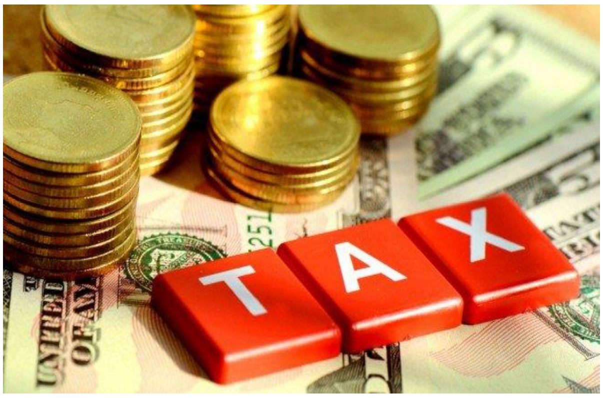
BANWO & IGHODALO

TAXABILITY OF VOLUNTARY PENSION CONTRIBUTIONS IN NIGERIA: APPRAISING THE PUBLIC NOTICES ISSUED BY THE LAGOS STATE INTERNAL REVENUE SERVICE AND THE JOINT TAX BOARD



In what appears like coordinated efforts against perceived abuse of the voluntary pension contribution ("**VPC**") option, under the contributory pension scheme (**"CPS"**) established by the Pension Reform Act, 2014 (**"PRA"**), the Lagos State Internal Revenue Service ("**LIRS**") and the Joint Tax Board ("**JTB**") recently issued separate Public Notices – ***"Public Notice on Tax Relief on Voluntary Pension Contributions"*** dated August 21, 2017 and ***"Public Notice on Abuse of Voluntary Pension Contribution Scheme"*** dated August 24, 2017 respectively.

Whilst both LIRS and JTB (collectively referred to in this piece as the **"tax authorities**") placed reliance on Section 16 of the PRA and Section 17 of the Personal Income Tax Act (**"PITA"**) (Cap P8, Laws of the Federation of Nigeria, 2004, as amended), as the legal basis for issuing their respective Public Notices,*;* the JTB also relied on Section 5(7) of the Labour Act (Cap L1, Laws of the Federation of Nigeria, 2004) for its action. Both tax authorities in their respective Public Notices lay claim to inherent powers derived from the stated sections of the PITA and Labour Act, to deem as invalid and as *"artificial transactions"*, withdrawals made in breach of the conditions spelt out in Section 16 of the PRA; to the effect that such withdrawals *"will be considered to fall outside the tax exemptions granted in Section 10(3) of the PRA"*.

The Public Notices vis-à-vis Statutory Provisions

The taxability of the compulsory pension contributions and of the income earned on voluntary pension contributions is determined by the provisions of Section 10 of the PRA. Section 10(1) includes contributions to the Scheme under the PRA as part of tax deductible expenses in the computation of tax payable by an employer or employee under the relevant income Tax Law and this is irrespective of the provisions of any other Law. Section 10(2) exempts all interests, dividends, profits, investment and other income accruable to pension funds and assets under the PRA from tax. Section 10(3) extends the tax exemption to any amount payable as a retirement benefit under the PRA. Further, Section 10(4) renders any income earned on any voluntary contribution made under Section 4(3) of the PRA subject to tax at the point of withdrawal where the withdrawal is made before the end of 5 years from the date the voluntary contribution was made.

Employees are permitted under Section 4(3) of the PRA to contribute additional portions of their earnings as VPC to their retirement savings accounts ("**RSAs**") maintained with any Pension Fund Administrator (**"PFA"**) of their choice. This is distinct from and clearly independent of the statutory contributions of a minimum of 10% of an employee's monthly emoluments by the employer and the minimum of 8% of the same income stream by the employee under the CPS.

The LIRS and JTB allege in their Public Notices incidences of pre-arranged contribution of large portions of employees' emoluments as VPC into their RSAs simply as a means of avoiding the payment of adequate personal income tax, to be subsequently withdrawn few years later (sometimes before the minimum five years of statutory tax holiday) in lump sum. Whilst the JTB in its Public Notice directly accuses PFAs of marketing the alleged pre-arranged uncapped VPCs by employees and allowing unrestricted withdrawal of same in breach of Section 16 of the PRA, the LIRS declared that it will begin periodic audit of PFA-approved withdrawals of VPCs by individuals, so as to subject such to taxes where they are proven to be in violation of the Section 16.

In specifics, the LIRS states in its Public Notice, that;

- any payments made by PFAs to individuals that do not meet the relevant conditions specified in Section 16 of the PRA will be considered to fall outside the tax exemption granted in Section 10(3) thereof;

- the LIRS will periodically audit withdrawals of voluntary pension contributions authorized by the respective PFAs and will be relying on the provisions of Section 17 of PITA;

- the LIRS will enforce the law with respect to recovery of any tax due which will include: applying interest and penalties on any resulting tax due on the employer under the PAYE scheme in line with Paragraph 8 of the Fourth Schedule of PITA;

- the LIRS is willing to defend its position with each taxpayer or employer through the available judicial process;

- a reporting obligation, on an annual basis, is placed on individuals claiming tax relief on VPC to submit alongside their income tax return, a copy of their RSA statements for the relevant tax year and any other period requested by the LIRS.

Similarly, the JTB Public Notice, in addition to deeming payments made by PFAs on account of VPCs in breach of Section 16 of the PRA as artificial transactions, seeks to restrict the amount that an employee may contribute as VPC to just one-third of the employee's salary, based on the provisions of Section 5(7) of the Labour Act.

Under Section 16 of the PRA, an employee who is below the age of 50 is generally not entitled to make withdrawal from his RSA except;

- after having attained the age of 50 years or where he is permitted in accordance with the terms and conditions of his employment to do so before attaining that age;

- where he retires, disengages or is disengaged from employment on the advice of a suitably qualified physician or a properly constituted medical board certifying that he is no longer mentally or physically capable of carrying out the functions of his office;

- if he suffers from total or permanent disability either of the mind or body; and

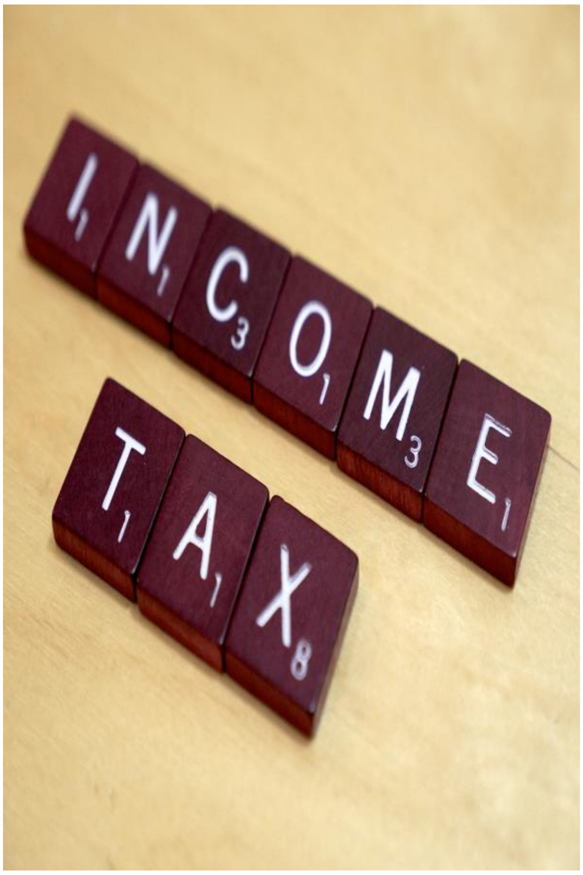
- where he is out of one employment and is unable to secure another employment within four (4) months.

Section 5(7) of the Labour Act limits the total amount of deductions an employer may make from a worker's wages in a month, for any approved purposes, including pension contribution, to one third of the wages of the worker for that month.

Section 17(1) of the PITA allows a tax authority to disregard or make such adjustments to the income of a tax payer which counteracts the effects of any disposition or transaction where it is of opinion that such disposition is not in fact given effect to, or that such transaction which reduces or would reduce the amount of any tax payable is artificial or fictitious.

Issues arising from the Public Notices

The main issues agitating the mind following the Public Notices are simply that of propriety and enforceability. The positions taken by the tax authorities in the Public Notices could face a number of legal hurdles and indeed open the floodgates of unending litigation, if the Public Notices are implemented as indicated.



First, we observe that VPCs as well as employer's and employee's statutory contributions under the CPS are covered by the general exemption of pension contributions from taxes provided in Section 10(1) of the PRA. This tax exempt status also extends to all interests, dividends, profits, investment and other income accruable to pension funds and assets (inclusive of VPCs as well as employer's and employee's statutory contributions) **except income earned on VPCs where withdrawal is made from the VPC by an employee within 5 years from the date of the voluntary contribution**. In this respect a distinction is made between the VPC itself (as a form of pension contribution) and the income accruing therefrom. Therefore, where the withdrawal is made from the VPC after 5 years from the date of the voluntary contribution albeit in contravention of section 16 of the PRA, it seems there would be no legal and valid basis for subjecting either the amount of the VPC withdrawal or the value of the income earned on same to any form of tax. Also, where such withdrawal is made before the expiration of 5 years from the date of the voluntary contribution, it does not appear that the provisions of section 10 of the PRA permits imposition of tax on such withdrawal. According to section 10(4), only income earned on such VPC can be subjected to tax.

Second, it would appear that the tax authorities presume that Section 16 of the PRA sets exhaustive rules for withdrawals from RSAs and subjects to tax any withdrawal made otherwise than in accordance with its provisions. However, a closer scrutiny of Section 16 would show that the section generally provides for the circumstances under which withdrawals may be made from the RSA and does not in any manner attempt to specifically set rules for VPC withdrawals. It is admitted that since VPCs are deposited in RSA, any withdrawal therefrom would amount to withdrawal from an RSA which will come within the ambit of Section 16 of PRA. However, it is doubtful that the tax authorities can apply Section 16 to override Section 10(4) such that any withdrawal made in contravention of Section 16 will be subject to tax or that income earned from VPC will be subject to tax where the withdrawal was made after 5 years of the voluntary contribution. This is especially so, in light of the fact that Section 10(1) of the PRA commences with the phrase "*Notwithstanding the provision of any other law…*"

Third, a deeper look at Section 5(7) of the Labour Act raises some concerns as to its applicability to the issue at hand. Though the section rightly limits the total allowable deductions from the monthly wages of a worker to one-third of the wages of the worker for that month, it is doubtful if such limit can be extended to voluntary contributions. It would appear that such limit is intended to be a statutory shield for workers in respect of permissible mandatory deductions to which their wages may be subjected and such deductions seem to be restricted to those listed in the preceding subsections – reasonable amount of fines for injury or loss caused to the employer by the willful misconduct or neglect of the worker; pension contribution such as is obligated under the CPS; membership dues to any recognized trade unions; and refund of overpayment of wages. Therefore, since VPCs are being made by the worker as a means of savings (employers would only be involved as mechanism for effecting the payment), they do not fall within the category of "deductions" covered by the said Section 5 of the Labour Act and a worker cannot be legally restricted from making voluntary personal savings from his legally earned income nor can the amount of such savings be capped.

Further regarding the applicability of Section 5 of the Labour Act, the definition of a "worker" under Section 91(1) of the Labour Act clearly excludes certain cadre of employees from the ambit of the Act. These are:

a) *any person employed otherwise than for the purposes of the employer's business; or*

b) *persons exercising administrative, executive, technical or professional functions as public officers or otherwise; or*

c) *members of the employer's family; or*

d) *representatives, agents and commercial travelers in so far as their work is carried on outside the permanent workplace of the employer's establishment; or*

e) *any person to whom articles or materials are given out to be made up, cleaned, washed, altered, ornamented, finished, repaired or adapted for sale in his own home or on other premises not under the control or management of the person who gave out the articles or the material; or*

f) *any person employed in a vessel or aircraft to which the laws regulating merchant shipping or civil aviation apply;".*

So, with the various exemptions created under Section 91(1), it is doubtful if the JTB can validly apply its Public Notice to the generality of employees as intended.

Fourth, and finally, while it appears the tax authorities have some measure of discretionary powers under Section 17(1) of the PITA, to classify any *disposition* as *artificial or fictitious* and the relationship existing between an employee and an employer on the one hand and that between an employee, an employer and a PFA on the other, both fall within the purview of the wide discretion granted under Section 17(3)(b), it is not clear whether pension contributions, which are usually not taxable in many jurisdictions globally, in order to encourage savings and stimulate provident funds among the populace; could validly be grouped with the certain transactions affected by Section 17(3)(b) of PITA.

Furthermore, employers of labour cannot be compelled to stop withdrawals of VPCs by their employees as the individual employee's RSA is completely outside the control of the employer. At any rate, it would appear difficult for tax authorities to singlehandedly impose penalties for any deemed breach of the conditions for permissible withdrawals under Section 16 of the PRA (against any erring PFA or possibly against an employee under the CPS), without the involvement of the National Pension Commission (**"PenCom"**), the regulatory authority for the pension industry in Nigeria.

Concluding Remarks

The objectives of the Public Notices issued on withdrawal of VPCs by the tax authorities are clear and understandable. Simply, they aim at;

- curbing the alleged abuse of the VPC scheme;
- reducing the rate of tax avoidance among income earners and blocking revenue leakages for the government;
- achieving the overall purpose of adopting the CPS model of provident fund which is steady, stable and secure future savings; and
- implementing the recently launched National Tax Policy (**"NTP"**).

As laudable as these objectives are, it is our opinion that enforcement of the Public Notices will face stiff challenges as to their legality or of steps proposed therein. We therefore advise the tax authorities to collaborate with other stakeholders towards initiating legislative reforms for streamlining the connected statutes such as the PRA, PITA and Labour Act and other relevant statutes with a view to providing the required legal framework for the current tax-revenue drive of the government and plugging any identified loopholes being utilized in tax avoidance schemes. This is certainly more expedient than embarking on a course of action that is likely to result in unending distractive litigation that is likely to trail any enforcement of compliance with the Public Notices and the attendant expenditure of time and resource.

The Grey Matter Concept is an initiative of the law firm, Banwo & Ighodalo

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