How Nigeria's tax system discourages investments

" Without investment there will not be growth, and without growth there will not be employment" – Muhtar Kent

Taxation affects investment decisions but the risk is not whether tax would be paid, it is the uncertainty of what, when, how and how much.

Ironically, what businesses and investors need, as a matter of priority, is not tax incentives; it is the removal of tax disincentives.

Businesses have to deal with a myriad of issues and overcome many hurdles to become established and remain afloat. From business registration to obtaining permits, raising capital, registering property, dealing with customs in some cases, getting the right people to hire, handling customer relations, internal control and fraud prevention, financial reporting, investors and other stakeholder management, and paying taxes among others.

Nigeria is currently facing significant challenges as a result of the falling oil prices which has negatively affected the economy in key areas such as the capital market which has lost over 15% of its value in less than 2 months, declining exchange rate of the Naira against major foreign currencies losing over a quarter of its value in the last few months.

We have seen this episode play out a few times and yet it doesn't seem we are doing enough to break the cycle. The real solution is to productively diversify the economy away from oil. This is not just about the contribution of the different sectors to Gross Domestic Product (GDP) but in terms of the revenue accruing to government from the various sectors. Nigeria, despite being the largest economy in Africa, has one of the lowest tax revenue to GDP ratios in the world especially if you consider non-oil tax revenue only.

Government has initiated some steps to raise revenue such as the introduction of luxury taxes and the ongoing process to review incentives such as pioneer status which has been the subject of abuse. Unfortunately government is not reviewing tax disincentives which hinder growth, prevent productive diversification of the economy and make it difficult to earn sustainable tax revenue outside oil.

Just a few days ago I was asked to advise some foreign investors who have businesses across Africa and wanted to establish their African investment headquarter in Nigeria. Unfortunately, they changed their minds once they realised the unbelievable amount of tax disincentives they would have to contend with. By the way this is not an isolated case and each of such opportunity that will lose means loss of employment, loss of taxes, loss of economic growth and diversification. And this is not just about foreign investments, consider the insurance industry for example, a sector that is bigger than banking in many countries and has the capacity to mobilise long term funds for real economic development better than banks. Apart from the regulatory issues, the insurance industry in Nigeria bears far more tax burden than the banking industry. It is almost as if the insurance tax regime was designed to ensure that the industry does not thrive.

To encourage both local and foreign investments, we must address the existing tax disincentives especially the following:

Excess dividend tax

Based on the tax authority's interpretation of the relevant provisions of the law, tax is imposed at 30% on the dividend distribution of a company if it is more than the current year taxable profit notwithstanding that the profit being distributed may have already been taxed or legally exempted from tax. For instance, a company that delays the distribution of profit to its shareholders for reinvestment in one period will be subject to the tax when subsequently paid out as dividend. Also, a company that distributes dividends from realised capital gains after paying the applicable capital gains tax will be subject to the 30% tax on the dividends paid notwithstanding that the applicable tax on the gain being distributed had already been paid. More importantly, and this is why no discerning investor would establish a holding company in Nigeria if they have a choice. A holding company that receives dividends from a subsidiary, associate and other equity investments will suffer 30% tax when it further distributes the dividends to its shareholders. This is absurd and contrary to another provision of the tax law that protects dividend received by a company from any further tax.

Minimum Tax

The Companies Income Tax Act (CITA) imposes minimum tax on companies where they have no taxable profits or taxable profits resulting in lower than minimum tax. This minimum tax also applies, in different forms, to some specific sectors such as insurance companies. This effectively means that such companies would have to pay taxes out of their capital. It is like forcing a man who is suffering from excessive loss of blood to donate some blood. This increases the risk of failure for such companies. If there are issues concerning the genuineness of losses being declared by some companies, it should be addressed as a separate issue through tax audit and transfer pricing rather than paint all companies with the same brush.

Commencement rule

CITA sets out some rules for the taxation of a company during commencement of business. These rules are unnecessarily complicated and result in double taxation of such companies during their start-up phase. Companies should be made to pay tax only on their actual profits on a preceding year basis right from start to finish (in the event of cessation of business).

Too many taxes and multiple revenue agencies

This is about multiplicity of taxes but also earmark taxes and statutory contributions. Beyond this, there are also multiple agencies that businesses have to deal with outside those required by the constitution. It also means multiple audits from different agencies that lack coordination and collaboration thereby increasing the cost of doing business. On the part of government, cost of revenue collection is unnecessarily high given that tax revenue collection structures are duplicated rather than centralised and strengthened.

Non-payment of tax refunds

Although there are specific provisions in the various tax laws for tax refunds to be paid to taxpayers who have genuine claims, in practice this is rarely the case. Certain provisions of the law such as deduction of VAT at source by government agencies and high withholding tax rates in some cases make the problem of tax refund a permanent feature of the tax system. Tax authorities should be more willing to refund genuine overpayment of taxes and government should set aside funds out of tax collection for refunds both at the federal and state levels.

The way forward

Government revenue may be down but the good news is that the most impactful changes do not require money - they are systemic, structural and institutional so what we need is a shift in mind-set to drive reforms that are designed to address the fundamental issues and a political will to implement.

Some of the tax changes required to make Nigeria conducive for foreign and local investments include simplification of the tax system, better clarity about taxes that are payable and removal of excess dividend tax, minimum tax and commencement rule.

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