

# Flaws of the Withholding Tax System in Nigeria (Part 1)

A survey conducted by PwC during a recent tax stakeholders' event revealed that sixty percent of taxpayers consider withholding tax as the most complex aspect of tax compliance in Nigeria.

**“...the process of obtaining refund is not only rigorous but almost impossible in practice. Taxpayers are subjected to intensive audits and even when the claims are certified, refunds are rarely granted. As a matter of fact, Arsenal has a higher chance of winning the Champions League than a taxpayer obtaining a WHT refund.”**

## Overview

The operation of WHT is not peculiar to Nigeria. It is a concept that has been adopted by many countries but subsequently scrapped by most countries. It has been used as a tax mechanism in the United States and United Kingdom as far back as the Second World War but only introduced into Nigeria's tax regime in 1977. In Nigeria, it is regulated by various income tax Acts and the WHT Regulations.

WHT was introduced in the Nigerian tax system to minimise the incidence of tax evasion, by ensuring that more persons are brought into the tax net through disclosure from the larger taxpayers to whom they supply goods or services. In this regard, it serves as a veritable means of gathering information of commercial activities carried out by both resident and non-resident taxpayers for statistical purposes and for formulating tax policy. It is also an efficient way of collecting tax on non-residents who may not have a strong nexus in Nigeria especially on investment income such as dividend, royalty and interest.

## Mechanism of WHT in Nigeria

For most types of business profits, WHT deduction from a taxpayer's income can be credited against the final income tax liability of the taxpayer at the end of the year. However, for investment income such as dividends, interest, royalty and rent WHT is the final tax especially for non-residents.

The operation of WHT in the Nigerian tax regime has various flaws and irregularities leading to aversion from taxpayers. To simplify tax compliance and increase tax collection, government must revamp the WHT process. We highlight some of the major flaws below.

### Flaw #1 – Payment point

By law, the obligation for the deduction and remittance of WHT rests with the customer i.e. the entity paying for goods or services received. In practice, the tax authorities expect the payer to deduct and remit WHT once the relevant expense has been accrued in the accounts even where no cash has been paid or credit otherwise granted. This creates a cash flow strain on

businesses due to the mismatch of accrual accounting and the timing of settlement. WHT should become payable only at the earlier of actual payment or when credit is granted (such as offsetting of intercompany balances) in line with Para 4(1) of the Withholding Tax Regulations.

### ***Flaw #2 – WHT credit notes***

In practice, both federal and state tax authorities issue WHT credit notes upon remittance of WHT. These credit notes are issued to the customer who deducted and remitted the WHT for the benefit of its suppliers (the beneficiaries), to defray the future income tax liabilities of the beneficiary. This practice is not in line with the law. The WHT Regulations actually obligates the customer deducting and remitting the WHT to issue receipts to the beneficiaries. The beneficiaries can then use this receipt (issued by the customer) as a credit for part payment of their final income tax liability. Not only does this not happen in practice, but the various tax authorities are not efficient in issuing the credit notes.

It takes anywhere between two months to a few years from the remittance date before the tax authorities issue credit notes to beneficiaries especially for foreign currency transactions. This approach taken by the tax authorities of issuing credit notes is inefficient. If the reason for introducing the current system instead of the system provided by the law is to combat fraudulent claims, it seems to serve another purpose of making it difficult for taxpayers to get benefit for their WHT. In many economies around the world that operate a WHT system, the accounts of beneficiaries are instantly credited when a payment of tax is made against the beneficiary's unique tax ID.

This automated approach cuts out unnecessary paperwork and inefficiency. Revenue authorities in Nigeria should consider automating this process too. The use of physical credit notes should be eliminated and replaced with a more effective automated system. If commercial banks can credit an account holder in minutes, why should it take months before tax credits are granted to taxpayers?

### ***Flaw #3 – Refund of excess WHT***

Taxpayers are also permitted by law to recover excess WHT where the amount of tax deducted from their income exceeds their income tax liability. So if an entity has WHT credit of say N10 million, and income tax liability of N7 million, the entity is permitted by law to recoup N3m in cash from the Revenue authority. However, the process of refund is not only rigorous but almost impossible in practice. Taxpayers are subjected to intensive audits and even when the claims are certified, refunds are rarely granted. As a matter of fact, Arsenal has a higher chance of winning the champions league than a taxpayer obtaining a WHT refund.

Invariably, low margin businesses end up having excess WHT credits. Funds are trapped and shareholder value is eroded where companies are forced to perpetually carry forward WHT credits with no chance of a refund. It also discourages future voluntary compliance in respect of

WHT. The Revenue authorities should urgently review this practice to ensure that companies which are entitled to tax refunds are not denied this benefit.

### ***Flaw #4 – Inconsistent/incomplete information circulars***

The FIRS has, over the years, released various information circulars relating to WHT. While these documents are meant to provide clarity on issues, this has not been the case because some of the positions in the circulars are not consistent with the provisions of the law. One of the grey areas in the WHT Regulation is the concept of “sales in the ordinary course of business” which are not subject to WHT.

The Regulation does not define 'sale in the ordinary course of businesses'. The FIRS tried to clarify the meaning of the phrase in some of its circulars, but created more confusion in the process. In practice, the various tax officers ignore this exemption and subjects all transactions to WHT apart from so called “across the counter” transactions. This is a phrase introduced by the FIRS and is not mentioned in any tax law.

To address this, WHT should be limited to transactions specifically stated in the Acts and Regulations. Those not specifically mentioned should be excluded to the extent that the transactions fall within the suppliers' ordinary business.

### ***Flaw #5 – Different WHT rates***

There are different WHT rates applicable depending on the transaction being considered. The WHT rates range from 2.5% to 10%. For instance, while rental arrangements are subject to WHT at the rate of 10%, contracts for services attract a 5% rate of withholding tax. There should be a clear distinction between contracts structured as rental arrangements from contracts of/for service. As an example, where a car hire company provides cars and drivers to a customer for a period of time (transportation), the WHT rate should be different from the mere hire of a car (rental).

### ***Flaw #6 – Franked investment income redistribution***

As earlier highlighted, WHT could be used as an efficient way of collecting tax where it may otherwise be difficult on not practicable to assess the recipient to tax. Dividend income is subject to WHT, which is the final tax incurred by the recipient of the dividend. Where WHT is deducted from the income of a company, same is remitted to the FIRS. However, WHT on the income of individuals is remitted to the states Internal Revenue. There are instances where dividend income received by a company is further redistributed. This is typical of holding companies and Trusts. Where this is the case, WHT due on the re-distributed dividend should be offset with the WHT suffered when the income was received in line with the law.

A practical challenge arises where the recipients of the redistributed dividend are individuals. It therefore becomes difficult to offset WHT due to states with those earlier paid to the FIRS. To deal with this difficulty, the relevant tax statutes should be amended to remove the obligation to deduct WHT from dividend payable to resident companies and Trusts.

## **Conclusion**

The new leadership of the FIRS and Joint Tax Board has identified the need to review FIRS circulars and introduce technology in tax administration. It is expected that

proper restructuring of the WHT mechanism will encourage voluntary tax compliance and increase the tax collection capacity of the Revenue. State tax authorities are also looking at ways of improving revenue generation. We therefore expect changes in the WHT legislation, practice and regime and hope that all ambiguities will be resolved sooner rather than later.



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