

Tax Appeal Tribunal says certain costs and employee remuneration are not deductible.



Background

Issue 1

Stanbic IBTC Bank Plc (“Stanbic” or the “Bank”) set up a reward scheme (the “Programme”) for exceptional employees. The Programme entailed subsidising the interest on mortgage loans taken by qualifying employees. The Programme was designed to enhance staff performance and boost profitability; as such, the costs were recognised as staff costs in the Bank’s books. The FIRS audited the Bank’s 2016 and 2017 records and disallowed expenses relating to the Programme, resulting in a liability of about N360m for the period.

Issue 2

In 2017, the Bank incurred legal expenses in respect of a Court of Appeal (COA) suit against the Financial Reporting Council of Nigeria (FRCN) and the National Office for Technology Acquisition and Promotion (NOTAP). The FIRS also disallowed the legal costs on the grounds that they were avoidable and were not necessarily incurred in the course of the Bank’s business. The FIRS further assessed the Appellant to another liability of N361m in this regard. The dispute between both parties resulted in the appeal at the Tax Appeal Tribunal (‘TAT’ or the ‘Tribunal’).

Analysis

Section 24 (1) (f) of the Companies Income Tax Act (CITA) allows a company to deduct expenses that are wholly, exclusively, necessarily, and reasonably (WREN) incurred for business purposes “including, but without otherwise expanding or limiting the generality of the foregoing -

- ...any outlay or expenses incurred during the year in respect of:
- i. salary, wages, or other remuneration paid to the senior staff and executives
 - ii. cost to the company of any benefit or allowance provided for the senior staff and executives, which shall not exceed the limit of the amount prescribed by the collective agreement between the company and the employees and approved by the Federal Ministry responsible for Labour matters...”

A major area of contention was whether items not specifically listed in Section 24(1) are automatically disallowable.

Stanbic’s arguments

- Section 24 of CITA is not intended to exclude other deductible items. The only test for deductibility is whether the expense is WREN incurred for generating taxable profits. If Section 24 were intended to be exclusive, salaries paid to junior staff will not be tax deductible.
- The Programme is a performance-based bonus scheme which forms part of the Bank’s personnel costs and are

therefore WREN incurred for profits generation.

- The reduction of tax payable by a transaction does not necessarily make it artificial. Transactions are artificial when they are not at arm’s length and are between “connected persons”. The definition of “connected persons” does not include an employer-employee relationship.
- On issue 2, the Bank argued that the legal costs were WREN incurred in preventing severe financial consequences on its business; and the expense did not result from defending a penalty, given that neither the FRCN nor NOTAP could award a penalty, but a court.

FIRS’ arguments

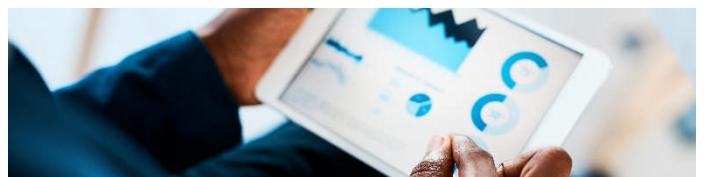
- Deductibility of expenses for tax purposes is governed by Section 24 of CITA. For any expense to be deductible, it must satisfy the WREN test per this section.
- Expenses associated with the Programme must be WREN, incurred in relation to senior staff, contractually agreed, and approved by the Federal Ministry for Labour (FML). The Appellant failed to jointly prove these.
- The Programme was artificial and designed to reduce the amount of tax payable. The loan was not given at arms-length and should be considered as fictitious.
- The legal costs incurred by the Bank were not WREN incurred to generate taxable profits but to defend an action resulting from infringement of NOTAP rules.

Decision

The Tribunal ruled in favour of the FIRS and held that the Bank was liable to the additional assessments in both instances.

On issue 1, the Tribunal ruled that costs must not just be WREN, but also satisfy any other specific requirements as included in the law, to be deductible. Therefore, the Programme costs should have been contractually agreed and approved by the FML, to be tax deductible.

On the issue 2, the TAT stated that the legal costs can be allowable if they were incurred in the ordinary course of the Appellant’s business and directly linked to its profitability. The TAT held that the legal charges in this case were not necessarily incurred in generating profits for the Bank, but arose due to a breach of the NOTAP Act.



Takeaway

On Issue 1, it is true that where there is a special requirement that must be fulfilled for an expense to be deductible, it must be applied to that expense even if the expense fulfils the general WREN test. This means that senior staff benefits, or allowances must be contractually agreed and approved by the FML to be deductible, based on Section 24(1)(f) of CITA. However, it should be noted that the FML does not have any established regulatory requirement or procedure to approve benefits and allowances. In addition, since the specific conditions apply to senior staff benefits and allowances only, the benefits incurred on behalf of the junior staff should be deductible where they meet the general WREN test. However, the Tribunal mentioned that they could not immediately distinguish whether the costs were incurred for junior or senior staff.

The Tribunal also stated that the Bank did not depict how the additional cost incurred from the Programme contributed to the generation of additional taxable income. Companies that intend to take a deduction for similar expenses may need to think about such justification and document them in case of disputes with the tax authorities. In the specific case of subsidised loans, companies could demonstrate that interest is actually earned from the loans even though it is not at market rate.

Considering that the FML does not have any formal regulation for approving discretionary benefits and allowances, this ruling may be counterproductive for Nigerian employees as companies may avoid providing additional benefits and allowances (e.g. bonuses) in order to avoid the risk of addbacks by tax authorities.

On Issue 2, the TAT's ruling that legal costs are not WREN incurred needs to be analysed further, especially considering the Bank's argument that the costs were incurred to sustain the Bank's profitability. Also, the Bank obtained a positive ruling at the COA that NOTAP approval does not invalidate the expense, which seems to support the Bank's arguments. In addition, the FIRS and the TAT wrongly suggested that the legal charges arose because the company refused to apply for NOTAP approval. However, based on the facts of the case (*Stanbic IBTC v. FRCN & NOTAP*), the Bank originally applied for approval but was turned down by NOTAP. We take the view that companies should be able to take tax deductions for legal and other related costs incurred to preserve its rights, where it reasonably fulfils its legal/regulatory obligations, except the law specifically disallows it, for example, in the Petroleum Industry Act.

The Bank has appealed the case and it will be interesting to see its outcome at the Federal High Court.

For a deeper discussion, please contact:

Kenneth Erikume

Tax Partner

kenneth.y.erikume@pwc.com
+234 1 271 1700 Ext 50004

Emeka Chime

Associate Director

chukwuemeka.x.chime@pwc.com
+234 1 271 1700 Ext 540458

Abiodun Kayode-Alli

Manager

Abiodun.kayode-alli@pwc.com
+234 1 271 1700 Ext 32104

Eniola Olanipekun

Senior Associate

eniola.olanipekun@pwc.com
+234 1 271 1700 Ext 54200

