pwc

Tax Bites

Understanding the impact of the proposed increase in VAT rate.

Russell Eastaugh

Oluwatoyosi Olakiigbe

The decision of the Federal Executive Council (FEC) to approve the proposed increase in the VAT rate from 5% to 7.5% did not come as a surprise as there have been several attempts by recent and past administrations to increase the VAT rate.

The funding of the new minimum wage is the supposed reason for the proposed increase. Based on various news reports, the increase is justified by the fact that our existing 5% rate is one of the lowest in the world. However, the low rate may not be a rational basis for the increase, considering that Nigeria currently operates an unusual VAT system. Unusual because of the severe restrictions on the Input VAT claim that are available to tax payers. For example, VAT incurred on services, overheads and capital expenditure are not claimable against output VAT. Input VAT is only claimable on the goods purchased for resale and items used in the direct manufacture of a product on which output VAT will be charged. This would only benefit manufacturers and businesses that buy goods to resell.

Other tax payers are only able to get a 32% benefit on input VAT incurred through an income tax deduction or a 30% capital allowance claim spread over several years. Businesses that are solely focused on export are even worse off as they are unable to get any benefit either through an income tax deduction or a capital allowance claim which is counterintuitive in a system where the government's agenda is to drive export sales. The tax refund system is also not completely effective and tax payers are usually not encouraged to apply for a refund.

In fact, our VAT is a levy which is similar to the sales tax system rather than the VAT system of other countries; sales tax rates are not usually as high as VAT rates and there are other countries with lower VAT rates that operate a "normal" VAT system and are able to maximise the process to efficiently generate revenue.

The 2020 budget sent to the national assembly for approval was accompanied by a finance bill. The finance bill proposes this VAT increase and if it is approved along with the budget, then the 7.5% rate will become effective in January 2020. However, there is recent information that the Senate rejected the proposed VAT increase and instead have put forward a bill for the imposition of 9% communication service tax on telephone and data users as well as the pay-per-view cable subscribers. The rejection by the senate could potentially slow down the process for the implementation of the new rate as the approval of the senate is crucial to the process.

Implications of the increased rate

The increased rate would certainly lead to increased collections that can be used to fund the payment of the minimum wage. It would also reduce the budget deficit and by implication the debt that would have been acquired to fund the minimum wage. However, there are downsides to the increase that could have been avoided if other avenues of generating additional revenue had been exploited other than an increase in the VAT rate.

The downsides would be higher inflation and a decrease in disposable income which would further shrink the economy.

Also, important to note is that there is bound to be increased cost of collection and cost of tax payer education which would mean that the increased rate would not exactly translate to a perfect 50% increase in VAT collections.

Businesses selling directly to the final customers especially in the fast-moving consumer goods and services sector would experience pressure to remain competitive and may have to absorb part or all the VAT increase so that the price of goods and services are not affected. Businesses whose goods or services are VAT exempt would experience an increase in cost as they are not able to claim input VAT incurred since their products are exempt. There is also a cascading effect on customers and businesses that operate in a value chain where VAT is unclaimable. For example, if a business sells a service that has a ratio of costs which suffer VAT to sales of 50%. 5/105 of the costs the business incurs is unclaimable VAT, which represents 2.4% of sales. Businesses pass on the unclaimable VAT cost to the customer by increasing the cost of the service provided which means that the actual VAT that the customer pays is 7.4% (which is the current 5% plus unclaimable 2.4% of sales).

If the VAT rate is increased to 7.5% then 7.5/107.5 of the costs incurred will be unclaimable which is 3.5% of sales. If this VAT is passed on to the customer, then the customer would effectively be paying VAT at 11% which means that the costs of certain goods and services may increase by more than 2.5%.

Transitional Considerations – Government & Tax Authorities

The increase in the VAT rate will be more accepted if other factors are put in place that would cushion the effect of the increase on businesses and taxpayers. The government should consider amending the VAT law to include the ability of tax payers to claim all Input VAT incurred without any restrictions. Also, an efficient tax refund system should be considered as this would increase the trust of tax payers in the system.

The provision of a threshold for registration and remittance of VAT such that small businesses do not have to worry about compliance would also be helpful. A VAT Bill, which would have dealt with most of the issues in our VAT law, was drafted some years ago and this may be a good time to revisit this bill. VAT is a regressive tax, meaning that it has a disproportional effect on poorer people who spend (and must spend) a greater part of their income than the rich. If the rate is increased, this effect will be more severe, and the government would have to consider some means to protect the poorer parts of society. This could include changing the current exemption on basic food stuffs to a zero rating (meaning that VAT would not be trapped in the production costs) recognising that many basic food items have to go through some form of processing. Then also defining more clearly what is meant by basic food or what specific food items would qualify for the exemption. We note that there are some amendments that may be made in the finance bill about basic foods and a VAT

registration threshold, we still await further details of exactly what has been proposed at the time of this article.

For transitioning, the tax authorities should ensure that a well thought out plan for taxpayers is circulated to capture issues such as the temptation to raise invoices before the effective date (at 5%) for supplies that will take place after the increase and treatment for bad debt written off and later recovered amongst others.

Transitional Considerations – Tax Payers

Taxpayers would also need to review existing contracts that provide for ongoing or periodic supplies of goods/service as well as the resulting system and documentation changes that should be effected internally before the effective date.

Tax payers would also need to consider the impact of the change on their business and take decisions on if the additional cost would be passed on to customers or absorbed internally. Business would also need to manage communication to customers in respect of the change.

Conclusion

We understand that the Government would require more money to fund the new minimum wage however, the Government should be taking a more critical look at how revenue generation is utilised and seek for more ways to manage expenditure. The recent announcement of restrictions on business travel for government officials and office holders is welcome especially if it will be strictly enforced.

Also, the government should look at implementing policies that can stimulate business environment in such a way that there are taxes to collect from more transactions.

Also, a radical change in the VAT system and how it currently operates should be considered so that it becomes a better tax system. These changes would include allowing input tax credits, including a VAT registration threshold, and implementation of an effective tax refund system. The government should also give more attention to how to protect the poorer members of society from the cost increase that would be experienced by consumers as a result of the increase in the VAT rate.

Russell is a Tax partner at PwC Nigeria. He has over 30 years experience in taxation matters with UK Inland Revenue and with Big Four accountancy firms in South Africa, Uganda and Nigeria.

Toyosi is a Manager in the Tax and Regulatory Service Unit of PwC Nigeria with specialisation in mergers and acquisitions, tax strategies, international tax planning, group structuring, business combination and tax function effectiveness.