and next year's order book.
iv. An analysis of the allowance for obsolete inventory.
v. Details of the increase in revenue and whether it has come from a different sales mix, price increases or volume increases.

vi. Confirmation that inventory has been valued at the lower of cost and net realisable value.

2. Folgo Nigeria Limited is a company that operates in the food and beverage sub sector of the food industry in Nigeria. The company is a good corporate citizen as it files its returns and pays the tax due timely. To your outer dismay, the company has been flagged for a tax audit exercise and you have been selected to lead the audit team.

Required:
List fifteen (15) reasons why the company has been flagged for a tax audit, though it has been a good corporate citizen and it has been discharging its tax obligations as at when due. **15 marks**

Solution to Question Two

Audit Triggers / Reasons for Tax Audit
Companies / enterprises are usually chosen for tax audit based on any or a combination of the following conditions:

a. Self-assessment filers: Every large taxpayer and small and medium tax payer every three (3) years based on available audit resources;
b. Genuine information received from intelligence or other FIRS departments. Or external sources about taxpayers. It could also be referral from other regulatory agencies like the EFCC, ICPC or report/ complain from external sources e.g whistle blowers, TV or Newspaper report etc;
c. Taxpayers with refund claims. i.e Returns showing refunds especially arising from excess withholding tax or VAT;
d. Taxpayer with poor tax adequacy ratios;
e. Claims under double taxation agreement;
f. Based on routine sectorial / industry audit;
g. Case referrals arising from desk review/ examinations;
h. Secondary files related party transactions. Connection with other taxpayer by way of holding, subsidiary, associated or related companies could be a criteria for selecting companies for audit;
i. Analytical review of tax returns;
j. Transfer pricing / thin capitalisation arrangements;
k. Deviation from inter-firm comparison;
l. Returns that are randomly selected;
m. Confirmation/ verification of poor or extraordinary performance;
n. Based on risk profiling report;
o. Conspicuous operating expenditure (unusual costs in relation to an industry);
p. Heavy liabilities: in this case it is possible that there are fictitious in payments or that the tax claims are in jeopardy;
q. Other tax audit triggers such as industry compliance review;
r. Whistle blowers;
s. Media reports;

t. Mergers or Acquisitions
u. Change in accounting package/system / method;
v. Reported figures inconsistent with previous years;
w. Figures in income tax returns differ from that reported for VAT;
x. Business with low paid up capital/asset backing but substantial liabilities;
y. Severely qualified accounts;
z. Use of tax havens; and
z(i). Business with substantial transactions among related parties.

Required:

a. Draw up the audit programme you plan to follow in this respect. 5 marks

b. What are the audit techniques that you will follow in gathering audit evidence to support the firm's capital allowance claim? 5 marks

c. What audit evidence are you required to have in your audit file in respect of capital allowance at the end of the audit. 5 marks

Total (15 marks)

Solution to Question Three

Fixed assets (Non-current assets)

The objective of non-current assets tax audit is to ensure that capital allowances are not claimed on assets which are neither purchased nor brought into use during the relevant basis period as well as confirming correctness of rate of capital allowances used.

Disposal giving rise to capital gains taxes are also detected through the process of reconciling movement of fixed assets.

a. The following audit procedures should be carried out:

i. Obtain the schedule of non-current assets and note addition for each year;
ii. Agree the schedules to the financial statements and other tax returns;
iii. Insist on third party documents evidencing ownership and acquisitions like purchase invoices, import documents for imported assets;
iv. Withdraw / Remove capital allowances earlier claimed on all assets that ownership and usage could not be proved;
v. Ensure that appropriate rate is used for the computation of capital allowances;
vi. Existence: The tax auditor should confirm that all the assets of the company are physically existing on the date of balance sheet etc (sighting); and
vii. Carry out a test – check or recomputation of the capital allowance claimed by the company.

b. Techniques for gathering Audit evidence are:

i. Physical inspection of tangible assets;
ii. Inspection of records and documents;
iii. Observation;
iv. Enquiry;
v. Confirmation;

vi. Re-computation;
vii. Retracing book-keeping procedures, that is, checking postings; and
viii. Analytical procedures.

This can provide reliable audit evidence about the existence of the assts. It may not be a good technique for confirming ownership or value of the assets.

i. Inspection of records and documents. These could be documents prepared outside the company e.g. receipts, invoices, etc or documents prepared inside the company e.g receipt, invoices, minutes of directors meetings etc.
ii. Observation: It is often said that "seeing is believing" so that auditor can see things for himself by watching how others are performing certain procedure or process e.g. inventory count.
iii. Inquiry: Asking question and seeking information from knowledgeable persons within and without the organisation can enable the auditor to obtain information not previously possessed or to corroborate information previously made available to him.
iv. Re – computation: The auditor can confirm independent calculations, additions, subtractions, etc to check the arithmetical accuracy of source documents and records.
v. Analytical procedures. The auditor can analyse and compare related figures, trends, ratios and other statistics such analytical review this may reveal unusual or unexpected variations or trends which could call for further investigations.

c. Audit evidence to have in the audit file in respect of capital allowance include:

i. Schedule of Non-Current Assets (NCA);
ii. Copies of invoices/receipts for purchased non-current assets;
iii. Details of non-current assets internally constructed – bill of materials, labour charges, payment vouchers, etc.;
iv. Insurance certificates relating to non-current assets;
v. Vehicle licences for motor vehicles;
vi. Fixed asset acceptance certificate;
vii. Details of capital allowances computation; and
viii. Evidence of disposal of Non– Current Asset (NCA).

3. In connection with Computer Assisted Audit Techniques (CAAT), write short notes on the following:

a. Flow charting (4marks)
b. Systems software data analysis (4marks)
c. Program code analysis (4marks)
d. Embedded audit facilities (3marks)

Total (15marks)

Solution to Question Four

a. Flow Charting

Flow charting software produces a diagrammatic representation of the code from a source program. This assist in examining program logic to identify control points and assess the impact of system changes from beginning to the end of the programme.

When recording a computer-based accounting system, a computer produced flow chart may provide part of the necessary documentation, whilst compliance testing general controls, it may assist during an examination of program code to ensure that installation standards have been applied in full and in sequence.

b. <u>System Software Data Analysis</u>

System software data analysis involves the examination of data concerning computer operations from the records maintained by systems software. Most systems software, including operations systems and data base management systems, provide facilities for logging information relating to computer/activity. The examination of this data incorporates both the logging process and the analysis of that data, often using audit software to enhance audit trail and systems log in tracking and password monitoring.

System software data analysis is generally used during the compliance testing of general controls. For example, many operating systems will write to a history file details of attempt to gain unauthorised access to data files and the identification of users who have submitted invalid passwords may be provided.

c. <u>Program Code Analysis</u>

This technique is also known as program code analysis. It comprises the examination by the auditor of source listings of operational programs to determine that the relevant programmes procedures are present and logically coded. The auditor must verify that the coding on the source listing that he is examining the same as that contained in the operational program which is used for processing.

This technique requires a good knowledge of the particular programming language and machine language in use at the client's installation. These requirements immediately restrict the number of audit staff who can perform the examination which the auditor requires through the use of systems passwords and authorisation to enhance system security safety/control.

d. <u>Embedded Audit Facilities</u>

These are program that have been written into and therefore form part of the enterprises application programs.

There are three types including:

- Integrated Test Facilities (ITF),
- Systems Control and Review File (SCARF), and
- Computer Assisted Audit Techniques (CAAT).

The ITF is referred to as the mini company or dummy company unique. ITF is an embedded audit facility and its use involves setting set-up records. Solely for audit purpose, on the client operational master files. Once they have been set-up the auditor can proceed to test data against these records at the same time as the client is processing actual data. By this means the need to obtain SCARF techniques involve in interpreting an audit program with a client's operational system, so that each transaction processed through the system is

analysed by the audit software. Where the transactions satisfy certain parameters, it is captured by the audit program for subsequent review by the auditor. This technique provides the auditor with the capability to monitor and analyse the processing of transactions continuously as part of the activities of everyday processing.

4. Forensic audit can also be defined as an examination of evidence regarding an assertion to determine its correspondence to establish criteria carried out in a manner suitable to the court. Since the tax auditor's work may result into a court action to enforce payment of established underpayment of tax, the tax auditor must gather enough evidence to support his claim of tax underpayment in the court. He, therefore, needs the skill of a forensic auditor.

Required:

a. Identify and briefly discuss four (4) things the tax auditor must do to effectively carry out the above duty. 4 Marks

b. List seven (7) ways tax fraud can be perpetrated through fraudulent financial reporting. 7 Marks

c. List and discuss three (3) methods of detecting tax frauds. 4 marks

Total (15marks)

Solution to Question Five

a. To effectively carry out the above duty, the tax auditor must:
   - Identify areas of risk of material misstatement that could affect the tax payable by the entity. This involves understanding the entity's business environment, its control environment and its industry environment;
   - Understand and assess the scale of risk;
   - Develop a risk response strategy, using appropriate audit procedures and tests to gather suitable evidence;
   - Documents sufficiently the evidence obtained; and
   - Carry out proper review of tax payers file.

b. Most tax frauds involve financial statements fraud, known as fraudulent financial reporting, and it is a type of fraud that causes a material misstatement in the financial statements. It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards. This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing sales revenue to reduce taxable profit. This usually involves falsification of annual accounts of the companies to show reduced turnover as well as reduced profits that will result in underpayment of tax. This can be achieved in the following ways:
   - Understatement of revenue through suppression of sales invoices;
   - Undervaluation of inventory to produce an over bloated cost of sales;
   - Using transfer pricing mechanism to reduce profit declared in a particular country while increasing profit in another territory;

- Large amount of unsubstantiated expenses that have no bearing to the company's operations;
- Passing Capital expenditures as Revenue expenditures so as to reduce profit of the year;
- Suppressing bank accounts to conceal the true level of business activities; and
- Cheating in foreign exchange transactions by showing fictitious imports.

c. Methods of detecting tax frauds
   - All the relevant documents and bank accounts of a company suspected to be involved in fraudulent activities are to be collected from the company's bankers directly.
   - Fraudulent activities of a company can also be traced by collecting information from diverse sources such as capital market, its related business concerns, promoters, directors and employees of the company obtained from banks, various records of companies available with different government agencies i.e. Customs & Excise, Director General of Revenue Intelligence (DGRI), etc.
   - Disgruntled employees and trading partners can be very good source for gathering intelligence and collecting evidence. Pattern of deteriorating financial condition of the company and flourishing economic condition of promoters, employees, directors and related concerns of the company can be analysed to detect possible fraud.

5. ABC Limited, a limited liability trading company dealing in computer hardware and software has been in business for many years in Nigeria. The company has consistently sustained losses in its business operations for the past five years. Federal Inland Revenue Service has notified the company of its intention to conduct tax audit and the tax file has been assigned to you as the Schedule Officer.

You are required:

a. To identify the risk areas in the tax audit of ABC Limited 6marks
b. Explain taxpayer and industry profiling under risk-based audit approach 3marks
c. Discuss the risk areas in conducting tax audit of telecommunication companies 6 marks

Total (15marks)

Solution to Question Six

(a). Risk areas in tax audit of ABC Limited (company that has sustained losses consistently for five years)

There are several risk areas to consider when auditing a company that has sustained losses consistently for five years. They include.

- Going concern: The Company's ability to continue as a going concern (i.e to be in existence) may be in question, which could impact on future tax revenue from the company.
- Valuation of assets: The Company's assets maybe overvalued which could lead to inflated depreciation, increase in inventories and decrease in taxable profits. This should be confirmed through testing the company's inventory, property and equipment, and intangible assets.

- Impairment of assets: The Company may have assets that are no longer generating income, and may need to be written down or impaired, which could result in additional losses.
- Revenue recognition: The Company may be recognising revenue prematurely or in a manner that does not comply with Generally Accepted Accounting Principles (GAAP). This could lead to overstated revenue and or increase in losses.
- Expense recognition: The Company may be recognising expenses in a manner that does not comply with GAAP, which could lead to overstated expenses and inflated losses.
- Tax Compliance: The company may not be in compliance with tax laws and regulations, which could result to overstated expenses and reduction in income.
- Fraud: The Company may be engaged in fraudulent activities, such as misstating financial information, which could result in significant financial losses and legal repercussions.
- Business Continuity: The Company may have operational issues that have led to its consistent losses, such as lack of market demand or competition, which could impact its ability to continue operating in the future.
- Record keeping potential and quality of records kept.

(b). **Taxpayer and industry Profiling**

Profiling is defined as: the act of extrapolating information about a person based on known traits or tendencies. Taxpayer and industry profiling is a risk assessment technique in risk – based tax audit. It involves an understanding of the taxpayer and its industry environment.

Taxpayer profiling is defined by the Australian Taxation Office as "the development of thorough understanding of taxpayer's compliance behaviour and its business.

(c). **Risk areas to consider when conducting tax audit of telecommunication companies**

There are several risk areas to consider when conducting tax audit of telecommunications companies, these include:

- Transfer pricing: Telecommunications companies often have complex international operations, which can make it difficult to determine the correct transfer pricing for inter-company transactions.
- Depreciation and capital allowances: Telecommunications companies typically have significant investments in fixed assets, such as network infrastructure which can be challenging to accurately depreciate and arrive at correct capital allowances for tax purposes.

- Regulatory compliance: Telecommunications companies are subject to a variety of regulations such as those related to net neutrality and data privacy, which can impact on their tax liabilities.
- Sales and use tax: Telecommunication companies may have to navigate sales and use tax laws of different jurisdictions, which can be complex and inconsistent.
- Research and development: Telecommunications companies often engage in significant research and development activities, which can have tax implications in terms of deductions, credits, and other incentives.
- Mergers and acquisitions: Telecommunications companies frequently engage in mergers and acquisitions which can have significant tax implications and require careful tax planning and compliance.
- IT system and record keeping: Telecommunication companies often have complex IT systems and record keeping processes, which can make it difficult for tax auditors to access and analyse the information they need.
- Cyber security: Telecommunications companies may need to consider the tax implications of cyber security and data breaches, such as potential deductions for mitigation costs.

Solution to Question Seven

a. Tax audit procedures for ascertainment of purchases

   The tax auditor will follow the following procedures to ascertain purchases of the tax payer for the relevant year:

- Summarise the monthly purchases daybook total to determine the total credit purchases during the year;
- Compare the summary with the monthly posting into the general ledger and the payable ledger and note any discrepancies;
- Summarise monthly cash purchases from the cash book or bank accounts to determine total cash purchases during the year;
- Add the credit purchases and cash purchases together to determine the total purchases for the year;
- Compare your total purchases as above with the figure used in calculating cost of sales reported in the income statement and note the difference;
- From the cash book or bank account, determine the payments to suppliers during the year;
- Add the payable balance at the beginning of the year with the total credit purchases for the year, which will give amount payable to suppliers;
- From the amount payable to suppliers, deduct the total amount paid to suppliers during the year, which will give expected payable balance at the year-end;

- Compare the expected payable balance with the figure of trade payable in the financial statements and note any variation;
- Ask for explanations for the difference from the taxpayer's management; and
- Check for related party transaction / arm's length transaction.

b. Tax audit procedures for ascertainment of wages and salaries, the tax auditor should follow the following procedures:
   - Collect the nominal roll (list of staff) of the taxpayer;
   - Collect the payroll of the taxpayer for the year;
   - Test checks the list of staff to the payroll;
   - Summarise the payroll for the year;
   - Compare the total of your summary to the figure of wages and salaries in the trial balance and in the financial statements, note any difference;
   - Summarise payments of salaries in the cash book or bank account month by month and get a total for the year;
   - Compare each month payment in the cash book with the net pay on the payroll for each month;
   - Check payroll journal, compare this with each month's payroll and test checks postings into the general ledger, noting any discrepancies; and
   - Discuss any discrepancy and or observations with the taxpayer's management.

THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

APRIL 2023: PROFESSIONAL EXAMINATION

PTE II: INTERNATIONAL TAXATION

TUESDAY 13TH APRIL, 2023 EXAM NO................................

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS. TIME: 3 HOURS

1. The threat of war between Russia and Ukraine started some years ago and has been having serious negative impact on most corporations operating in the two countries. Consequently, many corporations in both countries have shut down their businesses while those still operating are incurring huge losses. Many multinational enterprises (MNEs) in the two countries have relocated their businesses to countries considered to be safe and investment friendly.

   Milton Incorporation is a manufacturing company that was incorporated in Japan in 2001 and have subsidiaries in Ukraine and some Asian countries. The Ukraine subsidiary happens to be the highest contributor to the group performance over the years. However, due to the war in Ukraine, most of the resources have been diverted to the Asian countries operations with plan to equally exploit Africa markets. In view of this, Milton Nigeria Limited was incorporated in Nigeria in January 2021.

   Milton Nigeria Limited is the subsidiary of Milton Corporation. The company is into manufacturing of fast moving consumer goods and its operational base in Nigeria is located in Esa – Oke, Osun State. Milton Nigeria Limited commenced business in Nigeria in January 2021 and its financial year end is December 31, which is the same as its parent company, Milton Corporation in Japan.

   The first set of financial statements prepared by Milton Nigeria Limited was for the year ended December 31, 2021 and was audited by the Nigerian branch of a reputable audit firm in Japan.

   On September 15, 2022, Milton Nigeria Limited received a letter from the Federal Inland Revenue Service (FIRS) in Osun State requesting for the annual corporate tax returns of Milton Nigeria Limited. The General Manager of the company was surprised to receive such letter from the FIRS. He claimed that the company had paid personal income tax of its employees and directors, Value Added Tax on imported equipment and relevant custom duties. He argued further that, since the parent company is not

registered in Nigeria, there is no reason why it should be liable to corporate taxes in Nigeria.

The Managing Director of the subsidiary company in Nigeria, with the approval of the head office in Japan, appointed your firm as the company's tax consultant to help unravel the issue of payment of corporate taxes by resident and non-resident companies operating in Nigeria. He also submitted to your firm the statement of profit or loss for the year ended December 31, 2021 after conversion of the transactions in head office's Japanese currency (Yen) to Nigerian Naira.

	Japan	**Nigeria**	**Total**
	₦'000	**₦'000**	**₦'000**
Turnover	2,973,315	683,400	3,656,715
Miscellaneous income	46,813	10,660	57,473
Total income	3,020,128	694,060	3,714,188
Less: Direct cost of production	854,909	132,770	987,679
Gross profit	2,165,219	561,290	2,726,509
Expenses:			
Salaries and wages	404,110	141,708	545,818
Employer's contribution to pension	--	11,120	11,120
Electricity and rates	5,325	10,245	15,570
Legal expenses	15,600	5,460	21,060
Share of head office expenses	65,000	32,500	97,500
Depreciation	34,190	12,870	47,060
Allowance for doubtful debts	27,360	15,975	43,335
Income tax paid in Japan	83,820	--	83,820
Value Added Tax on essentials	--	3,750	3,750
Entertainment	3,360	4,760	8,120
Transport and travelling	16,320	2,144	18,464
Printing and stationery	23,655	3,960	27,615
Telephone, telex and postage	5,057	2,249	7,306
Motor vehicle running expenses	27,780	1,350	29,130
Foreign exchange loss provision	--	3,150	3,150
Debenture interests	--	1,800	1,800
Loss on revaluation of non-current assets	--	2,831	2,831
Repairs and maintenance	135,900	5,160	141,060
Audit and accountancy fees	14,700	--	14,700
Administrative expenses	175,140	62,440	237,580
Total expenses	1,037,317	323,472	1,360,789
Net profit	**1,127,902**	**237,818**	**1,365,720**

Your firm was presented with the following additional information for the Nigerian subsidiary:

(i) Miscellaneous income

This consists of income realised from sale of component parts to head office in Japan and the transaction was certified to have been made at open market price.

l expenses comprise:

	₦'000
:ollection	800
ıinary expenses	2,360
acquisition	1,550
ıership fee	750
	5,460

ʋance for doubtful debts are made up of:

	N'000
ance for doubtful debts	7,145
ic allowance for doubtful debts	5,300
ebts written off during the year	3,530
	15,975

irs and maintenance include:

	N'000
›vement to office building	3,250
rs of plant and machinery	1,910
	5,160

nistrative expenses include:

	N'000
fine	5,600
expenses	45,590
ription to Nigeria-Japan Trade Mission	5,250
ion of Japanese books to some public secondary schools in Osun	6,000
	62,440

dule of qualifying capital expenditure is as follows:

	of acquisition	**ınt**
		N'000
ץ building	ry 20, 2021	25,000
building	ry 25, 2021	17,000
and machinery	ary 23, 2021	28,000
vehicles	ı 18, 2021	15,120
ure and fittings	ry 17, 2021	14,700
equipment	ary 26, 2021	12,000

Required:

As the company's tax consultant, your firm is required to prepare a letter to the management of Milton Nigeria Limited, taking into consideration the tax implications of the following:

(a) Distinction between resident and non-resident companies (3 Marks)

(b) Relationship between a Nigerian branch and a foreign parent company (3 Marks)

(c) Relationship between a Nigerian subsidiary and the foreign parent company (3 Marks)

(d) Tax implications of overseas branch of a Nigerian company (3 Marks)

(e) Tax implications of overseas subsidiary of a Nigerian company (3 Marks)

(f) Circumstances under which profit of a non-resident company will be liable to tax in Nigeria (10 Marks)

(g) Advise on the corporate tax payable by the two businesses on their operations in Nigeria (if any) (15 Marks)

(Total 40 Marks)

SOLUTION TO QUESTION 1

February 14, 2023
The Managing Director
Milton Nigeria Limited
Plot 25, Esa Oke Industrial Layout
Agbata, Osun State

Dear Sir,

RE: TAXATION OF RESIDENT AND NON-RESIDENT COMPANIES IN NIGERIA

We refer to your email dated February 10, 2023 on the above subject matter, requesting us to unravel the issue of payment of corporate taxes by resident and non-resident companies operating in Nigeria.

Please find below the relevant information that will facilitate better understanding of the situation:

(a) Distinction between resident and non-resident companies

Resident company
A company is resident in Nigeria if it is incorporated or registered in Nigeria. This means that the taxpayer is liable to tax on the income or profits accruing in, derived from, brought into, or received in Nigeria.

A resident company is liable to tax in Nigeria based on its worldwide income or profits.

Non-resident company
This is a company that is not registered or incorporated in Nigeria, but which derives income or profits from Nigeria.

A non-resident company is liable to tax in Nigeria only on the profit or income deemed to be derived from Nigeria.

(b) Relationship between a Nigerian branch and a foreign parent company
No incorporation is required for a Nigerian branch of a foreign company in Nigeria. However, a Nigerian branch of a foreign company is treated as a corporate entity in Nigeria. Income or profits derived by such company in Nigeria is taxable in Nigeria.

The conditions under which such a Nigerian branch will not be liable to Nigerian tax are where:

(i) The branch of the foreign company is used solely for the storage or display of goods or merchandise; and

(ii) The branch is used for the collection of information.

(c) Nigerian subsidiary and a foreign parent company

(i) Under the Nigerian tax laws, the subsidiary of the foreign parent company must be incorporated in Nigeria and the income or profit is liable to tax in Nigeria.

(ii) The foreign equity participation may be 100% (wholly-owned) or less than 100% (partly owned), this will not affect the residence status in Nigeria.

(iii) Dividends distributed by the Nigerian subsidiary of the parent company are franked investment income and shall be exempted from tax in the hands of the parent company. The dividend will be subjected to withholding tax at the rate of 10%. However, if there is a double taxation agreement between Nigeria and the country where the parent company is located, the withholding tax will be deducted at the rate of 7.5% if specifically stated in the double taxation treaty between Nigeria and the country where the parent company is located.

(d) Tax implications of overseas branch of a Nigerian company

(i) For tax purposes, the profit of an overseas branch of a Nigerian company is deemed to be derived in Nigeria and is therefore fully liable to tax in Nigeria.

(ii) Assets in such a branch are eligible for capital allowances claim in Nigeria.

(iii) Losses incurred can be set off against profit in Nigeria provided such losses were incurred from the same source.

(iv) Double Taxation Relief is available for any foreign tax suffered.

(e) Tax implications of overseas subsidiary of a Nigerian company

(i) For tax purposes, the profit of an overseas subsidiary is not deemed to be derived in Nigeria and will therefore not be liable to tax in Nigeria.

(ii) It is only dividend received from such overseas subsidiary that will be considered for Nigerian tax purposes.

(iii) Technical and management fees paid to the Nigerian company by the overseas subsidiary will be subjected to tax in Nigeria.

(iv) Capital allowances will not be claimable on the property, plant and equipment of the overseas subsidiary.

(f) Circumstances under which a non-resident company will be liable to tax in Nigeria

The circumstances include the following:

(i) Fixed base of business/Sales outlet

If a non-resident company has a **"fixed base"** from which it carries on its business or trade in Nigeria, the profits from such activities would be deemed to be derived from Nigeria and liable to tax in Nigeria.

The term **"fixed base"** implies that the place must be easily identifiable and must possess some degree of permanence. It includes:

- facilities such as a factory, an office, a branch, a mine, gas or oil well, etc;
- activities such as building, construction, assembly, or installation; and
- furnishing of services in connection with the activities mentioned above.

However, two cases are specifically exempted and these include:

- facilities used solely for storage or display of goods or merchandise; and
- facilities used solely for the collection of information.

Where, however, a facility is so exempted but qualifies as a "sales outlet", it will be treated as a fixed base for the non-resident company. The profit arising from such a sales outlet is taxable.

(ii) Operation of a dependent agent

Where, however, a facility as so exempted but qualified as a "sales outlet" it will be treated as a fixed base for the non-resident company. The profit arising from such a sales outlet is taxable.

A non-resident company can have two types of agents in Nigeria – an independent agent or a dependent agent. An agent is regarded as possessing independent status when he acts on behalf of a non-resident company in the

ordinary course of his business. The status may however change if he devotes his activities wholly or almost wholly on behalf of the company.

Where a dependent agent makes an isolated sale of goods on behalf of a principal, that may not necessarily constitute the income from such an operation, the deemed profit is not liable to Nigerian tax. However, where the facts show that the sale of goods on behalf of the principal or of any company associated to it by the agent is on a regular pattern, this arrangement will conform with the intention of the term **"habitually"**.

(iii) Profits on a turnkey project

A turnkey project is defined as a "single contract involving survey, deliveries, installation or construction." The profit on a turnkey project is liable to tax in Nigeria. Such a profit should not be split between the so-called "Nigerian source" and "off-shore" profits but taxed wholly in Nigeria.

(iv) Transactions not at arm's length

The legislation allows the Board to make appropriate adjustment to the profits of Nigerian companies where:

- there is a controlling interest in the Nigerian company;
- the presence of a control of a Nigerian company may be exercised directly or indirectly by a parent company or any other company associated to it;
- the imposition of conditions in the financial and commercial relationship by the controlling interest;
- the conditions imposed must be different from what would obtain between independent parties or in an open market situation;
- Such relationship and conditions lead to the transfer of goods and services at prices not at arm's length; and
- the profits declared for the Nigerian tax are understated.

The 'imposition of conditions' or control and influence as mentioned above can move in various appearances like over-involving of goods and services, packaging of the terms of payment of interest on loans, frivolous charges for management fees, royalty, patent and rent, convenient shifting of profits between companies or in the allocation of expenses, all with the objective of minimising, avoiding or evading the Nigerian tax.

When the conditions analysed above hold, the profit deemed to be derived from Nigeria shall be as determined by the Board. In such circumstance, the Board will carry out comparative cost and price to establish the true market prices and make necessary adjustments to determine the true profit for tax purposes.

(v) Income derived by non-resident company from professional consultancy, management and technical services rendered in Nigeria.

(vi) Income derived by a non-resident company from investment, such as dividend, interest, rent and royalties. The withholding tax deducted from these incomes is taken as the final tax.

(vii) Income derived from a contract awarded to a Nigerian company, but subcontracted to a non-resident company.

(g) Computation of companies income tax payable by the Nigerian subsidiary

The companies income tax payable by the Nigerian subsidiary is ₦67,045,000 while the tertiary education tax is ₦6,914,000. In addition, the police trust fund levy to be paid is ₦12,000.

Please find attached Appendix 1, the detailed computations of tax liabilities and workings of capital allowances for your review and ease of reference.

The Japan operation is not liable to Nigerian tax, hence no computation of tax liabilities for the Japan operation.

If you need further clarification(s) on the foregoing, please do not hesitate to contact us.

We are pleased to be of service to your company.

Yours faithfully
For: ABC & Co (Chartered Tax Practitioners)

Danladi David
Managing Partner

Appendix 1

Milton Nigeria Limited

Computation of tax liabilities for 2022 year of assessment

	N'000	**N'000**
Net profit as per accounts		237,818
Add back: Disallowable expenses:		
Legal expenses - Preliminary expenses	2,360	
Legal expenses - Land Acquisition	1,550	
Allowance for doubtful debts (General provision)	7,145	
Repairs and Maint: Improvement to office Building	3,250	
Administrative expenses (court fine)	5,600	
Depreciation	12,870	
Foreign exchange loss provision	3,150	
Loss on revaluation of non-current assets	2,831	
		38,756
Adjusted profit/Assessable profit		276,574
Deduct: Capital allowances:		
Initial Allowance (working 1)	37,595	
Annual Allowance (working 1)	12,699	
Investment Allowance (working 1)	2,800	
Total Capital Allowance	53,094	
Absorbed/Relieved capital allowance	(53,094)	(53,094)
Unrelieved capital allowance carried forward	Nil	
Total profit		223,480
Companies income tax @30% of total profit		₦67,044,000.00
Tertiary Education tax @2.5% of assessable profit		₦6,914,350.00
Police trust fund levy 0.005% of Net profit		₦11,890.90

Workings							
(1) Capital allowances computation							
	Factory building	Office building	Plant & Machinery	Motor vehicle	Furniture Fittings	Office Equipment	Total Capital Allowance
Initial Allowance (IA) rate	15	15	50	50	25	50	
Annual Allowance (AA) rate	10	10	25	25	20	25	
	N'000	**N'000**	**N'000**	**N'000**	**N'000**	**N'000**	
2022 Year of Assessment							
Cost	25,000	17,400	28,000	15,120	14,700	12,000	
Initial Allowance (IA)	3,750	2,610	14,000	7,560	3,675	6,000	37,595
Annual Allowance (AA)	2,125	1,479	3,500	1,890	2,205	1,500	12,699
Investment Allowance			2,800				2,800
							53,094
2023 Year of Assessment							
Tax Written down value to 2023 YOA	19,125	13,311	10,500	5,670	8,820	4,500	
(2) Annual allowances for 2022 Year of Assessment in N'000							
Factory building	AA =		N25,000-N3,750)				
			10				
			N2,125				
Office building	AA=		N17,400-N2,610				
			10				
			N1,479				
Plant& machinery	AA=		N28,000-14,000				
			4				
			N3,500				
Motor vehicle	AA=		N15,120-N7,560				
			4				
			N1,890				
Furniture & fittings	AA=		N14,700-N3,675				
			5				
			N2,205				
Office equipment			N12,000-N6,000				
			4				
			N1,500				

2. The Income Tax (Transfer Pricing) Regulations, 2018, brought about some sweeping changes to the 2012 Regulations. The cumulative effects cut across all strata of business operations and finance, such that it has become mandatory, to a greater extent, for business owners to thoroughly appreciate and apply the provisions made by the prevailing regulations.

Required:
As a potential chartered tax practitioner, comment on the following:

(a) Clearly defined arm's length range (3 Marks)
(b) Capital-rich, low-function companies (3 Marks)
(c) Expanded scope of application and covered persons (3 Marks)
(d) Threshold for maintaining contemporaneous documentation (3 Marks)
(e) Redefined connected taxable persons (3 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 2

(a) **Clearly defined arm's length range**
It stipulates an **interquartile range** derived using a statistical approach as an appropriate arm's length range (ALR). The regulation empowers the FIRS to adjust financial indicators falling out of ALR to the most appropriate point in the arm's length range considering the facts and circumstances of the transactions.

(b) **Capital-rich, low-function companies**
Allocation of profits or losses associated with financial risks shall go to entities which manage those risks and have the capacity to bear them; while risk-free returns would be allocated to the funding entities which do not control or manage the financial risks. This is buttressing the fact that the higher the risk, the greater the reward.

(c) **Expanded scope of application and covered persons**
Permanent establishments (PEs) are now recognised as related party to a connected taxable person. Transactions between a PE, its head office and connected taxable persons (CTPs) are considered as controlled transactions.

(d) **Threshold for maintaining contemporaneous documentation**
Taxpayers whose total value of controlled transactions do not exceed N300 million may choose not to maintain contemporaneous documentation. However, whenever the Service so requests such taxpayers to submit TP Documentation, it must be done within 90 days from the date of receipt of a notice from the Service.

(e) **Redefined connected taxable persons (CTPs)**
Influential third parties are now seen as CTPs. Third parties who could exercise controls and influence a connected taxable person in making financial, commercial, or operational decisions are now recognized as related party with the reporting CTP.

3. The earning capacity of the Federal Government of Nigeria has been contracted in the recent years as a result of dwindling oil revenue and global economic crisis among others.

Various economic experts have suggested to the Federal Government of Nigeria the need to look into the areas of non-oil revenue with specific reference to taxation as means of resolving the revenue crisis among others.

The various recommendations by these experts, coupled with the compelling need to shore up the revenue base, informed the decision of the International Tax Division of the Federal Inland Revenue Service (FIRS) to write letters to several multinationals and group of companies in Nigeria reminding them of their obligations to file transfer pricing returns.

Pathway Nigeria Plc recently received one of such letters from FIRS and being a group of companies in Nigeria, the Chief Executive Officer was of the view that their group of companies may be in for a difficult time with the FIRS.

As the group's Tax Consultant, the Chief Executive Officer sent the letter received from the FIRS to your firm for review and advice.

Required:
Explain the following:

(a) The significance of Transfer Pricing (2 Marks)

(b) Three (3) objectives of the Income Tax (Transfer Pricing) Regulations, 2018 (3 Marks)

(c) The contents of the Transfer Pricing Disclosure Form to be submitted to FIRS (4 Marks)

(d) Describe briefly Three (3) of the transfer pricing methods (6 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 3

(a) Transfer prices at which goods and services are transferred between entities are significant for both taxpayers and tax authorities. This is so because they impact on the income and expenses as well as taxable profits of related companies in different tax jurisdictions in which the enterprise and multinationals operate. Many companies are interested in maximising their head office profits, hence they may adopt transfer pricing mechanism which boost the head office profits at the detriment of the associated or subsidiary companies which operate in other tax jurisdictions.

In other words, transfer pricing affects the profits on which the affected enterprises are subjected to tax. Since associated enterprises transact businesses among themselves, considerations other than market conditions sometimes dictate the prices at which goods and services are transferred within the group. This could result in the shifting of profit from the tax jurisdictions in which they arise to jurisdictions which are more convenient and beneficial to the head office or group company.

(b) The objectives of transfer pricing regulations are to:

(i) ensure that Nigeria is able to tax on an appropriate taxable basis corresponding to the economic activities deployed by taxable persons in Nigeria, including in their transactions and dealings with related persons;
(ii) provide the Nigerian authorities with the tools to fight tax evasion through over or under-pricing of controlled transactions between related persons;
(iii) reduce the risk of economic double taxation;
(iv) provide a level playing field for both multinational enterprises and independent enterprises carrying on business in Nigeria; and
(v) provide taxable persons with certainty of transfer pricing treatment in Nigeria.

(c) The following are the contents of Transfer Pricing Disclosure Form to be submitted to the FIRS:

(i) Particulars of reporting company or entity;
(ii) Income from controlled transactions;
(iii) Costs of controlled transactions;
(iv) Summary of controlled transactions with connected persons;
(v) Transfer pricing method and documentation;
(vi) Basic financial information for reporting entity and the group;
(vii) Particulars of the person making the disclosure; and
(viii) Declaration.

(d) Transfer pricing methods are:

(i) Comparable Uncontrolled Price Method (CUPM)

The comparable uncontrolled price method compares the price charged for transactions between associated enterprises (related parties) with prices charged for similar transactions between independent enterprises (unrelated parties) in comparable circumstances. If there is any difference between the two prices, this might be an indication that the transactions between the associated enterprises are not made at arm's length.

(ii) Resale Price Method (RPM)

The resale price method begins with the resale price to an independent enterprise of a product purchased from an associated enterprise and a gross margin is then deducted from this resale price.

(iii) Cost-Plus Method (CPM)

Under this approach, the costs incurred by the supplier in making the product transferred or services provided to an associated enterprise are ascertained and marked-up. An appropriate mark-up may be determined by reference to other enterprises - independent supplier earns in comparable transactions (internal comparable), or by reference to the mark-up earned in comparable transactions by entirely independent enterprises (external comparable).

(iv) Profit Split Method (PSM)

The first step is to determine the combined profit that arises from a business transaction in which the associated enterprises are engaged. This profit is then split between the associated enterprises in a manner that reflects the division of profit that would have been expected between independent enterprises. The combined profit or loss attributed to the transactions in which the associated enterprises participated is allocated to the associated enterprises in proportion to their respective contributions to that combined operating profit or loss.

(v) Transactional Net Margin Method (TNMM)

Under this method, the net profit margin that an enterprise earns from transactions with an associated enterprise is compared with the net profit margin earned in comparable transactions with an independent enterprise. An appropriate net margin may be determined by reference to the net margin that the enterprise earns in comparable transactions with independent enterprises (internal comparable), or by reference to the net margin earned in comparable transactions by independent enterprises (external comparable). The transactional net margin method operates in a manner similar to the cost plus and resale price methods. However, the transactional net margin examines the net profits in relation to an appropriate base (e.g. costs, sales, assets) and not gross margin on resale or mark-up on costs.

4. Base erosion and profit shifting (BEPS) is an advanced tax avoidance strategy usually adopted by multinational enterprises (MNEs). The Organisation for Economic Cooperation and Development (OECD) has identified certain actions against the menace of base erosion and profit shifting.

Required:
Explain any Five (5) actions against base erosion and profit shifting in line with OECD recommendations. **(15 Marks)**

SOLUTION TO QUESTION 4

The following are the actions against base erosion and profit shifting as recommended by Organisation for Economic Cooperation and Development (OECD):

(a) Limit base erosion via interest deductions and other financial payments

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

Transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. 3marks

(b) Counter harmful tax practices more effectively, taking into account transparency and substance

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.

(c) Prevent the artificial avoidance of permanent establishment (PE) status

Develop changes to the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.

(d) Prevent treaty abuse

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

(e) Address the tax challenges of the digital economy

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of value a tax or goods and services tax with respect to the cross-border supply of digital goods and services.

(f) Require taxpayers to disclose their aggressive tax planning arrangements

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be coordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.

(g) Make dispute resolution mechanisms more effective

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under Mutual Agreement Procedure (MAP), including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

(h) Re-examine transfer pricing documentation
Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that multinational enterprises (MNE's) provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

5. Mr Yan Yung is the Managing Director of Zinch Nigeria Limited, an organisation that recently commenced business in Nigeria. Zinch Nigeria Limited is a subsidiary of a company based in China. Mr Yan Yung recently attended a business meeting that involved some organisations affiliated to China and a discussion at the meeting that was strange to him was tax planning strategies.

As an experienced Tax Consultant, you have been invited by Mr. Yan Yung to make presentation to him on tax planning strategies to enable him have a better understanding of the matter.

Required
Write an advance letter to the Managing Director of Zinch Nigeria Limited on tax planning strategies which will form the basis of your discussion during your meeting with him. **(15 Marks)**

SOLUTION TO QUESTION 5

IGNATIUS EMODI & CO.
(Chartered Tax Practitioners)
10, Constitution Road, Kaduna

10 February 2023

The Managing Director,
Zinch Nigeria Limited,
55, Levis Street, Ikeja, Lagos

Dear Sir,

Attention: Mr. Yan Yung

RE: TAX PLANNING STRATEGIES

We refer to our telephone conversation of February 8, 2023 in respect of the above subject matter. In line with your request, we present below some information with a view to assisting you to have a better understanding of the tax planning strategies.

Tax planning

Tax planning involves anticipating a set of circumstances and the identification of opportunities to minimise or defer tax liabilities within the law. It involves arranging a company's affairs to ensure that the maximum allowances, exemptions and reliefs are enjoyed to pave way for payment of minimum possible tax.

Tax planning requires detailed knowledge of tax legislations and their applications to particular circumstances, identifying and taking advantage of loopholes, if any. It should also be noted that tax planning involves taking note of the applicable tax legislations, to ensure that the tax laws are properly complied with by the taxpayers, such that all taxes due are paid as and when due.

Tax planning check list

The following matters should be considered while planning tax strategies:

(a) List of approved taxes and levies due to federal, state and local governments;
(b) Timing of acquisition of property, plant and equipment (PPE);
(c) Timing of disposals of PPE in view of balancing adjustment;
(d) Timing of capital allowances claim and the amount to claim;
(e) Hire of assets as alternative to outright purchase- full hire charge is tax deductible;
(f) Where to invest e.g. fixed deposits Vs government bonds or treasury bills;
(g) Making specific instead of general provisions;
(h) PAYE properly deducted;
(i) Withholding tax properly deducted;
(j) Note critical dates such as:
    - (i) Filling of tax returns;
    - (ii) Filing of notice of objection;
    - (iii) Due dates of tax payment to avoid penalty and interest;
    - (iv) PAYE monthly remittance;
    - (v) PAYE year-end returns promptly filed;
    - (vi) Withholding tax remittance to Revenue;
    - (vii) VAT returns and remittance to Revenue;
    - (viii) National Pension fund contribution; and
    - (ix) National housing fund (NHF);
(k) In capital gains tax (CGT), consider roll-over relief;
(l) Consider current tax incentives:
    - (i) Pioneer companies;
    - (ii) Rural investment allowance;
    - (iii) Export processing zone allowance;
    - (iv) Export free zone exempted profit;
    - (v) Exempt profit of solid minerals mining;
    - (vi) Investment tax credit – spare parts fabrication and replacement of obsolete plants;
    - (vii) Hotel income exempted from tax;
    - (viii) Gas industry incentives;

(ix) Employment tax relief;
(x) Infrastructure tax relief;
(xi) Thin capitalisation;
(xii) Setting up subsidiaries or branches abroad;
(xiii) Investing in tax havens; and
(xiv) Investing in free trade zones.

(m) Consider income and profits exempted from tax as provided in the relevant sections of Companies Income Tax Act;
(n) Investment options-franked investment income; and
(o) Employees' remuneration: Structure of remuneration for lower effective tax rate, impact of benefits-in-kind on taxable remuneration; etc

It should be noted that tax planning is a right that taxpayers must exercise to reduce tax liability and improve profitability while fully complying with the provisions of the extant tax legislations to avoid penalties and further risks. Therefore, taxpayers (both corporate and individuals) should make sure they engage an experienced and trusted tax planning strategist/consultants to receive sound advice and guidance, and make informed decisions on how to protect themselves or company.

I implore you to go through the points stated above before our meeting which is scheduled to hold on February 13, 2023, at 10.00am to discuss the contents of this letter.

Whilst thanking you for the confidence reposed in us, we look forward to meeting your good self.

Yours faithfully,
For: IGNATIUS EMODI & CO. (Chartered Tax Practitioners)

Monday Ignatius
Managing Partner

6. (a) International organisations provide the platform for collaboration on tax matters, yet they are faced with challenges hindering the attainment of the stated objectives.

Required:
(i) State five (5) benefits of international organisations. (5 Marks)
(ii) State the challenges facing international organisations. (5 Marks)

(b) Explain briefly the concept of tax neutrality. (5 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 6

(a) (i) The benefits of international organisations in international taxation include:

- Facilitating negotiations;
- Implementing agreements;
- Resolving disputes;
- Offering technical assistance and developing rules;
- Mediating among States and to implement their decisions (neutrality);
- Ensuring impartiality: this suggests that neither party to a dispute is favoured; and
- Taking decisions for themselves that are binding on member States (independence).

(ii) The following are the challenges confronting international organisations:

(i) The structure and operations of these organisations;
(ii) The independence of these organisations;
(iii) The State can limit or extend their autonomy;
(iv) The State from time to time interferes in their activities;
(v) The State has 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.

(b) The concept of tax neutrality

A neutral tax is one that does not motivate taxpayers to change their behavior.

The primary purpose of a tax system is to raise the revenue needed to pay for government spending. As such, the goal is to raise this revenue without distorting the decisions that taxpayers would otherwise make for purely economic reasons.

Non-neutralities in the tax system lead taxpayers to devote more socially wasteful effort to transforming the form or substance of their activities to reduce their tax payments, for example, by hiring accountants to structure financial transactions in a manner that minimises tax liability.

Neutrality is an accepted standard for evaluating taxes. In several cases, the concept of neutrality provides a useful way to cut through some of the debates about tax policy and identify a more economically efficient way to organise a tax system.

Candidates are advised to prepare adequately for subsequent examination by reading the Institute's Pathfinders and relevant reference materials.

7. Thin capitalisation favours debt finance to equity finance within the capital structure of an organisation. It could be a deliberate action of multinational organisations as it takes advantage of charging interest expense to deplete the taxable income/profit of an organisation. To this end, the FIRS and the Revenue Service of other countries are at liberty to take measures to boost revenue and counter the tax avoidance effect of thin capitalisation.

Required:

(a) Explain "thin capitalisation". (3 Marks)

(b) Explain briefly the features of thin capitalisation. (5 Marks)

(c) Explain the implications of Finance Act, 2019 to thin capitalisation rule in Nigeria.

(7 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 7

(a) An entity is typically financed through a mixture of debt and equity. Thin capitalisation refers to a situation in which an entity is financed through a relatively high level of debt compared to equity and is therefore said to be highly geared or highly leveraged.

(b) In Nigeria, the problems of thin capitalisation usually arise between the Nigerian subsidiary and the holding company or between a multinational enterprise group and an associated recipient in Nigeria.

The foreign "mother" company office or the group lends loan to the Nigerian subsidiary or affiliate, as the case may be, and charges interest which is in excess of what would apply between unrelated persons operating on normal commercial basis. The excess interest can be regarded as "artificial or fictitious". The interest charged might arise from internal pricing method without intention of fraud and would be viewed as transfer pricing problem. In that case, only the excess interest will be disallowed. However, where the arrangement is fraudulent, the whole interest will be disallowed as a charge.

The problem of thin capitalisation can also feature between two Nigerian entities. This could arise, for instance, where the lending company is exempted under the domestic laws from tax on interests received. It, therefore, pays the company, tax – wise to invest heavily in debt finance rather than in equity finance.

(c) Prior to the Finance Act, 2019 there were no thin capitalisation rules in Nigeria. However, in practice, the Federal Inland Revenue Service (FIRS) sometimes seeks to disallow interest deductions considered excessive and in most cases the excess are arbitrarily determined.

The Finance Act, 2019 introduced a specific benchmark of thirty percent (30%) of earnings before interest, taxes, depreciation and amortization (EBITDA) as the limit for interest deduction on loans by a foreign 'connected person'. Any excess interest expense can only be carried forward for 5 subsequent years. The Finance Act, 2019 exempts Nigerian subsidiaries of foreign companies engaged in banking and insurance from this rule.

The benchmark introduced by the Finance Act, 2019 is consistent with the recommendation of the Organisation for Economic Cooperation and Development (OECD) through its Article 4 on base erosion and profit shifting (BEPS) project.

THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

APRIL 2023: PROFESSIONAL EXAMINATION

PTE II: FINANCIAL / TAX ANALYSIS

WEDNESDAY APRIL 19, 2023 **EXAM NO......................**

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS. **TIME: 3 HOURS**

1. According to Gowthorpe and Robins (2005), financial analysts need to use their judgement and experience when they interpret the results of financial statement analysis. It is not merely about calculating ratios and applying rules of thumb. The interpretation process is assisted by adopting an analytical framework, with the following main components:

a. Identification of the user of the analysis;
b. Understanding the nature of the business, industry and organisation, identification of relevant sources of data for analysis;
c. Numerical analysis of available data;
d. Interpretation of the results of the analysis;
e. Appreciating the limitations of the data and analysis; and
f. Communicating and reporting the analysis of the results and recommendations.

You are the Tax Controller of Lagos Area of the Revenue Authority in the country. You are required to present a paper in a training programme for the staff in your Area Office. Your paper is titled "The uses of analytical framework in interpreting and using financial statement analysis by the tax auditors".
To further help the staff, a session of the seminar is to be devoted for practical hand on experience of financial statement analysis. For this purpose, the financial statements of Democat Nigeria Plc. is attached for you to analyse using common size and ratios.

Required

a. Following the analytical framework above, prepare a paper with the above title that you will deliver at the training programme. (14 Marks)
b. Prepare a common size analysis of the attached financial statements and comment briefly on the results. (16 Marks)
c. Prepare ten ratios under the following major group of ratios:
   i. Profitability;

ii. Liquidity; and
iii. Efficiency.

You must provide at least three ratios under each group. (10Marks)

Appendix

Democat Nigeria Plc is a company dealing with distribution of household commodities. The company's financial statements for the year to December 31, 2022 are as follows:

Democat Nigeria Plc

Statement of comprehensive income for the year to December 31, 2022

	₦'m
Sales Revenue	2,500
Cost of Sales	1,840
Gross profit	660
Operating expenses	(190)
Profit before interest and tax	470
Interest payable	(40)
Profit before taxation	430
Taxation	(125)
Profit after tax	**305**

Statement of financial position as at December 31, 2022

		₦'m
Assets		
Non – current assets		
Property, plant and equipment		865
Current assets		
Inventories (2021, ₦ 345m)	370	
Trade receivables	410	
Short term deposit	50	
Cash in bank and in hand	280	1.110
		1,975
Equity		
Ordinary shares of ₦1	500	
Retained earnings	490	
		990
Non – current liabilities:		

Long term loan		400
Current liabilities		
Trade payables	460	
Taxation	125	585
		1,975

Notes:

a. Ordinary shares dividends of ₦165m were paid during the year to December 31, 2022; and
b. The market price of the company's ordinary shares was 350kobo per share on December 31, 2021.

Solution to Question One

a.

The Uses of Analytical Framework in Interpreting and Using Financial Statements Analysis by Tax Auditors

Tax auditors normally use analytical procedures to understand important details about the financial statements submitted by taxpayers along with other documents for tax purposes. Analytical procedures on financial statements includes calculation of ratios from the financial statements, common size statements and other financial statement analysis tools. This may involve comparison with other previous years of the same company's financial statements or with other companies in the same industry. However, the most important part of the analysis is interpreting the analysis to draw reasonable conclusions which will be used to determine whether the company is evading or avoiding tax as the case may be.
To be able to carry out effective financial statements analysis, the following framework has been recommended:

Users of financial statement analysis: Financial statements analysis is used to understand the current financial position of a company and its prospects for the future. There is a wide range of external user groups that may be interested in an entity's financial statements, in addition to existing and potential investors. Some of these include existing or potential lenders, suppliers and other creditors, employees, customers, governments and the public.
Although the various user groups will almost always use general purpose financial reports, their needs will differ. It is important that any analysis and interpretation exercise is tailored to the needs of the user.

Understanding the business and industry: To interpret the calculations, it is important to understand the relationship between the data and the underlying economic (and other reasons) for the company's current position. For example, the history, operating characteristics, management composition and attitude to risks of the business will help to explain its current position and future outlook. Comparisons of the results of the analysis against the industry can be very useful.
Therefore, it is important to identify industry characteristics and to establish benchmarks against which to compare position and performance.

Identification of data sources: The most obvious source of financial and non-financial information is a company's annual report. The annual report provides information that is required by law and by accounting standards. The report also usually provides further voluntary disclosures that may be helpful. Other sources of information include:
• interim announcements;
• analyst/broker reports;
• media announcements;
• company web page;
• specialist and industry groups; and
• corporate social responsibility reports.

Numerical analysis of data: Users are primarily interested in two areas:
- the company's performance; and
- the company's current financial position.

Preparers of financial statement analyses in this area will concentrate on the following key areas:
- Performance: This includes calculating profitability, activity and return on capital ratios, and studying movements in revenue;
- Liquidity: This includes calculating short-term liquidity ratios, analysing working capital and the cash position;
- Capital structure and long-term solvency: A company's ability to generate future revenues and meet long-term obligations. The effectiveness of the company's capital structure can also be analysed;
- Valuations and investor related: This area examines a range of ratios to value the company at specific dates in time for investment purposes. It looks at growth potential and the ability to generate future wealth and earnings for investors; and
- Cash flow: A company's cash flow is arguably the most important indicator of the financial health of a company. The three main totals on a cash flow statement (per IAS 7) can be examined: cash flows from operating activities, investing activities, and financing activities.
- In addition, various ratios can also be calculated. In these areas of analysis, a combination of studying movements in absolute numbers and the calculation of ratios is used to understand a company's performance, its current financial position and prospects for the future.

Interpretation of the results: An analysis should include, but not restricted itself, to the following:
- Time series analysis. Determining trends against past years or periods by examining year on year changes. Numbers should be presented both in absolute terms and in percentages;
- Comparing actual versus forecast results can assess the accuracy of forecasts and assist with future planning and can highlight areas for investigation; and
- Industrial or cross sectional analysis. Comparing with other companies within the same industry in the same year or to industry averages. By benchmarking a company's results against its peers, a company can determine if it is above or below average for its industry. It can then work to address weaknesses or to exploit strengths.

  Consideration should also be given to the company's accounting policies and style.

Appreciating the limitations of the data and analysis: A substantial limitation of financial statements is found in paragraph 13 in the IASB's Framework for the Preparation of Financial Statements (July 1989):

'Financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.'

Other limitations:

- **Timeliness:** When analysing financial statements, caution should be exercised, and additional information sought regarding post year end events. This is due to the delay between when financial statements are prepared and received (and therefore analysed by users).
- **Comparability:** The usefulness and accuracy of comparisons may become impaired over time. This is due to significant business changes, price inflation and changes in accounting policy and practices over the longer period. Complex businesses, for example, those operating in more than one business sector, may find comparisons with industry averages or with other companies difficulty.
- **International issues:** Different tax regimes, legal and regulatory regimes and differences in economic statistics (such as exchange rates and interest rates) must be considered when interpreting results.
- **Reporting of results:** How results are reported will depend on the end user of the information. The content should be tailored to the individual needs of the end user.

Communicating and reporting the results of the analysis: The final step in the analytical framework for financial statement analysis is communicating the results and recommendations to decision makers. A concise and understandable format using simple charts and graphs is an effective way to summarise and illustrate key messages.

b. Common size statements

Statements of comprehensive income

	2015
	%
Sales Revenue	100.0
Cost of sales	73.6
Gross profit	26.4
Operating expenses	7.6
Profit before interest and tax	18.8
Interest payable	1.6
Profit before taxation	17.2
Taxation	5.0
Profit after tax	**12.2**

Statement of financial position

	2015 %
Assets	
Non – current assets	
Property, plant and equipment	43.8
Current assets	
Inventories	18.7
Trade receivables	20.8
Short term deposit	2.5
Cash at bank and in hand	14.2
Total non – current assets	56.2
Total assets	**100.0**
Equity:	
Ordinary shares of ₦ 1	25.3
Retained earnings	24.8
	50.1
Liabilities:	
Non – current liabilities:	
Long term loans	20.3
Current liabilities:	
Trade payables	23.3
Taxation	6.3
Total non- current liabilities	29.6
Equity and liabilities	**100.0**

Comments on the common size

Common size analysis helps us to understand the impact of each item in the financial statements and its contribution to the resulting figure.

From the income statement, it is observed that 12.2% of the revenue translated to profit after tax.

Tax was 5.0% of the revenue.

Cost of sale is very high, 73.6% of revenue, while operating expenses of 7.6% of revenue is good.

From the statement of financial position, it could be seen that the company was equally financed with equity and debts.

Also, retained earnings was approximately 100% of the issued shares

However, there is no comparative figures that will help us evaluate the performance with the previous years. Also there were no industry average to enable us appraise the figure effectively

c. Accounting ratios

Profitability

Return on capital employed: $\frac{470}{1,390} \times 100$ (2022)

= 33.8%

Return on equity: $\frac{305}{990} \times 100$

= 30.8%

Gross profit margin: $\frac{660}{2,500} \times 100$

= 26.4%

Position
Liquidity:

Current ratio = $\frac{1,110}{585}$ (2022)

= 1.9:1

Quick assets ratio = $\frac{1,110 - 370}{585}$

= 1.26:1

Absolute liquid ratio = $\frac{280 + 50}{585}$

= 0.56:1

Efficiency

Asset turnover = $\frac{2,500}{1,390}$ (2015)

= 1.80

Inventory holding period = $\frac{357.5}{1,840} \times 365$

= 71days

Receivables collection period = $\frac{410}{2,500} \times 365$

= 60days

Payable payment period = $\frac{460}{1,840} \times 365$

= 91days

Long – term solvency

Capital gearing ratio = $\frac{400}{1,390}$ X 100% (2015)

= 28.8%

Debt – equity ratio = $\frac{400}{990}$ X 100%

= 40.4%

Interest cover = $\frac{470}{40}$

= 12times

2. One of the essential requirements to assess whether a company is able to pay an appropriate tax continually is the type of accounting information system being operated by the company. This is because the quality of the financial statements, which form the basis for determining the tax liability, depends on the accounting information system in place in the company. It is the accounting information system that will help the company to adequately capture the three groups of business cash flow activities of the company. The financial statements prepared from these financial activities at the end of the year must have certain qualitative characteristics.

Required

a. Discuss the qualitative characteristics of financial information as specified by the conceptual framework for the preparation of financial statements. (71/2 Marks)

b. Discuss the three (3) business cash flow activities groups and give two examples for each group. (71/2 Marks)

Total (15 Marks)

Solution to Question Two

a. The qualitative characteristics of financial information are:

Appropriateness: Appropriateness means the efficiency of financial statements and reports, and their success in serving their users through their ability to provide adequate and appropriate information to make appropriate decisions, so that this information is recognised for being suitable for decision-making and is presented properly and timely.

Reliability: Reliability is associated with the information integrity and the ability to rely on it. Accounting information is characterised as being reliable or can be relied on if it has

the ability to express the veracity of the information, to be free from error and bias, and to represent it fairly and honestly.

Consistency: This characteristic is realised when the company uses the same accounting treatment for the same event from one period to another without any change. This characteristic allows for easy comparison of organisational performance over a period of time

Understandability: it is a qualitative accounting information characteristic that helps a prudent wise user to identify the meaning and importance of financial reporting.

Comparability: This characteristic enables users of financial reports to identify similarities and differences between economic phenomena and events. The use of an incomparable accounting standard results in increased differences in the expression of economic phenomena and events.

The above stated qualitative characteristics are basic elements that can make financial statements useful for the users of financial statements in making good decisions with them**.**

b. Business activities consist of operating, financing and investing activities for financial reporting purposes. These three groups of activities are necessary for the achievement of 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 the sale of meals by a restaurant, the provision of services by a consulting firm, the manufacture and sale of goods by a manufacturing company and taking deposits and granting loans by a bank.

Investing activities: These are activities associated with acquisition and disposal of long- term assets. Examples include the purchase of equipment or sale of equipment (such as unserviceable equipment) by a construction company, however, the sale of equipment by equipment supplying company would be an operating activity.

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

Examiner's Report

The question is in two parts. Part (a) tests the candidates' knowledge on the qualitative characteristics of financial information while part (b) tests candidates' knowledge on business cash flow activities group. The question was well understood by the candidates and majority attempted the question.

The candidates' performance were above average. However, few candidates were not able to explain very well the characteristic of financial information and cash flow business activities group.

Candidates are advised to prepare well for the examination in order to improve their performance in future examination.

3. Mergers and acquisition are realities of managing business for survival and growth. However, mergers and acquisition have tax implications that must be considered in all talks of mergers and acquisition.

Required:

a. Discuss tax compliance issues that are associated with mergers and acquisitions. (9 Marks)

b. In carrying out tax due diligence in mergers and acquisitions, what are the specific questions to ask? (6 Marks)

Total (15 Marks)

Solution to Question Three

a. Compliance issues in mergers and acquisitions are:

i. 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 filling 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.

ii. 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 tax 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.

iii. Common risk areas are transaction taxes such as VAT and withholding tax where compliance is generally low or sometimes overlooked by taxpayers. In group situations, transaction taxes on inter-company transactions 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.

iv. The motives of a business combination and the risk appetite of the investor will usually drive the focus and approach of the due diligence exercise. An investor who is willing to take on the liabilities of the target would generally prefer an asset deal to share deal. In some cases, however, an asset deal may not totally shield an acquirer from the tax liabilities of the target. For instance, under the PPT Act, the tax authority is empowered to recover tax liabilities relating to assets transferred from the acquirer if in its view the transaction was consummated for the purpose of avoiding tax.

v. 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 to the acquisition.

b. When carrying out a tax due diligence on the proposed target, specific questions to ask are:

i. What is the target's level of tax compliance with respect to companies' income tax (CIT), tertiary education tax (TET), capital gains tax (CGT), information technology levy and payroll related tax?

ii. What are the available tax assets (e.g. unrelieved 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. filling 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?

4. a. Explain six (6) methods of creative accounting and management bias (9 Marks)
b. Explain four (4) main types profitability ratios. (6 Marks)

(TOTAL 15 MARKS)

Solution to Question Four

4(a) Creative accounting and management bias: Due to intentional bias of management, the financial statements can be manipulated by management, while still complying with the relevant accounting standards, through creative accounting. Some of the methods commonly used are:

(i) **Window dressing:** An entity enters into a transaction just before the year end and reverses the transaction just after the year end. For example, goods are sold on the understanding that they will be returned immediately after the year end; this appears to improve profits and liquidity. Cheques are issued to pay off overdraft or bank loans at the end of the year and immediately after the end of the year the cheque is reversed. The only reason for these transactions is to artificially improve the view given by the financial statements;

(ii) **Off statement of financial position finance:** Transactions are deliberately arranged so as to enable an entity to keep significant assets and particularly liabilities out of the statement of financial position. This improves gearing and return on capital employed. Examples include sale and repurchase agreements and some forms of leasing;

(iii) **Changes to accounting policies or accounting estimates:** For example, an entity can revalue assets (change from the cost model to the revaluation model) to improve gearing or change the way in which it depreciates assets to improve profits;

(iv) **Profit smoothing:** Manipulating reported profits by recognising (usually) artificial assets or liabilities and releasing them to profit or loss as required;

(v) **Aggressive earnings management:** Artificially improving earnings and profits by recognising sales revenue before it has been earned;

(vi) **Capitalising expenses:** Recognising 'assets' which do not meet the definition in the IASB Conceptual Framework or the recognition criteria. Examples include, human resources, advertising expenditure and internally generated brand names; and

(vii) **Big Bath Accounting**: Big Bath in accounting is an earnings management technique whereby a one-time charge is taken against income in order to reduce assets, which results in lower expenses in the future. This will result in a lower profit for the year.

4(b) **Profitability ratios**

The main profitability ratios are:

- Return on capital employed;
- Return on equity;
- Gross profit margin; and
- Net profit margin.

Return on capital employed (ROCE)

This ratio expresses a business entity's profit as a percentage of the amount of capital invested in the entity. Its common definition is:

$$ROCE = \frac{\text{Profit before long term loan interest and tax (PBIT)}}{\text{Share capital and reserves plus non-current liabilities}} \times 100$$

It could also be expressed as: $\frac{\text{PBIT}}{\text{Net Assets}}$

Where net assets mean total assets less current liabilities.

This ratio (ROCE) can also be broken down into subsidiary components as follows:

$$ROCE = \frac{\text{PBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Net assets}}$$

Return on equity (ROE)

It is a variation of ROCE, but it concentrates on the entity's equity holders and compares the equity capital with the amount of profit which can be attributed to them. The ratio is calculated as follows:

$$ROE = \frac{\text{Profit after interest, tax and preference dividend}}{\text{Ordinary shares capital plus reserves}} \times \frac{100}{1}$$

Gross profit margin

This ratio expresses the entity's gross profit as a percentage of sales revenue and is also known as gross profit percentage. It is simply calculated as:

Gross profit margin = $\frac{\text{Gross profit}}{\text{Sales}} \times \frac{100}{1}$

Net profit margin

It expresses the entity's net profit as a percentage of sales revenue. It is calculated as:

Net profit margin = $\frac{\text{Net profit}}{\text{Sales}} \times \frac{100}{1}$

5. Every accounting system have five specific financial statements elements, from which accounting equations can be derived.

Required:

a. List the five (5) elements of the financial statement and give two examples under each. (71/2 Marks)
b. Derive five (5) accounting equations from the five elements above and briefly explain the meaning of each. (71/2 Marks)

TOTAL (15 MARKS)

Solution to question Five

a. Five elements of the financial statements

Within the financial statement elements, accounts are sub classifications. Accounts are specific individual records of increases and decreases.

i. Asset – These are items that are used to generate revenue, e. g., plants and machinery, Building, Inventory, Cash, etc;
ii. Liability – These are other people's claims in the business assets, e. g., Loans, Overdraft, Payables, etc.;
iii. Component of owners' equity- These are the owners' claim in the assets of the business, e.g., Ordinary shares, Preference shares, Revenue reserves, etc.;
iv. Revenue- These are income generated from the business assets, e.g., sales revenue, other incomes; and
v. Expense – These are incurred in the process of generating income, e.g., Purchases, Wages, Advertising, etc.

b. Accounting equations

The five financial statement elements in part (a) serve as the inputs for equations that underlie the preparation of financial statements. This section describes the equations for three of the financial statements: statement of financial position, income statement, and statement of retained earnings. The statement of financial position presents a company's financial position at a particular point in time. It provides a listing of a company's assets and the claims on those assets (liabilities and equity claims). The equation that underlies

the statement of financial position is also known as the "basic accounting equation." A company's financial position is reflected using the following equation:

i. Assets = Liabilities + Owners' equity;
ii. Assets – Liabilities = Owners' equity;
iii. Owners' equity = Contributed capital + Retained earnings;
iv. Total assets = Non-current assets + current assets;
v. Working capital = Current assets – Current liabilities;
vi. Debt = Long-term liabilities + Current liabilities;
vii. Revenue – Expenses = Net income (loss); and
viii. Revenue – Cost of sales = Gross profit.

6. Business organisation could be a sole proprietorship, ordinary partnership, limited partnership, private limited liability company and a public limited liability company. Each businessman must decide which type of business organisation he wants to form.

Required:

a. Identify seven (7) factors a businessman will consider before deciding on which type of business organisation to register. (7 Marks).
b. What are the tax implications of each of the business organisations identified above. (6 Marks)
c. How can a sole proprietorship apply shifting as a form of tax planning strategy? (2 Marks)

Total (15 Marks)

Solution to Question Six

a. The type of business choice will depend on the nature of business, the goals of the business and other factors, including taxation. Therefore, in making a choice, you will want to consider the following:
   i. Your vision regarding the size and nature of your business;
   ii. The level of control you wish to have;
   iii. The level of "structure" you are willing to deal with;
   iv. The business's vulnerability to lawsuits;
   v. Tax implications of the different organisational structures;
   vi. Expected profit (or loss) of the business;
   vii. Whether or not you need to re-invest earnings into the business; and
   viii. Your need for access to cash out of the business for yourself.

b. The tax implications of the various business forms are:

   Sole Proprietorship

   i. No double taxation. .
   ii. Income reported on personal income tax return.

iii. Tax rate is low since it is assessed on personal income basis with maximum rate of 24%.

Partnership

i. No double taxation
ii. All income is taxed proportionately to each of the partners who report it on their personal tax returns.
iii. Tax rate as in sole proprietorship.

Company (Private and Public)

Double taxation since profit is taxed at company level and dividends to shareholder is also subject to WHT at 10%.

c. Sole trader, as a form of tax planning, can shift part of his profit to salary and pension payable to himself, provided it is reasonable. The maximum tax rate for salaries is 24%, whereas, if the turnover of the sole trader is more that ₦25m, the tax rate will be at least 30% of profit.

7. Today we are operating in a global market. Therefore, many entrepreneurial and growing companies are considering international expansion as a marketing and growth strategy.

Required:

a. State eight (8) advantages of operating an international business. (8 Marks).
b. State seven (7) disadvantages of operating in the international market. (7 Marks)

Total (15 Marks)

Solution to Question Seven

Today, many entrepreneurial and growing companies are considering international expansions as a marketing and growth strategy. Some advantages and disadvantages of international business are:

a. Advantages of operating an international business are:

i. Enhance domestic competitiveness;
ii. Increase sales and profits;
iii. Gain global market shares;
iv. Reduce dependence on existing market;
v. Exploit international trade technology;
vi. Extend sales potential for business expansion;
vii. Stabilise seasonal market fluctuations;
viii. Enhance potential expansion of business;
ix. Utilise excess production capacity; and
x. Maintenance of cost competitiveness in domestic market.

b. Disadvantages of operating in the international market are:

i. Need to wait for a long-term gain;
ii. Need to hire staff to lunch international trading;
iii. Need to modify production or packaging;
iv. Need to develop new promotional materials;
v. Frequent travelling by personnel;
vi. Payments may take longtime;
vii. Need for additional financing;
viii. Special licenses and regulations; and
xi. Need to set up specialised conferencing and communication tools.

THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

APRIL 2023: PROFESSIONAL EXAMINATION

PTE II: INCOME TAX FOR SPECIALIZED BUSINESS

WEDNESDAY APRIL 19, 2023 **EXAM NO..................**

ATTEMPT QUESTION ONE AND ANY OTHER FOUR QUESTIONS.

SHOW ALL WORKINGS. **TIME: 3 HOURS**

1 (a). DeSantis Life Assurance Company Plc is an insurance company incorporated in 2001. The company offers life policy cover to its numerous customers all over Nigeria. The financial statements of the company for year ended December 31, 2021 showed the following results:

	₦	₦
Premium received		580,400,000
Premium returned on policies cancelled		(48,200,000)
Net premium received		532,200,000
Claims expenses		(350,000,000)
		182,200,000
Investment income	135,800,000	
Commission and fee income	38,000,000	
Miscellaneous income	8,500,000	182,300,000
Gross income		364,500,000

Less:			
Salaries and wages	72,500,000		
Rent	35,000,000		
Repairs and maintenance	8,500,000		
Hotel and accommodation	15,800,000		
Depreciation		45,900,000	
Other administrative expenses		28,000,000	(205,700,000)
Net profit			158,800,000

Additional information:

(a) ₦4,200,000 distributed by the company as surplus arose from actuarial revaluation of life fund.

(b) Net liability on life policies as at December 31, 2021, was ₦585,200.

(c) Capital allowances agreed with the relevant tax authority was ₦15,620,000 while capital allowance brought forward from 2020 was ₦13,800,000.

(d) The balance of the life fund account as at December 31, 2021, was ₦1,600,000.

(e) The minimum authorised capital of the company is ₦1,800,000.

(f) The company's special reserve and general reserve as at December 31, 2021 were ₦1,400,000 and ₦850,000, respectively.

(g) The net liabilities on policies in force at time of actuarial valuation was ₦1,940,000.

(h) Included in other administrative expenses was a penalty of ₦3,250,000 paid to NAICOM for certain infractions by the company.

Required:

Compute the income tax liability payable in Nigeria, taking into consideration the provisions of the relevant Finance Acts. **(25 marks)**

(b) Mr. James Akpota is the Managing Director of XYZ Insurance Plc. He was worried that the key changes introduced by the Finance Acts relating to the taxation of insurance companies, could adversely affect the company's tax liabilities.

As the company's tax consultant, you were invited to a board meeting with a view to explaining to the directors the tax implications of these changes.

Required:

Discuss the following:

i) Gross premium and gross income (4 Marks)

ii) Minimum tax payable (4 Marks)

iii) Additional information to be filed by an insurance business (7 Marks)

(Total 40 Marks)

SOLUTION TO QUESTION 1

(A) DESANTIS LIFE ASSURANCE COMPANY PLC
COMPUTATION OF COMPANY'S TAX LIABILITY FOR 2022 TAX YEAR

	₦	₦	₦
Investment income			135,800,000
Add:			
Commission & fee income			38,000,000
Miscellaneous income		8,500,000	
Surplus on actuarial revaluation distributed		4,200,000	
Gross income			186,500,000
Deduct:			
i. General reserves	850,000		
Add: life fund account	1,600,000		
2,450,000			
Restricted to amount equal to net liabilities on policies in force at time of actuarial valuation	1,940,000	1,940,000	
ii Special reserves			
The higher of:			
1% of gross premium			
(1% x ₦580,400,000); or	5,804,000		

10% of net profit (10% x ₦158,800,000)	15,880,000	15,880,000		
All allowable business expenses:				
Salaries and wages	72,500,000			
Rent	35,000,000			
Repairs and maintenance	8,500,000			
Hotel and accommodation	15,800,000			
Other administrative expenses (₦28,000,000 – ₦3,250,000)	24,750,000	156,550,000	(174,370,000)	
Assessable profit				**12,130,000**
Less:				
Capital allowance:				
Balance B/F		13,800,000		
For the year		15,620,000		
Total capital allowance	29,420,000			
Relief restricted to 66 2/3 % of Assessable profit:(66 2/3% x ₦12,130,000)	(8,086,667)			(8,086,667)
Capital allowance C/F	21,333,333			
Total profit				**4,043,333**
Tax payable shall be the higher of:				
Tax @ 30% of total profit (30% x ₦4,043,333)			1,212,999.90	1,212,999.90
OR				
Tax @ 0.5% of gross income (0.5% x ₦186,500,000)			932,500	
Tertiary education tax @ 2½% of assessable profit				303,250

b. i. Gross premium is in respect of a non-life insurance, means the total premiums written received and receivable excluding unearned premium and premiums returned to the insured.

Gross income in respect of a life assurance business is the total income earned, including all investment income (excluding franked investment income), fees, commission and income from other assets but excluding premiums received and claims paid by reinsurers.

Gross income many also include other incomes, such as annuities, commission received, rent, as well as surplus arriving from actuarial revaluation of reserve for the unexpired risk account or life fund account transferred to profit or loss account for distribution.

ii. Minimum tax payable

section 16(14) of CITA (as amended), provides that the tax payable by any insurance company for any year of assessment shall not be less than:

- 0.5% of the gross turnover which means gross income and other income for non-life insurance business; and
- 0.5% of gross income for life insurance business, provided that all applicable minimum tax under this section shall be reduced to 0.25% for tax returns

prepared and filed for any two accounting periods between January 1, 2019 and December 31, 2021, as may be chosen by the taxpayer.

iii. Additional information to be filed by an insurance business.
Based on section 16(13) of CITA (as amended), an insurance company that engaged the services of an insurance agent, a loss adjuster and an insurance broker shall include in its tax returns, a schedule showing the names and addresses of insurance agent, a loss adjuster and an insurance broker, the date their services where employed and terminated (as applicable) and payments made to each of such agent, loss adjuster and insurance broker for the period covered by the tax returns.

An insurance company is expected to maintain the details and schedule of policies and risks accepted in a given year and the computation of unexpired risks associated with them. The schedule should comprise the name of the policy holder, type of policy, period of policy, amount of the premium and expired risk computed therefrom.

A schedule detailing the specific items making up the estimated amount of outstanding claims and outgoings shall be prepared by insurance companies.

Insurance companies shall maintain a schedule of estimated claims and outgoings that constitute the amount deducted every year.

In line with the provisions of section 16(5) of CITA (as amended), not more than three months after an actuarial revaluation of unexpired risks or any other revaluation has taken place, the company shall provide the service with full particulars of revaluation carried out, including a copy of the actuary's revaluation certificate.

2. (a). The Nigeria solid mineral sector has for a very long time been touted as the next big revenue earner for the government of the Federation. The sector is anticipated to take over from the oil and gas sector which is currently experiencing slow growth due to planned movement from fossil fuel to green energy because of the need to protect the earth and natural habitats.

It is believed that Nigeria has over forty types of minerals and they include iron ore, silver, granite, gold, lithium, marble, gemstones, gypsum, talc, coal, lead, uranium, etc. However, the sector is not performing at its optimum due to certain challenges faced by the sector, such as illegal mining, inadequate infrastructure, and other community challenges. These challenges essentially deterred potential investors from investing their resources in the sector.

The Federal Government has recently earmarked the solid mineral sector as a key source of revenue diversification and economic development for the country.

Required:

Explain the requirements and procedure for obtaining a mining license, and the requirements for granting a mining lease. (10 marks)

(b). There are a variety of incentives available to companies operating in the mining sector.

Required:

Explain five incentives available for companies operating in the mining sector.

(5 marks)

(Total 15 Marks)

SOLUTION TO QUESTION 2

(a) (i) The following are the requirements and procedure for granting mining license:
The company will first applies to the Honourable Minister in charge of the Ministry of Mines and Steel Development for Certificate of Entry into Mining Industry. The requirements for this include:

* Payment of the prescribed fees;
* Submission of the company's Certificate of Registration;
* Evidence of technical competence; and
* Evidence of financial capability.

The next step is for the company to apply for and obtain a Prospecting Right (PR) to enable it to carry out general and scientific prospecting for the categories of minerals within the prospecting right. If properly conducted, work on this right will guide the company towards zeroing into a particular mineral within a specific land area.

The company will then put up an application for an exclusive prospecting license (EPL) in the State Mines Office where the mineral is located. Once granted, the area is held exclusively by the company,

(ii) Requirements for grant of mining lease in Nigeria include the submission of:

- Exploration License;
- Certified true copy of company certificate and other incorporation documents;
- Completed application forms;
- Pre-Feasibility Report;
- Prospecting plan;
- Payment of processing fee;
- Evidence of financial capability;
- Evidence of technical competence or COMEG accredited geologist;
- Irrevocable consent from the landowner(s) and/or occupier(s) to the applicant; and
- Attestation of non-conviction of criminal offences under the Act by a Lawyer.

(b) The incentives available to companies engaged in mining operations include:

(i) Tax holiday for an initial period of 3 years from commencement of operations and renewable for additional 2 years. Any dividend recorded during the tax holiday period will not be subject to withholding tax upon distribution to shareholders;

(ii) Exporters of mineral products may be permitted to retain part of their foreign exchange earning in a domiciliary account for the purpose of acquiring spare parts and other mining inputs;

(iii) Exemption from customs and import duties in respect of plant, machinery, equipment and accessories imported exclusively for mining operations. However, the plant and

equipment can only be disposed of locally upon payment of the applicable customs and import duties;

(iv) Free transferability of foreign currency through the Central Bank of Nigeria (CBN) for the following:
- Payment for servicing of certified foreign loan; and
- Remittance of foreign capital in event of sale or liquidation of the business.

(v) Grant of personal remittance quota for expatriate personnel free from any tax imposed by any enactment for the transfer of external currency out of Nigeria;

(vi) Accelerated capital allowance on mining expenditure (95% initial allowance and retention of 5% until asset is disposed);

(vii) Grant of investment allowance of 10% on qualifying plant and machinery;

(viii) All infrastructure cost provided by the mining company and approved by the MCO to be capitalised and capital allowance claimed at 95% in the first year of operation;

(ix) A company may also be entitled to claim an additional rural investment allowance on its infrastructure cost, depending on the location of the company and the type of infrastructure provided;

(x) Annual indexation of unutilised capital allowance carried forward by 5% for mines that commenced production within five (5) years from the date of enactment of the Act. Whilst the period for new companies to enjoy this incentive lapsed in 2012, new producers may apply to the Minister of Finance, through the Minister of Mines and Steel Development, to enjoy this incentive. Such application may be considered on a case-by-case basis;

(xi) The Minister may grant a concession for the royalty payable on any mineral to be deferred for a number of years, subject to the approval of the Federal Executive Council; and

(xii) Actual amount incurred out of reserves made for environmental protection, mine rehabilitation, reclamation and mine closure cost shall be tax deductible subject to certification.

3. Excellent Farms Nigeria Limited is an agricultural company that engages in both farming, poultry and cattle ranching business. The company has been in business for over fifteen years and has been profitable over the years. The audited financial statements of the company for the year ended December 31, 2022, revealed the following results:

	₦	₦
Revenue:		
Sale of cassava and other crops		22,500,000
Sale of cattle and farm birds		14,600,000
Other miscellaneous income		1,800,000
Total revenue		38,900,000
Expenses:		
Purchase of seedlings and fertilisers	2,850,000	
Purchase of poultry feeds	1,200,000	
Purchase of medicines for poultry animals	800,000	
Repairs of farm equipment	3,400,000	
Depreciation of farm equipment	4,600,000	
Depreciation of office furniture & fittings	650,000	

Salaries and wages	6,650,000	
Interest on bank loan	5,500,000	
General expenses	8,000,000	(33,650,000)
Net profit		5,250,000

Additional information:

(a). Included in the other income was proceeds of sale of one of the company's farm equipment amounting to ₦800,000.

(b). The capital allowance brought forward from previous year and agreed with the FIRS is ₦2,500,000. Also, capital allowance for the year agreed with the FIRS was ₦1,800,000.

(c). General expenses included ₦300,000 given to community leaders as cash gift but FIRS considers the gift as gratification.

Required:

Compute the company's tax liabilities for the year ended December 31, 2022.

(15 marks)

SOLUTION TO QUESTION 3

EXCELLENT FARMS NIGERIA LIMITED
COMPUTATION OF TAX LIABILITY FOR YEAR ENDED DECEMBER 31, 2022

	₦	₦
Net profit as per accounts		5,250,000
Add/(Deduct):		
Depreciation of farm equipment	4,600,000	
Depreciation of office furniture and fittings	650,000	
General expenses - Gratification	300,000	
Proceeds from sale of farm equipment	(800,000)	4,750,000
Assessable/adjusted profit		10,000,000
Less: Capital allowance:		
Capital allowance brought forward	2,500,000	
Capital allowance for the year	1,800,000	
Total capital allowance	4,300,000	
Capital allowance claimable	(4,300,000)	(4,300,000)
Total profit		
Companies income tax at 20% of total profit	1,140,000	
Tertiary education tax @ 2.5% of assessable profit, that is, ₦10,000,000 x 2.5%	250,000	
Total tax liability		**1,390,000**

4. Toowoomba Airways is a foreign airline operating in Nigeria. Its financial statements for the year ended December 31, 2021, revealed the following:

	₦'000	₦'000
ıe from passengers, cargo, and mail:		
- Revenue from passenger and Cargo landed in Nigeria		10,500,000
- Revenue from passenger and cargo lifted in Nigeria		1,200,000
ıl transportation revenue		**11,700,000**
ıses relating to air transportation:		
- Salaries and other expenses	3,100,000	
- Depreciation	1,400,000	
- Other disallowable expenses	760,000	(5,260,000)
ırofit from transportation activities		**6,440,000**
- Income from maintenance services	1,000,000	
- Income from duty-free shops	400,000	
- Income from catering	450,000	1,850,000
ırofit		**8,290,000**

Notes:

(a). Toowoomba Airways has 20 employees on the ground in Nigeria and 140 employees on the ground in the various countries where it operates.

(b). The protocol agreement signed with Nigeria has a clause that the staff ratio would be used for the apportionment of non-transport business income for tax purposes.

Required

Compute the tax payable by Toowoomba Airways in Nigeria for the relevant year of assessment. **(15 Marks)**

SOLUTION TO QUESTION 4

Toowoomba Airways

Computation of income tax payable

For the year ended December 31, 2021 (Assessment year 2022)

A. Calculation of profit on the transportation business

Transportation business:	₦'000	₦'000
Net transportation profit as per accounts		6,440,000
Depreciation	1,400,000	
Other disallowable expenses	760,000	2,160,000
Global transportation assessable profits		**8,600,000**

B. Calculation of freight income tax

- **Computation of the relevant statutory ratios:**

(a) Profit ratio: $\frac{8,600,000,000}{11,700,000,000}$ x 100% = 73.50%

(b) Depreciation ratio: $\frac{1,400,000,000}{11,700,000,000}$ x 100% = 11.97%

- **Computation of tax payable on the freight income:**

Nigerian freight income as given	₦1,200,000,000
Total Assessable Profits: (73.50% of ₦1,200,000,000) =	₦882,960,000
Less:	
Depreciation Allowance: (11.97% of ₦1,200,000,000) =	(₦143,640,000)
Total Profit =	₦738,360,000
Tax at 30% =	**₦88,596,000**

Minimum tax (2% of the Nigerian sales): (₦1,200,000,000 X 2%) = ₦24,000,000

Tax on normal basis is higher than minimum tax, therefore, tax payable on freight income = **₦88,596,000**

C. Calculation of non-freight income

To determine the Nigerian tax payable on non-freight income, the total number of staff worldwide is:
Other countries (140) + Nigerian staff (20) = 160 ground staff

Total global non-freight income	₦1,850,000,000
The amount attributable to Nigeria: (20/160) X ₦1,850,000,000) =	₦231,250,000
Tax at 30% of N231,250,000	**₦69,375,000**

D. Calculation of total tax liability of Toowoomba Airways in Nigeria

		₦
(i)	Tax payable on freight income	88,596,000
(ii)	Tax payable on non-freight income	69,375,000
Total tax liability in Nigeria		157,971,000

5. Banks and other financial institutions engage in a variety of financing arrangements and loan relationships.

Required:

(a) Explain the term "Finance or Financing" as undertaken by banks and other financial institutions. (2 marks)

(b) Explain in details the various financing and loan arrangements engaged in by banks and other financial institutions. (9 marks)

(c) Differentiate between income earned by banks and other financial institutions in the ordinary course of business and income earned outside the ordinary course of business. (4 marks)

(Total 15 Marks)

SOLUTION TO QUESTION 5

(a) Finance, or financing, is the process of raising funds or capital for any kind of expenditure. It is the process of channeling various funds in the form of credit, loans, or invested capital to those economic entities that most need them or can put them to the most productive use.

(b) The following are the types of financing undertaken by banks and other financial institutions:

(i) Loan: This is the amount of money loaned at interest by a bank to a borrower, usually on collateral security, for a certain period of time. There are essentially different classes of loan:

- Short term loan: This is a contract between a borrower and the bank where the customer is provided a loan amount in an agreed currency for a period not exceeding one year and interest is charged on the individual drawings made under the loan at a rate agreed at the time of the drawing.

- Medium term loan: This is a contract between a borrower and the bank whereby the bank provides the borrower with a loan amount in an agreed currency for a period in excess of one year and up to 5 years. Drawings against the loan are usually made in one amount. The principal and interest will be repaid over the tenure of the loan as per the agreed terms.

- Long term loan: This is a contract between a borrower and the bank where it provides the borrower with a certain amount for a period in excess of 5 years and up to 7 years.

- Syndicated loan: A syndicated loan, also known as a syndicated bank facility, is financing offered by a group of lenders, referred to as a syndicate, who work together to provide funds for a single borrower. The borrower can be a corporation, a large project, or a sovereign government. The loan can involve a fixed amount of funds, a credit line, or a combination of the two.

(ii) **Financing through equipment leasing:** This can take the form of either:

- A loan that the borrower uses to lease equipment from an independent source; or
- A direct lease from a bank subsidiary company that owns the equipment.

The duration of the loan is tied to the lease term.
Assets commonly leased by small businesses include equipment, vehicles, real estate or facilities. Most banks require a solid operating history before engaging in leasing agreements with small businesses.

(iii) **Letters of credit:** A letter of credit (LC) is simply a guarantee of payment upon proof that contract terms between a buyer and seller have been completed. LCs are just fancy, two-way IOUs often used to facilitate international credit purchases.

Letters of credit are not the most common means of small business financing, but they are an important financing tool for companies that engage in international trade.

(c) The differences between income earned in the ordinary course of business and income earned outside the ordinary course of business, are:

(i) Income earned in the ordinary course of business are types of income generated from regular day-to-day business operations, excluding any income earned from the sale of long-term capital assets, such as land or equipment. While income earned outside the ordinary course of business are incidental incomes earned from non-regular day to day activities of a business such as income from the sale of a business fixed assets e.g., building or equipment; and

(ii) Based on the above, the sale of shares by a company can be said to be transaction not in the ordinary course of business. However, a similar transaction by a brokerage firm is considered as transaction in the ordinary course because the art of buying and selling of shares on behalf of a third party by a brokerage firm is in the ordinary course of business of the brokerage firm and income earned from such transaction is considered as being from the ordinary course of business.

6. (a). One of the tax incentives available to companies operating in Nigeria is the granting of tax holiday to companies that operate within approved industries or deal in approved product or services. This tax incentive is governed by the Industrial Development (Income Tax Relief) Act Cap 17 LFN 2004 (as amended).

The Federal Government of Nigeria through the Nigeria Export Promotion Council regulates the granting of a Pioneer Status incentive (PSI) to qualified companies in Nigeria. Under the PSI scheme, qualifying companies are granted tax holiday where specific conditions as defined /clarified by the Industrial Development (Income Tax Relief) Act (IDA) are met.

Required:

Explain the role of the relevant arms of government that are involved in the formulation, approval and issuance of Pioneer Status Incentive to qualifying companies.

(5 marks)

(b) Based on the provisions of section 1 of the Industrial Development (Income Tax Relief) Act (IDA), the President may direct the publication in a gazette of a list of industries and product/service as pioneer industries or pioneer product/service.

Required:

Explain the conditions that must exist before an industry or a product/service is designated as a pioneer industry or pioneer product/service.

(5 marks)

(c) The Industrial Development (Income Tax Relief) Act (IDA) provides specific tax incentives to be enjoyed by a PSI.

Required:

State the specific tax incentives available to a company under the IDA? (5 marks)

(Total 15 Marks)

SOLUTION TO QUESTION 6

(a) The relevant arms of government that are involved in the formulation, approval and issuance of Pioneer Status Incentive are:

(i) Federal Executive Council: On the authority of the President, the FEC is responsible for amending the list of pioneer industries and pioneer products ("Pioneer List") from time to time;

(ii) Federal Ministry of Industry, Trade and Investment ("FMITI"): The Minister of Industry, Trade and Investment, is responsible for specifying the mode of application for PSI;

(iii) Nigerian Investment Promotion Commission ("NIPC"):

- On the delegated authority of the Minister of Industry, Trade and Investment, NIPC is responsible for processing PSI applications and cancelling pioneer certificates, if the provisions of the IDA and the guideline document are contravened; and
- On the delegated authority of the President, NIPC is responsible for approving and extending PSI, and issuing pioneer certificates;

(iv) Industrial Inspectorate Department of FMITI ("IID"): The Industrial Inspectorate Department (IID) is responsible for certifying the date of production/date from which the PSI will take effect; and

(iv) Federal Inland Revenue Service ("FIRS"): The FIRS is responsible for implementing PSI and issuing certificates of qualifying capital expenditure; and Identify various pioneer industries and products, on the pioneer list.

(b) The following are the conditions that must exist before an industry or a product/service is designated as a pioneer industry or pioneer product/service:

(i) The industry is not carried on in Nigeria on a scale suitable to the economic development of Nigeria; or

(ii) There are favourable prospects of further development of such industries in Nigeria; or

(iii) It is expedient in the public interest to encourage development or establishment of such industry in Nigeria.

The pioneer designation is conferred by the inclusion of the industry or product on a list approved by the Federal Executive Council (FEC). The pioneer list as approved by the FEC shall be made available on the websites of NIPC and FMITI. The pioneer List shall be reviewed at most every two years for possible additions and deletions from the list. Any additions approved by the FEC shall become effective immediately after approval. Any deletions approved by the FEC shall become effective three years after approval.

(c) The following are the specific tax incentives available to a PSI under IDA:

(i) Treatment of assets acquired during the period

Capital expenditure incurred by the pioneer company in respect of assets acquired during the tax relief period shall for capital allowances purposes, be deemed to have been incurred on the day next following the end of its tax relief period;

(ii) Treatment of losses incurred during pioneer period

Where the FIRS is satisfied that a PSI company has incurred a loss in any accounting period within the tax relief period, it shall issue a certificate to the company accordingly. (IDA Section 10(6)).

In determining whether such a loss has been made, the FIRS may in its absolute discretion exclude such sum as may be more than an amount appearing to it to be just and reasonable in respect of:

- Remuneration to directors of the company; and
- Interest, service, agency, or other similar charges made by a person who is a shareholder of the company or by a person controlled by such shareholder (IDA Section 13(3)).

A net loss incurred by a pioneer company shall be deemed to have been incurred by the company on the day on which its new trade or business commences, that is, on the day following the expiry of the tax relief period (IDA Section 14(3)).

For each accounting period, the Revenue Service shall issue to the pioneer company a statement showing the amount of the income or loss for that period.

Net loss means the aggregate of losses incurred during the tax relief period after deduction of profits, if any, made at any time during that period.

Any dispute between the FIRS and the PSI company with regards to the statement of income or loss issued by the FIRS shall be subject to objection and appeal in like manner as if such statement were an assessment under CITA;

(iii) Exempt profits

Any profits shown on the statement issued by the FIRS in respect of the income of a pioneer company for each of the accounting periods of its tax relief period shall not form part of the Assessable profits or Total profits of the PSI company for any year of assessment and shall be exempt from tax under CITA – (IDA Section 16); and

(iv) Dividend distribution

Any amount of profits that is exempt from tax as above should be credited by the PSI company to an account to be kept for the purpose of dividend distribution by the company. Any dividend that is declared by the PSI company out of such profits shall be exempt from tax in the hands of the shareholders and shall for the purposes of CITA and PITA be deemed to be paid out of profits on which tax is not paid or payable.

7. Nigeria currently ranks as one of the major oil and gas producers in Africa. Nigeria has two types of crude oil that are currently available in the Niger delta basin: light crude with around 36° gravity and the comparatively heavy crude with 20°–25° gravity. However, both types of crude are paraffinic and low in sulfur content.

Revenue generated from the petroleum industry, has largely supported Nigeria's economy and budget since independence from Great Britain. However, recent statistics show that the Nigerian oil sector contributes about 10% to the entire GDP of the nation. This is largely due to a myriad of reasons ranging from crude oil theft to restiveness in the Niger delta areas which essentially inhibit crude oil production.

Therefore, due to the urgent need for holistic reforms in the petroleum industry, the Petroleum Industry Act (PIA) was enacted to address the identified problems in host communities and encourage local contents in the petroleum industry, amongst other reasons.

The Act provides legal, governance, regulatory and fiscal framework for the Nigerian Petroleum Industry. If well implemented, the PIA will facilitate Nigeria's economic development by attracting and creating investment opportunities for local and international investors.

Required:

Explain the following terminologies:

a. Casing head petroleum spirit (3 marks)
b. Chargeable natural gas (3 marks)
c. Concession (3 marks)
d. Crude oil (3 marks)
e. Abandonment (3 marks)

(Total 15 Marks)

Solution to Question 7

Explanation of the terminologies:

(i) **Casing head petroleum spirit**: This is any liquid hydrocarbons obtained in Nigeria from natural gas by separation or by any chemical or physical process but before the same has been refined or otherwise treated.

(ii) **Chargeable natural gas:** In relation to a company engaged in petroleum operations means natural gas actually delivered by a relevant company to the NNPC Ltd under a gas sales contract but does not include natural gas taken by or on behalf of the government of the Federation in pursuance of the Petroleum Industry Act.

(iii) **Concession:** This includes a petroleum exploration license, a petroleum prospecting license, a petroleum mining lease, any right, title or interest in or to petroleum oil in the ground and any option of acquiring any such right, title or interest.

(iv) **Crude Oil:** This means any oil (other than oil extracted by destructive distillation from coal, bituminous shale, or other stratified deposits) won in Nigeria, either in its natural state or after the extraction of water, sand or other foreign substance therefrom but before any such oil is refined or otherwise treated.

(v) Abandonment which is also known as decommissioning, is a process required by license requirements and relevant legislation/ practice whereby:
* oil wells are abandoned and plugged;
* wellhead, production, and transport facilities are dismantled; and
* producing areas are remediated and restored.

An oil or gas well is plugged and abandoned when it reaches the end of its useful life or becomes a dry hole.
Companies operating in the upstream sector (that is, exploration and production (E&P) companies) are required to implement an abandonment programme. The E&P companies usually set up an abandonment fund.