

COMPANIES' INCOME TAX AUDIT IN NIGERIA: LEGAL AND ADMINISTRATIVE FRAMEWORK AS WELL AS RIGHTS AND OBLIGATION OF TAXPAYERS

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ABSTRACT

This study discussed the development of companies' income tax audit and highlights the legal and administrative framework including, the rights and obligations of taxpayers in Nigeria. We employed the exploratory research approach using extant tax laws provision as well as review of relevant books and journals. We recommend that companies and institutions should deduct taxes and remit same to relevant tax authorities as provided in tax laws. For control purposes and especially with the practice of self-assessment scheme, FIRS should carry out tax audit on a regular basis and on reasonable taxpayers, in order to detect cases of underpayment, non-payment and overpayment of taxes. This should be in line with generally acceptable audit rate and selection manner. Hence, the companies and institutions and FIRS should employ and train personnel with technical capacity to undertake this responsibility.

Key Words: Tax Audit, Tax Investigation, Legal and Administrative Framework

Introduction

Taxes and tax systems are fundamental components of any attempt to build nations and this is particularly the case in developing nations. As Brautigam (2008) noted, taxes underwrite the capacity of states to carry out their goals; they form one of the central arenas for the conduct of state-society relations, and they shape the balance between accumulation and redistribution that gives states their social character. In short, taxes build capacity (to provide security, meet basic needs or foster economic development) and they build legitimacy and consent (helping to create consensual, accountable and representative government).

According to Mc KERCHAR and EVANS (2009), a key component of any tax system is the manner in

which it is administered. "No tax is better than its administration, so tax administration matters a lot" (Bahl and Bird, 2008:296). As the National Tax Policy (2008) puts it, tax administration cut across the three tiers of government and a core success factor for any system is its position on administrative issues. Therefore an effective tax policy document should be one that establishes clear guidelines on current tax administrative issues.

The essential objective of tax administration is to ensure maximum possible compliance by taxpayers with their tax obligations. Unfortunately, according to Brautigam (2008) in many developing countries, tax administration is usually weak and characterized by extensive evasion, corruption and coercion. In many cases,

overall tax levels are low and large sectors of the informal economy escapes the tax net entirely.

Tax administration is the framework established by statute to ensure that the purpose, scope and objectives of a tax policy are achieved. It covers all the processes involved in taxation from the identification and registration of tax payers to issuance of tax returns forms through tax assessment, appeal and payment procedure, tax audit to the eventual issuance of tax clearance certificates to tax payers. Tax audit which is the focus of this study has been defined by the Organization for Economic Co-operation and Development (OECD) (2006), as a specialized examination carried out to determine whether a taxpayer has correctly assessed and reported its tax liabilities. Ojo (2008) opines that it involves checking of the books and records of the taxpayer to ensure strict compliance with tax laws and relevant statutes.

The challenge of enhancing tax compliance has not been adequately tackled in Nigeria. Nigeria's tax system has been described as woefully lacking in the required manpower, infrastructure, and technology (Ajayi and Onwuekwe, 2001; and McPherson, 2004). No wonder the National Tax Policy (2008) seeks to provide a set of guidelines, rules, and modus operandi that would regulate Nigeria's tax system and provide a basis for tax legislation and tax administration.

Again, as the country is striving to be one of the 20 most developed nations in the world in the year 2020; the need to promote tax culture and ensure that the audited financial statements and the related tax computations submitted by taxpayers agree with underlying records cannot be overemphasized.

Therefore, this study is timely and relevant to all citizens and employees in tax audit unit in companies and institutions, as well as other

stakeholders to better understand the importance of tax audit as well as their rights and obligations.

Literature Review

Tax Audit

The importance of auditing has necessitated its application to areas other than corporate financial reporting, resulting in the concept of specialized audit. ICAN (2009) defines specialized audit as audit where special concentration is required to achieve other objectives that are not part of the objective of statutory audit. Tax audit is an example of specialized audit. They are additional to statutory audit and are carried out by tax officials.

OECD (2006) states that tax audits are practised in countries like Australia, Canada, France, New Zealand, United Kingdom and United States.

ICAN (2009) states that tax audit can be in the form of desk audit and field audit. OECD (2006) described desk audit as an audit carried out as soon as a tax return is submitted within the Inland Revenue office. The focus of a desk audit is to ensure completeness of the items submitted for tax purpose and also look for apparent errors or mistakes in the computations or in accompanying documents and records. Basically, desk audit could be on pre-audit information, arithmetical accuracy and risk profiling. When additional information or more documentary evidence is required at the end of a desk audit, it results in field audit.

Kastlunger, Kircher, Mittone & Pitters (2009) describes field audit as all-encompassing and undertaken outside the tax authority's office. It typically entails a comprehensive examination of all information relevant to calculation of a taxpayer's tax liability for a given period. The objective is to determine the correct tax liability for a tax return as a whole. Weris (2000) says in some

countries, field audits are carried out as part of random audit programs that are used to gather data on the extent, nature and specific features of tax compliance risk. Given the broad scope, Ishola (2005) stated that field audit is typically costly to undertake. A substantial program of field audit will require considerable resources and reduce the rate of coverage of taxpayers that could otherwise be achieved by a more varied mix of audit type.

Ojo (2009) opines that tax audit exercise is meant to enable the Revenue Authority to further satisfy itself that audited financial statements and the related tax computations submitted by the taxpayer agrees with the underlying records. And with the adoption of self assessment scheme (SAS) by tax authorities in Nigeria, tax **audit** becomes a useful tool to check tax payers. Two issues are relevant in tax audit and these include audit selection and audit rate. They are discussed below.

Audit Selection

The first type of taxpayer-tax authority interaction is similar to the standard principal- agent model, in which the “principal” (or the tax authority) must design some rule to affect the behavior of the “agent” (or the taxpayer). The second type of interaction can be examined using the standard tools of game theory. A factor intimately connected to assessment is the manner by which the tax agency selects tax returns for audit. There are many ways to select individual returns for a tax audit. The simplest and most widely used is a random audit rule, in which each individual faces a fixed, predetermined probability of audit, regardless of his or her report. Many tax agencies do in fact randomly selected some returns for audit.

However, most audit selection is heavily dependent on the information received from taxpayers on their tax returns; that is, the tax

authority does not always select tax returns randomly for audit but instead uses information from the returns to determine strategically whom to audit. The probability of audit is therefore not fixed and random, as assumed in the basic model, but rather is variable and endogenous, depending in part on the behaviour of both the taxpayer and on the other, the tax authority. From this perspective, there are a number of ways in which the tax authority utilizes the transmission of information from taxpayers in the strategic selection of tax returns for audit.

Audit selection methods that utilize information provided on the tax return are far more effective in generating tax compliance than purely random selection methods, even when the random audit rate is 20, 30, or 50 percent (Collins and Plumlee, 1991; Alm, Cronshaw, and McKee, 1993). On the other hand, a cut-off rule, in which a taxpayer who reports less than some cut-off level of income is audited with certainty, is the most effective in increasing compliance, although it requires a large number of audits.

Another rule requires that an audited individual will face some back audits if found to be noncompliant in the current period (a conditional back audit rule). This rule is also able to increase compliance significantly and the audit rate is far lower than the cut-off rule. Auditing an individual found to be noncompliant in the current period with certainty for a number of future periods (a conditional future audit rule) appears to be the least effective of the endogenous rules, although compliance still exceeds that under all random audit rules.

Audit Rates

Audit rate refers the number of sample selected for audit as compared to the total number of tax returns received by the tax authority. Estimation results suggest that a higher audit rate leads to more

compliance, with an estimated reported income – audit rate elasticity ranging from 0.1 to 0.2. Witte and Woodbury (1985) and Dubin and Wilde (1988) use cross section information from the TCMP and generally find that higher audit rates discourage evasion. Dubin, Graetz, and Wilde (1990b) use pooled time series – cross section information on actual USA IRS collections. They estimate and found that as audit rate declines income tax collection also reduces. Kinsey (1992) and Sheffrin and Triest (1992) examine individual survey data and also find that compliance increases with a greater (perceived) probability of audit. Audit rates and prior audit experience have been ambiguously discussed in relation to tax compliance.

Audit and tax Compliance

Studies such as Jackson and Jaouen, 1989; Shanmugam, 2003; Dubin, 2004, claimed that audits have a positive impact on tax evasion. These findings suggest that in self-assessment systems, tax audits can play an important role and their central role is to increase voluntary compliance. Audits rates and the thoroughness of the audits could encourage taxpayers to be more prudent in completing their tax returns, report all income and claim the correct deductions to ascertain their tax liability. In contrast, taxpayers who have never been audited might be tempted to under report their actual income and claim false deductions. Butler (1993) also found that tax audits can change compliance behaviour from negative to positive. These findings complement the Witte and Woodbury (1985) and the Beron, Tauchen and Witte (1988) studies. Witte and Woodbury in their study of small proprietors found that tax audits have a significant role in tax compliance. They did not empirically test individual taxpayers, thus left open room to conduct research in this area.

While Butler (1993) and Witte and Woodbury (1985) found significant results between audit and tax compliance, Beron *et. al.* (1988) found a contradictory result. They reported that audits did not significantly correlate with evasion for all groups they studied. Audits were found to be more effective in inducing taxpayers to over claim deductions rather than encouraging them to correctly report actual income (Beron *et. al.*, 1988). Another study by Dubin, Graetz and Wilde (1987) estimated the determinants of income tax reporting as a function of audit rates using state-level, time-series and cross-section data from the Annual Report of the IRS for the years 1977-1985. They found that higher audit rates often have a positive impact on income tax reporting but one that varies by audit class and one that is not always statistically significant. The study also found that there is a spillover effect from tax audits; that is, taxpayers who are not themselves audited pay more in taxes when audit rates increase.

Difficulty with existing theoretical and empirical literature has lead to the use of experimental economics as an additional approach to compliance research. Laboratory experiments seem particularly well suited for the study of some aspects of the taxpayer reporting decision. Unlike empirical work, experiments generate data under different settings in which there is control over extraneous influences (Alm, 1999).

Nearly all experimental studies have found that a higher (random) audit rate leads to more compliances, with an estimated reported income-audit rate elasticity ranging from 0.1 to 0.2 (Friedland, Maital, and Rutenberg, 1978; Beck, Davis, and Jung, 1991; Alm, Jackson, and McKee, 1992a, 1992b; Alm, Cronshaw, and McKee, 1993). However, Alm, McClelland, and Schulze (1992) find that this impact appears to be small and nonlinear, so that the deterrent effect of a higher

audit rate eventually diminishes. They also find that many subjects appear to substantially overweight the probability of an audit, so that there is far more compliance than is predicted by expected utility theory; indeed this result is nearly universal across all experimental designs. Also, Spicer and Hero (1985) and Webley (1987) find that individuals who have been audited report more income post-audit than individuals who have not been audited.

In summary, previous studies have evidenced that tax audits play an important role in increasing voluntary compliance. Audits rates and the thoroughness of the audits could potentially encourage taxpayers to be more prudent in completing their tax returns.

The tax audit program of a tax authority performs a number of roles that effectively makes a significant contribution to improved administration of taxation. Kastlunger, Barbara, Erich Kirchler, Luigi Mittone, and Julia Pitters (2009) describe these roles as follows; promote voluntary compliance, gathering information on the health of the tax system, education of taxpayers and identification of areas of the law that requires clarification.

From the foregoing, the importance of tax audit on tax compliance has been studied and findings suggest that tax audits are important in both SAS and GAS. And especially in SAS where taxpayers compute and pay their tax liability, tax audit becomes useful to check incidences of under-reporting of income. At the 3rd Lagos State Taxation Stakeholders' Conference, Fashola (2010) explained that the government through its tax audit recovered #15billion in 2008 while #17billion was recovered in 2009. This clearly reveals that tax audit is very necessary in Nigeria which practices SAS and where a high degree of honesty is required to enhance tax compliance.

Legal and administrative framework including rights and obligation of the taxpayers

However, prior to the establishment of the Self-Assessment Scheme in 1991 in Nigeria, there was no specific provision in the Companies Income Tax Act for tax audit. Section 43 Subsection 4 of the Companies Income Tax Act 2007 was introduced to empower the Inland Revenue to carry out Audit. The subsection states “nothing in the foregoing of this section or in any other provision of the Act shall be construed as precluding the Board from verifying by tax audit any matter relating to entries in books, documents, accounts or returns as the Board may from time to time specify in any guideline”. Therefore, an integral part of the self-assessment scheme is the periodically verification of the tax return filed by taxpayer through a tax audit process.

Again, though tax audit is not specifically mention in the Federal Inland Revenue Establishment Act 2007, S. 27, says FIRS may give notice in writing to any person it considers necessary, requiring such person to deliver fuller or further returns in respect of any matter relating to its functions. Of course the functions of the FIRS are among others, to assess and collect taxes. Any company or institution may be called in this regards about their employees, debtors, creditors, contractors and retainers.

S. 28 (1&2) provides that every bank shall prepare upon demand by the FIRS quarterly returns in respect of their customers for the purpose of obtaining information relating to taxation. Any contravention of the provisions commits an offence and shall on conviction liable to fine of between #50,000.00 and #500,000.00. Furthermore, sections 29(1-8) gives power to an authorized officer of FIRS free access to all lands, building, places, books and documents including those stored or maintained in computer or

electronic media, for the purpose of collecting any tax under any of the relevant enactment or law. According to S.30, such books and documents could be removed for the purpose of making copies and returned as soon as practicable. Companies and institutions should know that their banks or offices could be visited

Tax investigation is related to tax audit and S.35 (1-4) of FIRS Establishment Act gives power to the FIRS to employ special purpose tax officers to assist any relevant law enforcement agency in the investigation of any offence under the Act. In addition, the FIRS shall have the power to investigate or cause investigation to be conducted to ascertain any violation of any tax law and if it appears to FIRS that the lifestyle of a taxpayer and the extent of his properties are not justified by his sources of income, such investigation may be conducted into the properties of the taxable person. It must be emphasized that where investigation reveals any offence, persecution is carried out.

As part of the tax administration process, the 2010 National Tax Policy S.5.6 provides for tax authorities to carry out routine verification of tax returns filed by taxpayers to confirm correctness and accuracy. On the other hand, tax authorities may when deemed necessary carry out specific review of taxpayers' records in order to ascertain the tax status, whether the records have been previously provided or not. In other words, audit of taxpayers' returns are routine and carried out periodically while investigations are done for a specific purpose or in respect of the specific activities of a taxpayer.

The NTP provides for frequent and periodic tax audit while it should be simplified and made taxpayer friendly. To reduce time and cost, electronic and other technology related system should be deployed. It is expected that tax

investigation should take the same manner but should be more rigorous as it could lead to legal action against taxpayers. On the whole, both processes should be open, fair and independent and taxpayers shall be allowed to make representations and provide relevant information to assist tax authorities. Meanwhile, taxpayers could make review and appeal to appeal tribunal.

According to the Handbook on the implementation of self-assessment tax regime in Nigeria (2011), the self-assessment regime relies on taxpayers' willingness to voluntarily comply but fear of being audited by tax authorities helps to ensure tax compliance. Hence tax audit stands to verify the records of taxpayers and if a taxpayer is selected to be audited, it does not necessarily mean the taxpayer is suspected of underpayment rather, it could serve as a good reason to make taxpayer stay honest and make sure he keeps records especially the deduction of claims. In addition, the handbook, says tax investigation is introduced into the tax system to deal with taxpayers unwilling to comply with the tax laws provision or taxpayers scheming to circumvent the provision of the tax laws in order to reduce their tax liabilities. However, special investigation deals with all suspected cases of deliberate or willful tax evasion or fraud.

Conclusion and Recommendations

Taxation is a major fiscal policy instrument available to governments to raise revenue and regulate the economy. Government's determination in ensuring sustainable revenue generation through taxation cannot be overemphasized. In this paper, we discuss the development of tax audit and highlighted the legal and administrative framework including the rights and obligations of taxpayers in Nigeria.

Companies and institutions should deduct taxes and remit same to relevant tax authorities as provided in tax laws while ensuring that annual tax

returns are rendered as well. For control purposes and especially with the practice of SAS, FIRS should carry out tax audit on a regular basis and on reasonable taxpayers, in order to detect cases of underpayment, non-payment and overpayment of taxes. This should be in line with generally acceptable audit rate and selection manner. Hence, companies, institutions and the FIRS should employ and train personnel with technical capacity to undertake this responsibility.

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