S.P.A. AJIBADE & CO, Lagos, NIGERIA

THE LEGALITY OF GROSS-UP PROVISIONS IN COMMERCIAL AGREEMENTS REVISITED[1]

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ABSTRACT:

"Every man is entitled, if he can, so … that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in so ordering them so as to achieve this result, then, however unappreciative the Commissioners for Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."[2]

> *The above mentioned fundamental principle of tax law is not only time-honoured, but of great antiquity. From the English Shipmoney case[3] which laid down the principle that no tax can be levied without parliamentary consent, to the decision in the Duke of Westminster[4] case, penumbra areas in tax legislations have always been resolved in favour of the tax-payer.*
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> *Subsequent decisions of the English House of Lords in WT Ramsay Limited v. Inland Revenue Commissioners[5] and Furniss (Inspector of Taxes) v. Dawson[6] both introduced a substance based approach in the determination of whether a transaction was consummated in order to solely obtain a tax advantage. These decisions, whilst preserving the right of tax-payers to arrange their affairs within the ambit of the law, also discourage transactions which, if viewed as a whole, can be considered to be self-cancelling as a tax avoidance strategy.*

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[1] Olalekan Sowande, Senior Associate with SPA Ajibade & Co., Lagos Office, Nigeria.
[2] Per Lord Tomlin, Duke of Westminster's case, (1936) AC 1.
[3] Shipmoney was a tax of medieval origin levied intermittently in the Kingdom of England until the middle of the 17th century. It was assessed only on the inhabitants of coastal areas of England, it was one of the several taxes that English monarchs could levy by prerogative without the approval of Parliament. The attempt of King Charles 1 from 1634 onwards to levy ship money during peace time and extend it to the inland countries of England without Parliamentary approval provoked fierce resistance, and was one of the grievance of the English propertied class in the lead up to the English civil war.
[4] Supra.
[5] (1981) 1 All ER, 865. A tax avoidance scheme designed to produce allowable loss matched by capital gains which is not liable to tax.
[6] (1984) 1 All ER 854.

The stage of economic development of Nigeria and its position as a capital-importing country imply that the freedom of both individual and corporate citizens to enter into contracts cannot be shackled, fettered or indeed sacrificed on the altar of increased tax revenue as this approach will, in itself, be self-defeating. The economic doctrine of laissez faire[7] *which connotes free enterprise, non-intervention, as well as freedom to freely enter into contract is central and lies at the heart of effective mobilization of Foreign Direct Investment (FDI).*

This article will re-examine the debate on the legality or otherwise of the concept of gross-up provisions in commercial agreements. The writer will review relevant and existing legislations and case law in Nigeria in light of available literature on the topic and argue that parties to an agreement may, once the parties are ad idem, freely contract and consequently gross-up payments in commercial agreements.

INTRODUCTION

A gross-up provision is a provision in an agreement or contract which provides that payments due to the payee in consideration of the terms of the agreement or contract must be made in full free of any deductions or withholding and without any right of set-off by the payer. The rationale for inserting gross-up provisions in a commercial agreement is to ensure that the recipient of payments made in consideration of the Agreement receives full payment net of any deductions by way of withholding tax or such other deductions as may be required by the tax laws.

Withholding tax, also known as retention tax, is a tax collection mechanism devised to ensure that taxes are deducted at source by the payer of any amount due to a payee under a commercial agreement or contract. In contrast to direct taxes such as companies income tax (corporation tax in the United Kingdom), personal income tax, capital gains tax etc., withholding tax is a form of indirect tax which is collected by an intermediary on behalf of the relevant tax authority. According to Mill.[8]

> *Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of the other…*

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[7] Governmental abstention from interfering in economic or commercial affairs. *See* Black's Law Dictionary, 8th ed., p. 892.

[8] *See* John Stuart Mill, PRINCIPLES OF POLITICAL ECONOMY, 1848, Book V, ch 3. *See also* John Tiley, REVENUE LAW 6th ed. p. 18.

Properly defined, indirect taxes are collected and remitted by persons other than the person with the ultimate economic burden of payment i.e., the party on whom the tax incidence is to fall. Withholding tax is a collection mechanism devised to counteract the incidence of tax evasion under an arrangement whereby the payer of any amount due under a contract or an agreement is converted to an agent of the tax authority.

ENABLING TAX LAWS/LEGAL REGIME

In Nigeria, withholding tax is provided for in Sections 78 – 84 of the Companies Income Tax Act (CITA).[9] It provides for the deduction of tax from proceeds of passive investment income such as interests payable on inter-bank deposits, loans, dividends,[10] royalty as well as from salaries under the operation of the Pay As You Earn (PAYE) system. It also provides for deduction of withholding tax on rent.[11] Similar provisions are also contained in the Personal Income Tax Act (PITA) which is the legislation governing the taxation of individuals,[12] the Petroleum Profits Tax Act,[13] (PPTA) as well as the Federal Inland Revenue Service Establishment Act.[14]

Gross-up provisions are incorporated into a variety of commercial contracts, agreements and instruments. For example, in commercial leases, gross-up provisions are incorporated to ensure that a lessee/tenant in addition to paying rent would also, if required by law, be solely responsible for payment of taxes (tax gross up) incidental to the consummation of the lease agreement i.e. from the rent. It should be stated that there are standard clauses in lease agreements which makes it the duty of a lessee to pay certain heads of taxes, rates, fees and levies payable pursuant to the exercise of *usufructuary rights*[15] over the leased property.

In Nigeria, it is standard practice to incorporate certain provisions in lease agreements by which the lessee/tenant covenants to pay all existing and future payments attaching and relating to the use of the property. An example of such a provision is reproduced below:

> *"To pay and discharge all existing and future rates, taxes, assessments and outgoings imposed or charged upon the Property or any part of it and whether or not separately assessed"* [16]

It is debatable whether the above provision is indeed a gross-up clause, as argued and as advanced by some tax practitioners and previous writers on the topic.[17] The purport of the

[9] Companies Income Tax Act Cap. C21, Laws of the Federation of Nigeria 2004.
[10] Ibid, Section 80.
[11] Section 79.
[12] Section 69 – 74 Personal Income Tax Act, Laws of the Federation of Nigeria, 2004 as amended.
[13] Sections 54 and 56, Cap. P 13, LFN 2004.
[14] Ibid.
[15] The right to enjoy the use and advantage of another's property short of the destruction or waste of its substance.
[16] Culled from The Encyclopedia of Forms and Precedents, 5th ed., (1996 Reissue) Vol 13 (1) p. 53.

above provision in a lease, whether residential or commercial, is to confer on the lessee the obligation of paying rates, levies, assessments and such other similar payments due and arising from the use and occupation of the property to the relevant tax authority i.e., local, state or federal government. This provision cannot, ordinarily and in the view of the writer, pass the responsibility of payment of income tax or indeed taxes which are statutorily required to be remitted by the lessor to the tax authority unto the lessee.

The above provision can be distinguished from certain provisions in commercial leases in jurisdictions such as the United States under which the landlord may pass to the tenant the costs associated with **operating** the building or the leased property. It is an additional payment by the tenant for the purpose of reimbursing the landlord for paying the costs of operating, maintaining, insuring and furnishing utilities for the building which are ordinarily the responsibility of the landlord.[18] These provisions allow the landlord to "gross up" these operating expenses payable by him and pass them on to the tenant.

With respect to taxation of companies in Nigeria, the rate at which tax is deducted is provided for in a subsidiary legislation cited as the Companies Income Tax (Rates, ETC., of Tax Deducted at Source (Withholding Tax)) Regulations (WHT Regulations).[19] It provides for the rate at which tax shall be deducted from a payment made for an activity or service. Specifically and particularly instructive are the provisions of Sections 2 and 5 of the Regulation. These provisions are reproduced below:

1. ***Deduction not to be regarded as extra cost***

   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.

2. ***Offences***

   A person required to deduct tax at source under the Act and under these Regulations who fails to do so or having deducted tax fails to pay the tax to the Federal Inland Revenue Service within thirty days from the date the tax was deducted or the time the duty to deduct the tax arose is guilty of an offence and liable on conviction to the penalty set out in section 64 of the Act.

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[17] *See* Olumide Obayemi and Esther Deji-Ojomo, *The Gross Up Clauses in Commercial Leases Within the Context of WHT Regime in Nigeria, available at https://www.proshareng.com/news/Taxation/The-Gross-Up-Clauses-in-Commercial-Leases-Within-the-Context-of-WHT-Regime-in-Nigeria/25451, accessed on 17/08/2016. See also* "Legality of Gross-Up Clauses in Nigeria" in LEGAL ASPECTS OF FINANCE IN EMERGING MARKETS, by Olaniwun Ajayi LP (2005) LexisNexis, p. 615.

[18] Evan L. Randall and Jennifer E. Gannon, *Gross–Up Provisions in Commercial Leases* by Holland & Hart *available at* https://www.hollandhart.com/files/GrossUpProvisionsCommLeases.pdf*, accessed on* 16/08/2016.

[19] Cap. C21, Laws of the Federation of Nigeria, 2004.

Section 2 attempts to prohibit an increase in the contract sum by the amount of any tax that may fall due on payment by use of the word “shall” but without specifically making this an offence. Section 5 of the WHT Regulations however, makes the non-deduction of tax that may fall due on any payment an offence under Section 64 of the parent legislation, the CITA. The philosophy behind the introduction of Section 2 of the WHT Regulations is unclear as it appears not to serve any useful purpose. Moreover, if the efficacy of a law is in its enforcement, the impracticability of the tax authorities to enforce the provisions of Section 2 of the WHT Regulations for each and every contract or agreement entered into and subject of deductions renders the provision unnecessary and superfluous. In a free market economy and in an era of globalization and free movement of goods and capital across borders, it appears that what should be of paramount importance to the tax authorities is whether deductions with consequential remittance to the authorities was made and this has been taken care of by Section 5.

The case of *Total (Nig.) Plc. v. Akinpelu,*[20] has been cited by tax practitioners as one in which the Courts in Nigeria have been invited to pronounce on the legality or otherwise of inclusion of gross-up provision in a contract, in this instance, a lease. In brief, the facts of the case are that sometime in 1957, one Belo Akinpelu as Lessor, leased the property subject of the lease agreement to the lessee for a certain number of years (the head lease) to one Jean Wadu Gamra. Before the expiration of the head lease, the lessee demised the residue of his lease amounting to 50 years to Total (Nig) Plc (the Appellant).

As provided in the head lease, it was part of the lessee’s obligation to abide with the following covenant as contained in Clause 2 sub 2 of the lease:

> *“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 shall be liable”.*

Subsequent to the above, the head-lessor died testate and the property eventually devolved upon the Respondents. The question that arose for determination by the Court of Appeal in this matter was whether in light of the provisions of Clause 2 sub 2 of the lease agreement reproduced above, the Appellant is entitled to deduct the sum of ₦135,000.00 (One Hundred and Thirty Five Thousand Naira) being 10% of the total revised rental sum of ₦1,350,000.00 (One Million Three Hundred and Fifty Thousand Naira) payable to the lessor for a period of ten years for the term 1996 – 2006, as withholding tax.[21]

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[20] 17 NWLR (Pt. 903) p. 509.

[21] The prevailing provision at the time was Section 68 of the Personal Income Tax Decree which is in *pari materia* with Section 69 Personal Income Tax Act, Cap. P8, Laws of the Federation of Nigeria (2004) as amended. *See* Section 79 Companies Income Tax Act.

The Appellant offered to pay the rent amount less the 10% withholding tax as required by law. The Respondent disagreed and rejected the Appellant's offer and contended that the Appellant has contracted to pay **all existing future taxes, rates, assessments and outgoings of every description** (emphasis supplied) based on the covenant contained in the lease. The Respondent instituted an action at the High Court to enforce the provisions of the lease and in its judgement, the trial Court held the Appellant liable to pay the withholding tax chargeable on the rent , i.e., the Court held that the Appellant was under a contractual obligation to pay the rent in addition to the 10% withholding tax.

Upon appeal to the appellate Court, it was the contention of the Appellant that the provisions of the law i.e. Section 68 of PITA which made it the duty of the Respondent to deduct 10% withholding tax on rent due and payable to the Respondent has effectively frustrated the provisions of the lease agreement and that there was a legal obligation that has been cast on the appellant to so deduct for the purpose of onward remittance to the appropriate tax authority. The respondent countered that the provisions of Section 68 of PITA did not frustrate the contractual duty of the Appellant to pay all taxes, rates and assessment levied in respect of the property as contained in the lease agreement.

The Court of Appeal took the position that the Appellant's argument to the effect that the provision of the law has frustrated the covenant contained in the lease would have the effect of overreaching the Respondent. In its judgement, the Court of Appeal held that the Appellant was liable to pay from its coffers the withholding tax of 10% on the rent due to the Lessor and that the obligation has not been frustrated by the provisions of Section 68 of PITA. In the words of Justice Omage JCA:

> *"…It is clear therefore that the Clause 2/2; the covenant undertaken by the Appellant in the deed has not become impossible of performance. It is settled law 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. In my view, an agreement in a deed creates a binding obligation between the parties; in the absence of specific provisions affecting the obligation the provisions at (sic) the statute should not be used as an excuse to breach the obligation…."*[22]

The import of this decision goes to strengthen the position that parties to a contract are entitled to arrange their affairs as they deem fit and in so far as their mutual position has been expressed in writing free of undue influence or any other similar vitiating act or omission, the Court must uphold that which has been freely agreed. Therefore, if the parties

[22] At p. 524 supra.

have agreed to gross-up payments to be made under an agreement, one party should not be allowed to resile from the agreement.

Some writers have argued that gross-up provisions are illegal due to the fact that it has the effect of shifting tax burden in breach of Section 2 of the withholding tax Regulation[23] and that it constitutes an impermissible income tax shifting technique by which a landlord with his superior bargaining powers out-muscles the lessee to accede to a tax liability appropriately chargeable to a landlord.[24] It appears that the ground upon which a gross-up provision is viewed as being illegal is that it has the effect of shifting the tax burden from the one to the other pursuant to the provisions of a contract or an agreement.

If the foregoing is correct, it should be stated that the mere shifting of tax burden *simpliciter* cannot be said to be illegal, it is simply a tax avoidance strategy which remains contractually legal and if done within the ambit of the tax laws. Also, and as argued by Afolabi Elebiju,[25] how would the tax authority effectively monitor the ultimate bearer of the burden of payment for every contract subject to deduction of withholding tax in light of the myriad of challenges faced by tax administrators in the collection and enforcement of the tax laws, couple with the state of development of our tax system? It appears that the primary concern of the revenue authorities and, understandably so, should be the collection of the right amount of taxes into its coffers rather than who ultimately bears the burden as freely expressed in an agreement

In conclusion, it is submitted that rather than advancing the illegality argument of gross-up provisions, a more practicable panacea is to make it impossible for recipients of "grossed-up" payments under a contract to rely on such payments to claim tax credit from the tax authorities. Conversely, and as far as practicable, the party who made such tax payments should enjoy the benefit of the payment in order to avoid a situation in which the payee will utilize such remittances to claim tax credit from the tax authorities.

For further information on this article and area of law please contact Olalekan Sowande at S.P.A. Ajibade & Co by Telephone (+234 1 472 9890), Fax (+234 1 4605092) Mobile (+234 7083086333) or Email osowande@spaajibade.com.

www.spaajibade.com

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[23] *See* "Legality of Gross-Up Clauses in Nigeria", *supra* in LEGAL ASPECTS OF FINANCE IN EMERGING MARKETS (2005) by Olaniwun Ajayi LP, LexisNexis, p. 615.
[24] Ibid.
[25] *See* Afolabi Elebiju, "Withholding Tax: The A –Z of Grossing Up", *available at* https://www.yumpu.com/en/document/view/40187506/withholding-tax-the-a-z-of-grossing-up-templars-law-firm, *accessed on* 16/08/2016.