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TAX INITIATIVE

TAX CONSEQUENCES OF DEBT CANCELLATION OR DEBT FORGIVENESS IN NIGERIA

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BACKGROUND

Business reorganizations and other forms of restructuring arrangements are critical to corporate commerce. They are used to achieve flexibility and seamless capital mobility for efficient business administration. They are also used to revive dying enterprises, improve tax efficiency, and increase quality service delivery to clients across sectors. Debt-for-equity swaps and other debt release or debt forgiveness arrangements are common business restructuring tools used to achieve the above-stated commercial objectives.

However, they have certain critical tax implications that must be considered by restructuring entities before implementation. This commentary highlights the key tax consequences of debt cancellation or debt forgiveness and what restructuring businesses seeking to employ this reorganization tool should look out for.

Save for some minor changes, the Nigeria Tax Bill 2025 (the Bill), which may soon become law, has not proposed any material changes to the operative or controlling tax provisions referenced in this commentary. As such, we reasonably believe that the tax treatment of debt cancellations in Nigeria may remain the same under the Bill.

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COMMENTARY

The tax consequences of a debt cancellation or debt release arrangement differ for the creditor and the debtor.

The Creditor

Where a company writes off debts owed to it by another company for no apparent valuable exchange, the creditor would effectively be treating such debts as bad debts for accounting purposes. Generally, the creditor may, subject to certain restrictions, enjoy a tax deduction of bad debts written-off, when computing its taxable profits in a relevant assessment year by virtue of section 24(f) of the Companies Income Tax Act (CITA).

Pursuant to the provisions of section 24(f)(iii) of the CITA, notwithstanding that such bad or doubtful debts were due and payable before the commencement of the reporting period, such tax deductibility of bad or doubtful debts shall be permissible, in so far as the same is proven, to the satisfaction of the Federal Inland Revenue Service (FIRS), that the debts in respect of which a tax deduction is claimed were either included as a receipt of the trade or business in the profits of the year within which they were incurred; or were advances not falling within the provisions of the trade or business in the profits of the year within which they were incurred; or were advances not falling within the provisions of section 23(1)(e) of the CITA, made in the course of normal trading or business operations. (Note that the FIRS will be known as the Nigeria Revenue Service (NRS) under the NRS (Establishment) Bill 2025.)

Section 23(1)(e) of the CITA exempts from tax the profits of any company being a trade union registered under the Trade Unions Act, in so far as such profits are not derived from a trade or business carried on by such trade union.

A non-resident creditor will not benefit from the deduction of bad debts allowed under section 24(f) of the CITA unless it is subject to tax in Nigeria under section 13(2) of the CITA in that its profits are deemed to be derived from Nigeria.

A non-resident company is generally deemed to derive its profits from Nigeria for tax purposes if it: (i) has a fixed base of business or a dependent agent in Nigeria; (ii) operates a digital business in Nigeria and is determined to have significant economic presence in the country; (iii) executes a turnkey project for surveys, deliveries, installations, or construction in Nigeria; (iv) provides technical, management, consultancy, or professional services to a person in Nigeria; or (v) transacts with a related person in Nigeria in a manner that is not at arm's length. Also, if the non-resident creditor is a related entity to the debtor, writing off the debt may raise significant transfer pricing concerns with the FIRS.

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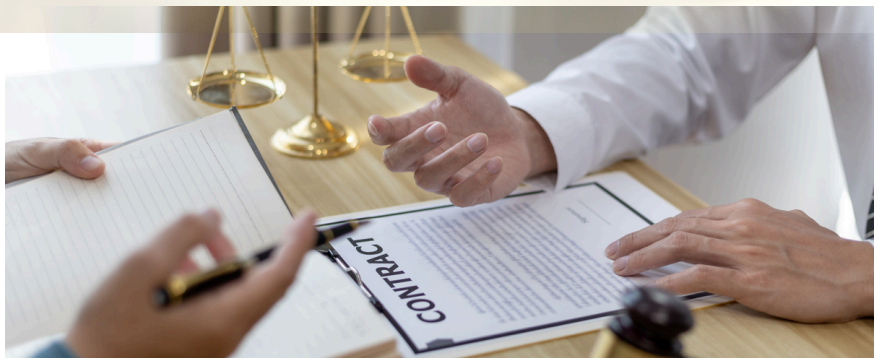

It is noteworthy that in Nigeria, section 78(1) and (2) of the CITA provides that interest payments (other than interest on inter-bank deposits) from one company to another shall be subject to Withholding Tax (WHT), at the rate of 10%, on the date when payment is made or credited (whichever first occurs). The WHT, when paid over to the FIRS, shall be the final tax due from a non-resident recipient of the payment.

It is equally noteworthy that as decided in the case of *Tetra Pak West Africa Limited v FIRS* (unreported judgment of the Tax Appeal Tribunal (TAT) delivered on 30 November 2020, in Appeal No. TAT/LZ/WHT/007/2019), WHT is not a separate tax but operates as a payment-on-account of the ultimate income tax liability (in Nigeria) of the recipient of payment.

Prior to the enactment of the Finance Act 2019, foreign lenders enjoyed 100% exemption from WHT (pursuant to the provisions of section 11 of the CITA and the Third Schedule thereof), where the tenor of the loan exceeded seven (7) years, and the Nigerian borrower was granted moratorium on principal repayment and interest payment for a minimum period of two (2) years.

However, under the Finance Act 2019, the regime now confers a maximum 70% tax exemption on such loan arrangements, subjecting foreign lenders to a minimum 3% WHT (that is, 30% of the 10% imposed under section 78 of the CITA).

It is noteworthy, for the purposes of determining corporate foreign lenders, that section 11(4) of the CITA defines "foreign company" to mean any company or corporation (other than a corporation sole) established by or under any law in force in any territory or country outside Nigeria.

It is equally noteworthy that, for the purposes of determining qualifying foreign loans, the Third Schedule to the CITA and the Finance Act 2019 define – (1) "moratorium" to mean a period at the beginning of a loan term during which the borrower is not expected to make any principal or interest repayments, provided that where any principal or interest repayments are made during the period, the tax exemptions provided under the Third Schedule to the CITA shall be adjusted by the FIRS in a proportionate manner; and (2) "repayment period" to mean the agreed tenor of the loan facility, provided that where the loan is repaid before expiration of this period, the tax exemptions provided under the Third Schedule to the CITA shall be adjusted by the FIRS in a proportionate manner.

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Regardless of whether the loans were granted interest-free or not, our view is that the creditor's cancellation of the debts owed to it by a related debtor will raise significant transfer pricing red flags with the FIRS. By Regulation 3(1)(e) and (g) of the Income Tax (Transfer Pricing) Regulations 2018 (TPR), the TPR shall apply to transactions between connected persons (called controlled transactions) involving the lending or borrowing of money and those affecting profit or loss.

By Regulation 4(1) of the TPR, in such transactions, the connected person shall ensure that the taxable profits resulting therefrom adhere to the arm's length principle. This entails that the conditions of the transaction would have applied between independent persons in comparable transactions carried out under comparable circumstances. (See Regulation 4(2) of the TPR.)

Generally, persons are deemed connected under Regulation 12(1) of the TPR where one person has the ability to control or influence the other person in making financial, commercial, or operational decisions, or there is a third person who has the ability to control or influence both persons in making financial, commercial, or operational decisions.

If the debtor lacks financial liquidity when the debt is cancelled, the transaction would be presumed to fail the arm's length test, and the FIRS may compute taxable profits in accordance with the provisions of section 22 of the CITA and Regulation 4(3) of the TPR. The FIRS may further assume interest payments on the canceled debt and apply a 10% WHT to the assumed interest amount.

The resident debtor may then be liable for remittance of the WHT to FIRS, unless the parties involved successfully rebut the presumption of failing the arm's length test in their execution of the debt release or debt cancellation arrangement. (Note that section 22 of the CITA allows the FIRS to counteract artificial transactions designed specifically or principally to avoid tax by effecting such adjustments as would subject the transactions to higher tax rates deemed appropriate by the FIRS in the circumstance.)

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Debt-for-Equity Swap

In some cases, the parties may engage in a debt-for-equity swap rather than an outright debt cancellation to help create an exchange of value and satisfy the arm's length requirement in related-party deals, or to act as a debt repayment option.

However, this may be challenging when the creditor is a non-resident party. Section 24(a) and the Seventh Schedule to the CITA restricts deductibility of interest on foreign loans exceeding 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) of a Nigerian company, although excess interest can be carried forward for a maximum of five (5) years.

This is important as interest on the loans would have an impact on the tax payable by both the lender and the borrower in the related party loan facility transaction. The conversion of debt to equity reduces or eliminates interest expense on the related party loan and the WHT and transfer pricing issues highlighted above.

It is noteworthy that section 30 of the Capital Gains Tax Act (CGTA) imposes 10% Capital Gains Tax (CGT) on the disposal of shares in a Nigerian company, except where the share disposal proceeds are: (i) reinvested within the same year of assessment, in the acquisition of shares in the same or other Nigerian company; or (ii) the share disposal proceeds, in aggregate, is less than NGN100m (now NGN150m and provided the chargeable gain does not exceed NGN10m under the Bill) in any twelve (12) consecutive months, provided that the person making the disposal shall render appropriate returns to the FIRS on an annual basis. Partial reinvestment will attract CGT proportionately.

Transfer of shares between an approved borrower and lender in a Regulated Securities Lending Transaction (RSLT) as defined in the CITA, is exempted. RSLT is defined in section 105 of the CITA to mean any securities lending transaction conducted pursuant to rules made by the Securities and Exchange Commission.

In this regard, CGT should apply only to the gains accruing to a person on disposal of their shares in a Nigerian company under section 30 of the CGTA.

It is arguable that the provisions of section 30 of the CGTA do not contemplate debt-for-equity swaps. This conclusion is based on the settled principles of Nigerian tax law that: (i) tax statutes are construed strictly, regardless of the harsh taxing effect (if any) it may have on either the taxpayer or the relevant tax authority – see *FBIR v Halliburton (WA) Ltd.* (2014) LPELR-24330(CA); and (ii) gaps or ambiguities in tax statutes must be construed or resolved in favour of taxpayers – see *Chief M. A. Okupe v FIRS* (1974) LPELR-SC.223/72. However, this may be a straight-jacket assessment of the issue.

The FIRS may resist such argument, and the Nigerian courts may agree with the FIRS. In accordance with the provisions of section 6(1)(c) and (d) of the CGTA, a disposal of chargeable assets, including shares of a Nigerian entity, occurs whenever there is receipt of a capital sum from the sale, lease, transfer, assignment, compulsory acquisition, or other disposition thereof. This applies even where no chargeable asset is acquired by the payer, particularly where a capital sum is received for the forfeiture or surrender of rights, or for refraining from exercising rights, relating to the relevant chargeable asset, or as consideration for the use or exploitation of the chargeable asset.

This means that a debt-for-equity swap between a debtor and a creditor may be treated as the exchange of shares in a Nigerian company (where the equity swapped is held in a Nigerian company) for money or money's worth (in the form of the value of the debt cancelled or released by the creditor) derived from the debtor's surrender of its rights in the equity held in a Nigerian company to the creditor in exchange for the debt cancellation or release.

It is noteworthy that section 45 of the CGTA requires production of evidence of tax payments as a condition for effecting change of ownership of property, including shares and stocks. In this case, a 10% CGT will be levied on the debt traded for equity after applicable deductions have been recognized.

By the provisions of section 2(4) of the CGTA, the seller of the chargeable asset must calculate the applicable CGT, file self-assessed returns, and pay the tax due to the FIRS before 30 June and 31 December of the relevant year.

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The Debtor

Based on section 28 of the CITA, a debt release may be treated as taxable income or profits accruing to the debtor company (without more), which may be set-off against any unrelieved losses of the debtor company and taxed on the assumed corresponding tax gain arising from the debt release. The same is provided in section 10(2) of the Petroleum Profits Tax Act (as amended) (PPTA) and section 263(2) of the Petroleum Industry Act 2021 (PIA). These provisions would only apply if the waived liability was tax deductible under the provisions of section 28 of the CITA, section 10 of the PPTA, and section 263 of the PIA, respectively.

Where the debtor has no allowable tax deductions for the debt under the relevant tax laws, the provisions of section 28 of the CITA, section 10 of the PPTA, and section 263 of the PIA may not apply. Only interest incurred solely on inter-company loans borrowed at arm's length market terms (such as the London Inter-Bank Offer Rate) during the relevant accounting period will be deductible for income tax purposes.

It is noteworthy that whilst section 13(2) of the PPTA disallows deduction of interest expenses incurred on inter-company loans, the TAT held in *AGIP v FIRS* (2014) 16 TLRN 25, that interest on inter-company loans obtained at arm's length are allowable deductions for PPT purposes under the PPTA. It is possible that the Nigerian courts may apply the same reasoning to the deductibility of inter-company loans under the provisions of both the CITA and the PIA – or other similar provisions of the Nigeria Tax Bill 2025 when it becomes law.

In any event, sums borrowed by a company and employed as capital in its business are clearly non-deductible for tax purposes under the provisions of section 13(1)(b) of the PPTA, section 27(a) of the CITA, and section 264(h) of the PIA.

In the circumstance, a debt release cannot qualify as taxable profit or income for the purpose of tax liability in Nigeria, if the debt release is not income or profit accruing to the debtor within the meaning of the applicable tax statute. Again, we have arrived at this conclusion based on the settled principles of Nigerian tax law that: (i) tax statutes are construed strictly, regardless of the harsh taxing effect (if any) it may have on either the taxpayer or the relevant tax authority; and (ii) gaps or ambiguities in tax statutes must be construed or resolved in favour of taxpayers.

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DISCLAIMER

This commentary is not legal or tax advice to readers. Taxpayers and businesses should consult their legal and tax advisors for specific advice regarding their debt-for-equity swaps and other debt release or debt cancellation arrangements, including compliance requirements and recourse available to them against tax authorities.

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