TAX GROSS-UP CLAUSES IN AGREEMENTS AND NIGERIA'S NEW WITHHOLDING TAX REGULATIONS: ISSUES AND PRACTICAL CONSIDERATIONS

1. Introduction

Following the coming into effect of the Deduction of Tax at Source (Withholding) Regulations 2024 (the "Withholding Tax Regulations") on 1st January, 2025, there have been questions about the continued relevance, applicability, and enforceability of tax gross-up clauses in agreements for various commercial transactions. The concerns being expressed are based on a provision in the Withholding Tax Regulations that a deduction made from payments should not be a separate tax or an additional cost of the contract or included in the contract price. This has resulted in various questions being asked, such as, whether gross-up provisions are still lawful and enforceable? Whether gross-up clauses have been outlawed in Nigeria?

We have provided in this article an overview of tax gross-up clauses in commercial agreements, examined their continued application in the context of the Withholding Tax Regulations, and explored practical considerations for taxpayers to minimise the impact of the application of gross-up clauses. Although tax gross-up clauses are relevant to various types of agreements for commercial transactions, we have made particular references in this article to agreements for lending transactions so as to contextualise our analysis.

2. Withholding Tax and Gross-up Clauses

2.1 Withholding tax is an advance payment of income tax required by law to be deducted at source from payments for various types of transactions. Such payments include interest, dividends, rent, royalty, fees, contract sums, etc. Essentially, the payer of the income is required to withhold a prescribed percentage of the payment before the balance is paid to the recipient and then remit the amount withheld to the relevant tax authority. While the payer of the income is obligated to deduct and remit the tax, the financial burden is by law on the recipient of the income. This is because the applicable laws require the tax to be deducted by the payer from the payment liable to withholding tax before the balance is paid over to the recipient.

2.2 While tax obligations are statutory, in practice, parties tend to include tax provisions in agreements to clearly spell out their respective obligations and address how the financial burden of taxes applicable to the relevant transaction will be handled. This is particularly so in the case of withholding tax where the recipient of the income may require the payer to assume the financial burden through a tax gross-up clause in the relevant agreement. Under a tax gross-up clause, the payer agrees to pay the recipient an amount sufficient to cover the

amount withheld, where withholding tax is required to be deducted from the payment, so that the recipient will still receive the full agreed-upon sum payable as if there was no deduction. The payer, in this case, would be responsible, not only for the obligation to withhold and remit the tax to the relevant tax authority but also for assuming the contractual obligation to pay the amount required to be paid by the recipient on account of the withholding tax imposed on the sum.

2.3 Tax gross-up clauses are typically used when the recipient of the income holds a position of leverage in a transaction and, thereby, compelling the payer (such as a borrower, a lessee, etc) to agree to terms that safeguard the transaction's success. The party with less bargaining power, usually the payer, is often willing to bear the needed additional financial burden to ensure that the deal is executed. For example, it is a standard market practice in lending transactions, whether bilateral or syndicated, to include provisions in the agreements that: (a) prohibit the borrower from deducting or withholding any amounts from any payment due to the lender unless that deduction or withholding is required to be made by law; and (b) if a tax deduction or withholding is required by law to be made by the borrower, the amount of the payment due from that borrower to the lender shall be increased to an amount which (after making any tax deduction or withholding) leaves an amount equal to the payment which would have been due to the lender if no tax deduction or withholding had been required and made. Since lenders would usually be in a position of leverage, borrowers would often accept the gross-up condition in order to facilitate a quicker and seamless closing of the deal.

3. The Position under Nigerian Tax Laws and Impact on Tax Gross-up Clauses

3.1 Regulation 5 of the Withholding Tax Regulations provides that: "*A deduction made from a payment shall not be — (a) regarded as a separate tax or an additional cost of the contract or transaction; or (b) included in the contract price, but treated as an advance or final tax of the supplier, as the case may be".* There has been a misconception among some taxpayers that this provision is new and that it was introduced specifically to address and prohibit tax gross-up clauses in agreements. This is, however, not the case. The provision (now contained in Regulation 5) has been in existence for a significant period and has never prevented taxpayers from incorporating tax gross-up clauses into their contracts. Specifically, paragraph 2 of the Companies Income Tax (Withholding Tax) Regulations, 1997 (which regulations have now been repealed) stipulated that "*a deduction made from a payment shall not be regarded as an additional cost of the contract to be included in the contract price but as tax due on the payment*". This is what has been repeated

in Regulation 5, albeit in broader terms. This historical context of tax gross-up clauses, which both tax authorities and taxpayers never have issues with as outlawing gross-up clauses, underscores the fact that Regulation 5 is not intended to prohibit tax gross-up clauses. As a result, the longstanding recognition and acceptance of gross-up clauses in contracts continues to be upheld. The tax authorities have also not taken steps to push that tax gross-up clauses are unacceptable despite their very common practice. In addition, the several recent amendments to the tax laws through the various Finance Acts have not proscribed tax gross-up clauses. What this means is that tax gross-up clauses remain valid, acceptable, binding, and enforceable.

3.2 On the impact of the application of gross-up clauses on taxpayers, section 27(1)(l) of the Companies Income Tax Act 2004 (as amended) (the "CITA"), which was introduced by the Finance Act 2019, provides that notwithstanding any other provision of the CITA, *"no deduction shall be allowed for the purpose of ascertaining the profits of any company in respect of any tax or penalty borne by a company on behalf of another person*". This provision acknowledges that there are situations where a company may bear the tax burden of another entity. Rather than outrightly criminalising or prohibiting such arrangements, the provision simply disallows the deduction of such amounts (paid as taxes on behalf of another party) as allowable deductions when determining the profits of the company that assumes this responsibility. The combined effect of the provisions of section 27(1)(l) of the CITA and Regulation 5 of the Withholding Tax Regulations on the treatment of tax gross-up clauses is not to interfere with such clauses but to ensure that the tax paid by one party on behalf of another will not be: (a) regarded as a separate tax or an additional cost of the contract or transaction; (b) included in the contract price; and (c) allowed for deduction when calculating the paying party's taxable profits as the amount paid cannot be said to have been wholly, exclusively, necessarily and reasonably incurred for the generation of the taxpayer's profits.

3.3 Although the above statutory provisions make the application of tax gross-ups less appealing, they do not render it illegal. The provisions can be interpreted to have given recognition to gross-up practice since they acknowledge that where a company bears the tax burden of another entity, such additional payment will not be part of the contract price and not an allowable deduction. In our view, had the legislature intended to explicitly prohibit the use of tax gross-up clauses, they would have done so by including an express provision in the statute to that effect. Since there is no such express provision in the relevant statutes, taxpayers remain free to include tax gross-ups in their contracts, provided the payer is willing to bear the financial consequences.

3.4 The position in Section 27(1)(l) of the CITA is re-affirmed in the Nigeria Tax Bill (the "NTB") which seeks to repeal certain tax laws and consolidate the legal framework for taxation in Nigeria. Section 21(m) of the NTB provides that *"a deduction shall not be allowed for the purposes of ascertaining the profits or*

income from any trade, business, profession, or vocation in respect of any tax or penalty borne on behalf of another person". The implication of this is that where the NTB is passed into law, a taxpayer who assumes the responsibility of paying tax on behalf of another party — whether through a gross-up clause or otherwise — will still be unable to claim a deduction for such payments when calculating its taxable profits. Notably, the retention of this provision in the NTB implicitly recognises tax gross-up arrangements as it acknowledges that there are situations where a taxpayer may bear the tax burden of another entity or individual, as the case may be. The NTB and other similar statutes are currently pending before the National Assembly undergoing legislative processes before they could become laws.

3.5 The application of gross-up provisions in Nigeria has also received judicial recognition. For instance, in the case of *Total v Akinpelu [2004] 17 NWLR (Pt. 903), 509 at 528*, which was in relation to a clause in a deed of lease that requires the lessee to pay all existing and future taxes, rates, assessments and outgoings of every description to which the premises or the lessor or lessee in respect of the premises are or is or shall hereafter be liable, the Ibadan Division of the Court of Appeal held that the lessee was required to pay from its own resources the withholding tax of 10% due on the rent payable for the premises and imposed by the Personal Income Tax Act. This was notwithstanding that the tax liability was that of the lessor who was the recipient of the rent (a taxable income).

3.6 The Court of Appeal also held that unless the provisions of a statute are specific about the object of preventing the performance of an obligation under a contract, the statute should not be used as an excuse to avoid a contractual obligation. The court further held that, in the absence of specific provisions affecting the obligation, the provisions of the statute should not be used as an excuse to breach the contractual obligation. Consequently, once parties have agreed to regulate their legal position by a written document, neither of the parties can withdraw from it.

4. Our Position on the Relevance of Regulation 5

Based on our foregoing analysis, the conclusion that we have arrived at is that Regulation 5 of the Withholding Tax Regulations does not prohibit the inclusion and application of tax gross-up clauses in contracts. Going by the regulation and the above provision of the CITA, the consequence of grossing up is that the relevant tax authority will not permit a taxpayer to treat the additional withholding tax amount (to ensure that the counterparty receives the same sum under the contract as if there was no withholding) as an allowable deduction. If a taxpayer has already deducted the amount, the tax authority will disregard it and add the amount back to the payer's taxable profits. This does not make

contractual grossing-up unlawful. Regulation 5 serves more as guidance to taxpayers to understand that the grossed-up amount cannot be (a) regarded as an additional cost of a contract or transaction; or (b) included in the contract price for tax deduction purposes. The tax authorities are primarily concerned with ensuring that the correct withholding tax amount is deducted and remitted, rather than who ultimately bears the withholding tax burden.

5. Managing Withholding Tax Obligations and the Impact of the Application of Gross-up Clauses

5.1 While tax gross-up clauses remain valid, binding, and enforceable, depending on the nature of the parties and the type of transactions, parties sometimes structure their transactions in a way that minimises withholding tax implications in respect of sums payable under such transactions. For example, in cross-border lending to Nigerian borrowers, the CITA grants some exemptions from withholding tax on interest payments on foreign loans if the following conditions are met: (a) where the term of the loan is above seven years (with a grace period of not less than two years); (b) where the term of the loan is between five to seven years (with a grace period of not less than eighteen months); or (c) where the term is between two to four years (with a grace period of not less than twelve months). The grace period applies on both the repayment of principal and payment of interest. The withholding tax exemption on interest payments is 70%, 40%, and 10% respectively, depending on the structure of the loan.

5.2 To the extent possible, parties sometimes transact with tax-exempt entities where there will be no obligation to withhold tax on the income of such entities. In lending transactions, borrowers occasionally take loans from lenders that are entitled to exemption from withholding tax or to withholding tax at a reduced rate. For example, the Diplomatic Immunities and Privileges Act 2004 and some orders made pursuant to it, grant tax exemptions to various multilateral financial institutions of which Nigeria is a member. Since there will be no withholding tax on the interest payments accruing to such entities, borrowers will not have the burden of the tax of that entity through a gross-up provision. Consequently, any tax gross-up clause in the facility agreement may have minimal impact on the borrower. To enable a borrower to continuously monitor its tax obligations and exposure in this scenario, borrowers may require such a tax-exempt lender to disclose its tax-exemption status and to notify the borrower if there is any change to the lender's tax status thereafter.

5.3 Similarly, parties occasionally enter into transactions with counterparties that are resident in countries with which Nigeria has effective double tax treaties ("DTT"). Where this is the case, such parties may enjoy certain treaty benefits. For instance, while the withholding tax rate on interest payments is 10% under the CITA and the Withholding Tax Regulations, where: (a) the recipient of the interest is a foreign entity or individual residing in a country that has a DTT with

Nigeria; and (b) the DTT specifies a lower withholding tax rate (that is, lower than the 10% prescribed in the CITA and Withholding Tax Regulations), the rate specified in the DTT will take precedence over the 10% domestic rate. A borrower may also require a DTT resident lender to notify the borrower if the lender should cease to be so resident. Parties, however, need to ensure that their transactions are not structured with the primary intention of minimising taxes through the use of DTT-resident entities as tax authorities usually frown on such cases.

6. Conclusion

Despite concerns that have been expressed in some quarters regarding the interpretation and application of Regulation 5, our conclusion is that the longstanding practice of including tax gross-up clauses in contracts remains valid, binding, and enforceable in Nigeria. The application of tax gross-up provisions in transactions, therefore, remains lawful and parties remain free to include the same in contracts. For businesses and other taxpayers, the key takeaway is that with careful structuring, transactions could be optimised to leverage the tax incentives and exemptions in the tax laws to minimise tax burden and exposure. This will be in a way to ease and minimise the financial strain that conventionally accompanies the implementation of tax gross-up provisions in contracts. On treaty benefits, transactions should be conducted with legitimate business purposes in mind, and care should be taken to avoid any arrangements that could be construed as a treaty shopping mechanism.

This publication has been provided by Joseph Eimunjeze and Tochukwu Nwankwo of the Tax team at Udo Udoma & Belo-Osagie. For more information about our Tax practice group offerings, please visit our website at www.uubo.org or email us at joseph.eimunjeze@uubo.org and tochukwu.nwankwo@uubo.org.

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