

3 March 2005

MEMORANDUM FOR

Mr. G.O. Adesina  
Acting Director, Tax Policy Research and Development  
Department

cc: Ms. Ifueko Omoigui  
Chair – FIRS  
Professor Paul Collier  
Ms. Karin Lissakers  
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From: Robert Conrad

Subject: VAT Withholding

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I. Current Policy

I understand that all supplies to the government regardless of governmental level (federal, state or local) are subject to VAT withholding.<sup>1</sup> For instance, the VAT on a supply of 100 is 5 under Nigerian law. The government is required to withhold the 5, instead of paying that amount to a VAT.

There are three difficulties with this approach:

a. The Government May Be Collecting Too Much VAT Revenue

The status of the taxpayer's input credit is not clear. It is clear that if all the taxpayer's business transactions are government contracts then the taxpayer

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<sup>1</sup> Both goods and services, in addition to exempt supplies, are covered by this provision. I understand that the extension to goods is based on the notion that the supplier is effectively defined as a service provider if that supplier enters a government contract. That is, an automobile dealer is supposedly contracted to provide the service of obtaining automobiles on behalf of the government. The extension of VAT withholding to suppliers of exempt goods is evidently justified by that same interpretation. An alternative example is that a drug company supplying medicines to the government under a contract is deemed to be providing the service of supplying such goods and thus is subject to VAT withholding. Evidently, there had been discussion about the nature of relative incentives when the provision was enacted. For instance, in the case of otherwise exempt supplies, an employee of a government agency can buy exempt goods for cash without VAT but the same supplier would be subject to VAT withholding if there was a formal contract with the agency. Finally, VAT withholding is extended to any person with a government contract regardless of their status as a VAT taxpayer. That is, VAT withholding is required even in cases where the supplier does not issue, or is legally prohibited from issuing, a VAT invoice.

will have no input credits, at least de facto because refunds are nonexistent. The government will collect too much in such cases.

The situation is ambiguous, however, with respect to taxpayers that sell both to the government and to the private sector. A VAT taxpayer with VAT receipts sufficient to claim all credits, both for sales to government and to other sectors, will be largely unaffected by the rule.<sup>2</sup> VAT revenue will be too high, however, for taxpayers with mixed sales but who do not have sufficient VAT revenues from other sources to claim credits for all inputs. Suppliers of exempt goods and non-registered taxpayers simply receive less for their goods and services unless the contract value is grossed up to include the withholding.

b. FIRS May not Be Collecting the Revenue from Other Parts of Government

It appears that FIRS cannot collect all revenue withheld in this manner. Government agencies have been reluctant to deposit amounts withheld into the appropriate government account. This problem may be particularly acute for amounts withheld by state and local governments. The central government may not be able to withhold revenue sharing (from the Federation Account) to the state and local governments for amounts not remitted.<sup>3</sup>

c. VAT Withholding and Reverse Withholding

There is confusion about VAT withholding and the reverse withholding provision under the income tax. A withholding tax of 5% on gross payments is imposed on certain persons as a prepayment of the personal or companies' income tax. Government and the private sector withhold this tax. There appears to be confusion about how the two withholding taxes are applied, reporting procedures and other matters.<sup>4</sup>

Despite these problems, there is a proposal to expand VAT withholding by requiring firms in the oil and gas sector to withhold in a manner identical to the government.

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<sup>2</sup> I am not aware of an apportionment rule that would disallow input credits from supplies to government. Such a rule would be bad policy because sales to government are not exempt.

<sup>3</sup> There is also the question about whether the FIRS auditors know the total amounts withheld at the various governmental levels.

<sup>4</sup> A VAT should be independent of the income tax. That is, VAT collections are not part of an income taxpayer's gross revenues and VAT paid on inputs is not deductible (if the output is taxable). Thus, the most straightforward solution is to impose a 10% withholding tax on suppliers subject to both types of withholding. Half of the tax should be VAT withholding and the remaining half should be an advanced payment for the income tax.

## II. Recommendation

The proposal for expanding VAT withholding should be resisted. This proposal will place oil and gas producers in a difficult situation. They will have to withhold VAT from suppliers who may have little opportunity to obtain legitimate credits. The net result might be that the tax will cascade and increase costs for oil and gas producers. In addition, the government will attempt to retain revenues that are not legally the government's property under standard VAT definitions.

In addition, I believe there should be an effort to dismantle VAT withholding by government, perhaps except in some specified cases where services are imported.<sup>5</sup> Other things equal, VAT revenues will fall if the system is dismantled. According to the statistics supplied to me, almost 13% of 2004 VAT receipts were from "Government".<sup>6</sup> I believe that much, if not most, of this revenue arose because of the VAT withholding. The loss of revenue from eliminating VAT withholding is justified because a significant amount of that revenue should not be retained by Government in the first instance.

One alternative might be to continue VAT withholding but to restrict the process to VAT taxpayers and allow suppliers to use the amount withheld as deemed VAT revenues and allow full credit. I do not believe this will work. Record keeping is complicated and there is the potential for significant abuse. The refund system is not working well and thus nothing will change if taxpayers are allowed to file for refunds but are not able to obtain them.

An alternative would be to restrict VAT withholding to persons supplying taxable services to government. I understand this is the practice in Kenya. I do not recommend this policy unless it is necessary to obtain some positive movement from current policy. There is still an issue for persons who supply services to both government and other sectors. In addition, there is a presumption that the ratio of taxable inputs to taxable output is small, at least small enough to justify the elimination of the credit. This assumption may not be valid depending on wages and other costs. For instance, the cost of maintenance and repairs, fuel and other taxable inputs might be a significant proportion of value added for a transport company, particularly in a relatively low wage country. Other examples include the ratio of wages to value added in construction and the ratio of wages to value added in telecommunications.

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<sup>5</sup> Withholding would become a reverse charge in this case and a reverse charge might be required by all VAT taxpayers (government and private sector) who import services. Such a provision would reduce the negative protection that might be created when domestic services are subject to tax and imported services are effectively exempt because the supplier is not a domestic VAT taxpayer.

<sup>6</sup> In 2004, the Government collected almost 20 billion Naira in VAT while total VAT collections by all sources equaled about 155 billion Naira.

Policies such as VAT withholding may be an indicator that either policy makers, tax administrators or the general public might not be well informed about the purpose of the VAT or that the VAT is being used for revenue purposes without regard for the economic intent of the tax (that is to impose a tax on final consumption). I hope that a series of public (and governmental) educational activities might be developed so that interested parties understand the VAT's purpose, what a reasonable design might be and how Nigerian practice deviates from international norms. Such a process will enhance the likelihood of successful reform.

I hope this memorandum is helpful.

Thank you.