TAXATION OF DIVIDENDS FROM RETAINED EARNINGS

The Black's Law Dictionary 8th Edition defines dividends as 'A portion of a company's earnings or profits distributed pro rata to its shareholders, usually in the form of cash or additional shares'. Dividends therefore earn income in the hands of shareholders and are hence liable to Withholding tax. ***Section 80 (1)*** and ***(2)*** of the ***Companies Income Tax Act CAP C20 LFN 2004 (as amended) (CITA)*** states *inter alia* that where a Nigerian company distributes dividend to any company or person, the distributing company shall at the point of payment of such dividend, deduct from such payment, tax at the rate of 10% and remit the deducted amount to the FIRS. This tax which is deducted and remitted at the point of payment of dividend to the shareholder is called the withholding tax on dividends (WHT).

Such dividend received after the deduction of WHT is regarded as franked investment income. Franked investment income is not liable to further charge of tax even when it forms part of profits to a recipient company except where it is re-distributed and in such a case the re-distributing company may off-set the WHT which it had suffered. ***(See Section 80 (3) CITA).***

In some cases companies, such as holding companies who mainly derive income from dividends it receives from its subsidiaries, may elect not to distribute its franked investment income and to accumulate the income for other causes, such as long term finance or for distribution in later years. In other instances, companies may elect to accumulate undistributed profits though they have suffered companies income tax. These accumulated undistributed profits and franked

investment income fall under a class of company earnings called retained earnings. Retained earnings are profits earned in previous years and which had been subjected to tax but not distributed as dividends.

A company's retained earnings could be distributed as dividends to shareholders in a company's difficult years such as when the company does not post a profit or its profit is considered low. Are such retained earnings of a company liable to tax when it is being distributed in a year other than the year when the earnings accrue?

EXAMINING SECTION 19 OF CITA (BEFORE THE FINANCE ACT 2019)

Section 19 of ***CITA*** provides that:

Where a dividend is paid out as profit on which no tax is payable due to:

(a) No total profits; or
(b) Total profits which are less than the amount of dividend which is paid, whether or not the recipient of the dividend is a Nigerian company, is paid by Nigerian company, the company paying the dividend shall be charged to tax at a rate prescribed in subsection (1) of section 40 of this Act as if the dividend is the total profits of the company for the year of assessment to which the accounts, out of which the dividend is declared relates.

Thus section 19 of CITA contemplates that where a company pays dividends in a year of assessment in which the Company does not record total profits or records total profit in sum below the amount paid in dividends, then the dividend becomes the total profit of the company in computing companies income tax, at the rate specified in section 40 (1) of CITA, for that year of assessment. This situation resulted in a lot of conflict between taxpayers and the tax authority because in any year where a company distributed its retained earnings to shareholders and it posts no total profits or posts total profits less than the total dividends it distributes, it was thence subject to companies income tax on the dividend distributed. Such dividend distributed was by law 'deemed taxable

profit'. The relevant tax authority would subtract the actual taxable profit which is the total profit of the Company, (where the total profits was less than the distributed earnings) and tax the excess (the dividends distributed) at the applicable companies income tax rate. This situation caught a lot of companies who elected to distribute retained earnings which often occur in years when total profits were low or no profits were posted at all.

A case in point is ***OANDO V. FIRS (2016) 26 TLRN 1***. In that case, by Notice of Appeal, the Appellant challenged the Respondent' application of ***Section 19*** of ***CITA*** when the Respondent subjected to further tax, the dividends from Appellant's retained earnings paid out, in 3 (three) consecutive years of assessment, to Appellant's shareholders. In that case, Appellant contended that it would amount to unlawful and impermissible double taxation if a second tax is imposed on the Appellant on the same profits that had been previously taxed in full, merely because the Appellant deferred the distribution of dividends to a later date. The Federal High Court considered the provisions of ***Section 19*** and ***80 (3)*** of ***CITA*** and came to the conclusion that ***CITA*** should be interpreted strictly and literally. Thus, it did not matter that the dividends were paid out of retained earnings of the Appellant but what mattered was that such dividends exceeded the total profits of the Appellant for the year of assessment. This, the court held, despite the provisions of ***Section 80 (3)*** of ***CITA*** and uncontroverted evidence of the Appellant that some of its earnings were franked investment income. The Court held further that, ***Section 19*** of ***CITA*** being a later amendment of the Act, must prevail over ***Section 80 (3)*** of ***CITA*** as it presents the new legal order and conforms to the times. See **Ikene V. Edjerode (2001) 18 NWLR (Pt. 745) 446**. In making this decision, the Federal High Court relied on the Court of Appeal decision in **Oando V. FBIR (CA/I/409/2008**).

This was the position in Nigeria and was applied in the recent case of ***UAC of Nigeria V. FIRS (2020) 49 TLRN 17*** resulting in the taxation of companies retained earnings in any year that distribution was made from such earnings and the

distributing company did not post any total profits for that year or its total profits was less than the distributed earnings.

AMENDMENTS MADE BY THE FINANCE ACT 2019

The controversy resulting from the subjection of companies retained earnings to further taxation was laid to rest by ***Section 7*** of the ***Finance Act 2019***. ***Section 7*** of the ***Finance Act*** amends ***Section 19*** of ***CITA*** by inserting a new subsection (2) and it provides thus:

"The provisions of subsection (1) shall not apply to –

(a) Dividends paid out of the retained earnings of a company, provided that the dividends are paid out of profits that have been subjected to tax under this Act, the Petroleum Profits Tax Act, or the Capital Gains Tax Act;

(b) ..

(c) Profits or income of a company that are regarded as franked investment income under this Act;.."

This implies that a tax payer must demonstrate by adducing sufficient evidence that dividends distributed from earnings of previous year(s) had suffered tax under the applicable law, in the year the earnings accrued to enable it fall under the exception to ***Section 19*** of ***CITA***.

The provision reproduced above preserves the essence of retained earnings in Nigeria. The assumed necessity to distribute all income in any financial year to avoid further taxation was thence removed.

COMMENTARY

The interpretation given to section 19 of CITA by the tax Appeal Tribunal and the Courts together with its application by the relevant tax authority resulted in what could only be termed double taxation of companies retained earnings. It had the

resultant effect of repelling holding companies from setting up holding structures in Nigeria taking a cue from holding companies such as UAC of Nigeria in ***UAC of Nigeria V. FIRS (Supra)***. Section 7 of Finance Act 2019 is a welcome provision and a relief to tax payers in Nigeria.

For more information please contact:

Blackwood & Stone LP

info@blackwoodstone.com

+234 903 3501 613