BLACKWOODSTONE

Highlights of the Non-Interest Finance (Taxation) Regulation 2022

Introduction

Pursuant to the powers of the FIRS to make regulations that are necessary to give full effect to the provisions of the FIRS (Establishment) Act, the FIRS issued the Non-Interest Finance (Taxation) Regulations 2022 with effect from April 2022 to amongst other things regulate the taxation of institutions offering non-interest financial services in Nigeria, in accordance with principles of Islamic commercial jurisprudence. The Regulation is also aimed at providing a legal framework on the tax regulation of financial institutions offering non-interest financial services as well as ensuing equal treatment for both conventional and non-interest finance transactions. Notably, the regulations are applicable to non-interest financial instruments and institutions operating under the principles of Islamic Commercial Jurisprudence.

Sale Based Products

Murabaha

Murabaha is defined by the Regulation as a contract of sale where an institution sells a specified asset to a customer wherein the selling price is the sum of the cost price and an agreed profit margin.

Pursuant to the regulations, where a Murabaha transaction occurs, the Regulation provides that the purchase price paid by the financial institution to the vendor is to be treated as a loan from the Financial Institution to the customer while the purchase price paid by the customer to the financial institution, excluding markup, is deemed to be treated as a loan repayment which is exempted from Value Added Tax (VAT), Stamp Duties (SD) and Capital Gains Tax (CGT).

Notably, the Markup is treated as interest payable on a loan and accorded the same treatment with conventional interests. It is vital to note that the asset purchased under this arrangement shall be subject to the provisions of the VAT Act and withholding tax (WHT) regulations.

Istisna or Parallel Istisna

The Regulation also covers situations where a financial institution undertakes the financing or engagement of a third party for a construction or manufacturing of goods or assets (the project) on behalf of its customers and transfers the project to the customer upon the completion of work by the third party. The implication of these situations by the regulations is that the financing of the project shall be treated as a loan and would not be liable to VAT or WHT. However, the transaction between the financial institution and the third party shall be subject to the provisions of the VAT Act and WHT regulations.

Furthermore, the contract sum paid by the financial institution, excluding markup shall be deemed the principal repayments which are not liable to VAT, SD, and CGT while the markup payable shall be deemed as interest payable on loan. For the purposes of Companies Income Tax (CIT), the customer may treat the capital portion and mark up, as capital expenditure in line with the provisions of the Companies Income Tax Act (CITA).

Notably, the Regulation defines Istisna as a sale of a specified asset, with an obligation on the part of the seller to manufacture or construct it using the seller's materials and to deliver it on a specific date in return for a specific price to be paid in one lump sum or installments.

Salem or Parallel Salam

The Regulation also apply instances where a financial institution executes a Salam agreement with a customer. The Regulation defines Salam as a purchase contract with delivery at a later date, while payment is made at the time of contract execution. The transaction between the financial institution and the customer is to be treated as a loan which shall not be liable to WHT or VAT but the transaction between the financial institution and the third party shall be subject to the provisions of the VAT Act and WHT regulation. This is usually applicable in the case of agricultural produce.

Hence, for instance, where Bank A purchases a commodity and fully pays an advanced price to Mr. Y who is to deliver the commodity at a deferred date and subsequently enters into an agreement with Ms. J for the sale of that commodity, the transaction between Bank A and Mr. Y would be treated as a loan which shall not be liable to WHT or VAT. However, the transaction between Bank A and Ms. J will be subject to the provisions of the VAT Act and WHT regulation.

Equity Based Products

Musharakah

The Regulations also apply where a financial institution enters a joint venture with a customer to finance the acquisition of an asset, with profits distributed at an agreed ratio while losses are borne according to capital contribution and the customer chooses to acquire the financial institution's share in the partnership at the end of the term of the joint venture. The implication of this is that the financing of the acquisition shall be deemed a loan and the financial institution's share of profit shall be treated as interest on the loan and treated in the same way as a conventional interest on loan (which is generally tax exempt) while the payments to acquire the financial institutions' share in the joint venture shall be the loan repayment and not liable to VAT, SD, and CGT.

Notably, the share of loss attributable to the financial institution shall be an allowable deduction where such loss can be shown to flow from expenses wholly, reasonably, exclusively, and necessarily incurred towards generating taxable income. It is worth stating that the instrument of transfer of interest of the financial institution to the customer as beneficial owner shall be subject to the Stamp Duties Act (SDA). However, only the customer may treat the cost of the asset as capital expenditure in compliance with the provisions set out in CITA.

Diminishing Musharakah

A financial institution may jointly acquire an asset from a vendor in partnership with a customer, with the understanding that the customer shall eventually acquire complete ownership interest in the asset. Notably, the customer would have exclusive right to possess and use the asset; make such payments to the financial institution (which would amount in the aggregate to the consideration paid for the acquisition of the financial institution's beneficial interest in the asset and the periodic rent) thereby reducing the financial institution's stake in the asset with every such payment and acquires the financial institution's stake in the asset upon final payment.

The Regulation provides that where this occurs, any amount contributed by the financial institution shall be treated as loan to the customer and the periodic rent paid by the customer is to be treated in the same manner as a conventional interest for tax purposes while the payments made by the customer towards the acquisition of the financial institution's interest in the asset, shall not be subject to the provisions of VAT Act or WHT regulations. However, the Regulations provide that the instrument of transfer of the interest of the financial institution to the customer as beneficial owner is subject to the SDA. To compute CIT, only the customer may treat the cost of the asset as capital expenditure subject to the provisions of the CITA.

Mudarabah (as Deposit)

In addition, the Regulation is also to apply where a customer provides capital to a financial institution, which acts as a manager, the financial institution utilizes the capital for the purpose of generating profit and both parties are entitled to a portion of the profit derived from the utilization of the capital provided in the transaction. In the circumstances, the payment made in respect of the customer's share of profit shall be deemed in substance, a return on investment of the money and be treated with conventional return on investment.

Lease based Products

Ijarah Waa Iqtina

Further to the above, the Regulations would also apply to finance leases. Where a financial institution acquires an asset from a vendor and subsequently leases the asset to a rent paying customer, at an agreed rent rate and for such pre-agreed period with ownership of the asset and major maintenance remains with the financial institution throughout the lease period while beneficial interest in the assets resides with the customer and the financial institution seeks to recover the capital cost of the assets plus a profit margin out of the lease rentals receivable during the period of the lease, the Regulations would apply.

Furthermore, the transaction between the financial institution and the vendor for the purchase of the asset, is subject to the provisions of the VAT Act, SDA and WHT regulations. In the same vein, the instrument executed between the financial institution and the customer would be liable to the provisions of the SDA where the customer acquires the asset at the expiration of the lease period for a nominal value or gift. The regulation notes that the capital and markup is to be treated as capital expenditure and in compliance with the CITA.

Ijarah (Operating Lease)

The Regulation is also to apply to situations where a financial institution acquires an asset from a vendor and leases it to a customer, who pays rent, at an agreed rate, for the use of the property to the financial institution. In this case, ownership and maintenance of the asset remains with the financial institution throughout the period of the lease and the beneficial interest resides with the customer.

The Regulation stipulates that the property purchase transaction between the financial institution and the vendor is subject to the VAT Act, SDA and WHT regulations. In the same vein, the lease rentals paid by the customer shall be subject to the provisions of the VAT Act and liable to WHT where it is practical to deduct same.

It also stipulates that the customer is entitled to claim the total lease rental incurred in this arrangement as an expense provided the asset is used to earn income for the business.

The financial institution is to treat the capital portion (purchase price) as a capital expenditure.

Fee or Agency Based Products

Takaful

Where a takaful operator arranges with a group of participants or policy holders to maintain and manage a common fund on their behalf for a fee and each participant agrees to donate a portion or all of the participant's takaful contribution to the common fund to indemnify any member that suffers a loss, the provisions of the Regulations shall apply. By virtue of this provision, the agreement between the Takaful Operator and each of the policy holders shall be subject to stamp duties, while the takaful operator's share of the participants' contribution shall not be subject to VAT.

Furthermore, the Regulation provides that where a Takaful operator invests the common fund on behalf of the participants for a consideration, which may be in form of a management fee, a percentage share of the return on investment, or both, as in Wakala, Ju'alah, or any other Shari'ah complaint arrangement, the consideration received shall be subject to the provisions of the VAT Act and the amount distributed as surplus of returns on investment to the policy holders shall be subject to WHT Regulations. The agreement between the operator and the participants or policy holders under the regulation shall be subject to the provision of the SDA.

Other investment products

Sukuk

Where there is an arrangement between an originator or sponsor of financial securities and an investor or where a special purpose vehicle is established solely to issue securities for the purpose of raising funds to finance a project, business venture, purchase an asset or other shariah compliant business activities and the securities are structured based on the principles of non-interest finance that are approved by the Securities and Exchange Commission and other relevant authorities, the provisions of the regulations would apply.

For the purposes of taxation, the arrangement above would be treated in the same manner as a conventional bond as provided under the CITA and CIT Exemption of Bonds and Short-term Securities Order. By virtue of the Order, companies are granted exemption on their trading income from corporate and government bons, treasury bills and other short-term securities. The regulation also stipulates that the SPV, is subject to tax administrative procedures, including filing of returns.

Islamic Fund Management

In addition to the above, the Regulation applies where there is an arrangement between a fund manager and an investor to pool funds for the purpose of investment and generating returns, in line with Sharia'h principles; and the arrangement is based on the

principles of Wakala, Mudarabah, Musharakah, or any other Sharia'h compliant arrangement that may be approved by SEC. These arrangements would be treated in the same manner as with conventional fund management under the CITA.

Islamic Real Estate Investment Trusts (I-REITs)

Where there is an arrangement to pool funds for the purpose of investment in real estate related assets based on the principles of Wakala, Mudarabah, Musharakah, or any other Sharia'h compliant arrangement approved by SEC and in line with shariah principles and similar rules as those applicable in conventional real estate investment apply. These forms of real estate investment are to be treated as the conventional real estate investment under the CITA.

General Provisions

It is however notable that income under the non-interest finance arrangements shall be subject to the provisions of the CITA, the Tertiary Education Trust Fund (Establishment) Act 2011, National Information Technology Development Agency Act and Personal Income Tax Act. In the same vein, fees charged on any transaction conducted pursuant to the Regulation are subject to WHT Regulations, and the VAT Act and transaction documents are subject to the SDA, where applicable.

Furthermore, where money is paid, distributed, or shared to participants or customers in the form of a share of profit or return on investment, such payment or distribution shall be subject to the provisions of the WHT Regulations. In the same vein, where a financial institution grants a customer rebate, discount, waiver, or reduction of an amount, it shall be deemed an income to the financial institution and taxed appropriately. However, where there is an agreement between the financial institution and the customer for such rebate, there shall be no tax liability.

Conclusion

It is useful to note briefly that the introduction of the Non-Interest Finance (Taxation) Regulation is a step in the right direction as it provides a useful legal framework for the taxation of non-interest financial institutions (NIFIs) in line with the extant tax laws. Notably, the Regulation would be significant in ensuring that NIFIs and conventional financial institutions receive similar treatments, where practicable, for the services offered. It is however recommended that the relevant provisions of the Regulations may be included in the proposals for amendment of the relevant laws in the Finance Bill 2022.

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