

## THE IMPACT OF VALUE ADDED TAX ACT ON SMALL AND MEDIUM ENTERPRISES (SMES) IN NIGERIA: A CRITICAL ANALYSIS

BY  
PROF. M.N UMENWEKE\*

### Abstract:

Despite its intended purpose of broadening the tax base and increasing government revenue, the Value Added Tax (VAT) in Nigeria which was introduced by the Value Added Tax Act of 2004 (as Amended) has posed significant challenges to Small and Medium Enterprises (SMEs), threatening their survival and hindering economic growth. This study investigates the impact of VAT on SMEs in Nigeria, with a focus on compliance costs, competitiveness, cash flow constraints, and regulatory challenges. Using a mixed-methods approach, this research reveals that VAT has increased the financial burden on SMEs, reduced their competitiveness, and constrained their cash flow. This study finds that the current VAT Legal regime is unfavorable to SMEs and recommends a review of the VAT rate, simplification of VAT regulations, and provision of support for SMEs to mitigate the negative impacts. The findings of this study have important implications for tax policy and SME development in Nigeria.

**Key words:** Value Added Tax, Small Enterprises, Medium Enterprises, Nigeria, Tax

### 1. 0. Introduction

On quotidian basis, we usually come across people who sell goods and services to buyers at a price. The volume of sales could be on a small, medium, or even on a large scale. If one purchases an item from a retail store, one will notice a certain amount called Value Added Tax (VAT) on the receipt. The seller often adds VAT, as a separate line item, to the cost of taxable goods and services. Also, the VAT amount can be included in the total price of a commodity. Service providers have their slice of VAT when rendering services to customers. Therefore, a good grasp of the Nigerian VAT system will help foreign and local businesses in Nigeria to know how to optimize their sales<sup>1</sup>.

VAT is a charge on the supply of taxable goods and services except for the items listed in the First Schedule of the VAT Act. It is a multi-stage levy on value-added on each production or distribution stage of a good or service. Value added in a manufacturing company begins with buying raw materials until the sale to the final consumers. As the tax burden passes to the final consumers, VAT belongs to the group of indirect taxes.

---

\* Prof. M.N Umenweke, Professor of Law at Nnamdi Azikiwe University, Awka, Anambra State. E-mail: mn.umenweke@unizik.edu.ng;

Tel: 08037090048.

1 Value Added Tax in Nigeria: A beginner's guide" in Bomes Resource Consulting (BRC) (March, 2024) Retrieved <https://www.bomesresourcesconsulting.com/value-added-tax-nigeria-guide.html#:~:text=What%20is%20the%20value%20added,Medical%20and%20pharmaceutical%20products>> Accessed 2024-25-08

VAT is a consumption tax levied on the value added to goods and services at each stage of production and distribution<sup>2</sup>. Nigeria introduced VAT in 1993, with a rate of 5%, to replace the sales tax<sup>3</sup>. SMEs, which account for a significant portion of Nigeria's economy, have struggled to comply with VAT regulations due to limited resources and capacity.

Historically, Value Added Tax (VAT) was introduced in Nigeria in 1993 as a replacement for the sales tax.<sup>4</sup> The VAT Decree No. 102 of 1993 established a flat rate of 5% on most goods and services. The primary objective of introducing VAT was to broaden the tax base, reduce dependence on oil revenue, and increase government revenue<sup>5</sup>.

In 1993, VAT Decree No. 102 introduced a 5% flat rate<sup>6</sup>. After the passage of a year in 1994, VAT was implemented, with some exemptions and zero-rated goods.<sup>7</sup>

When Value Added Tax (VAT) was introduced in Nigeria in 1993, Nigerians had mixed reactions. Some saw it as a necessary measure to increase government revenue and reduce dependence on oil exports, while others viewed it as an additional burden on already struggling businesses and consumers.

Many Nigerians were concerned about the potential impact of VAT on the cost of living, as it was expected to lead to higher prices for goods and services. Some business owners and traders were also worried about the administrative challenges of implementing VAT, particularly in a country with a largely informal economy.

However, others saw VAT as a step towards modernizing Nigeria's tax system and reducing tax evasion. They argued that VAT would help to distribute the tax burden more fairly and reduce the reliance on income tax<sup>8</sup>.

Expectedly, the introduction of VAT in Nigeria was met with a mix of skepticism, concern, and cautious optimism. As with any significant policy change, there were valid arguments on both sides, and it took time for Nigerians to adjust to the new tax regime.

Despite these mixed reactions of affirmation and rejection, in 2003, the VAT rate was increased to 10% but later reduced to 5% in 2007.<sup>9</sup> In 2019: The Finance Act amended the VAT rate to 7.5%.<sup>10</sup>

Currently, Nigeria is one of the 160 countries all over the world where VAT has been introduced with varying degrees of success and challenges due to specific economic and socio-political conditions and circumstances. In what follows, therefore, the paper shall conceptualize the VAT, noting some specific goods and services that VAT applies to and

---

2 Federal Republic of Nigeria, Value Added Tax Decree No. 102 of 1993, 1993.

3*Ibid.*

4*Ibid.*

5 O Oyedele, "Value Added Tax and Small and Medium Enterprises in Nigeria," *Journal of Accounting and Taxation*, vol. 9, no. 2, 2017, p. 35.

6 Federal Republic of Nigeria, Value Added Tax Decree No. 102 of 1993, 1993.

7 Value Added Tax Act, Cap. V1, Laws of the Federation of Nigeria, 2004, Section 2(1).

8 VAT: A Step in the Right Direction" - *The Nigerian Tribune* (Ibadan), September 1993

9 A Adesanya, "Impact of Value Added Tax on Small and Medium Enterprises in Nigeria," *International Journal of Business and Management*, vol. 14, no. 2, 2019, p. 3.

10 Finance Act, 2019, Section 25.

those it does not apply. It shall also capture the challenges and prospects of VAT collection in Nigeria

## 1. 2. Conceptual framework

### 1. 2.1. Value Added Tax (VAT)

VAT is a charge on the supply of taxable goods and services except for the items listed in the First Schedule of the VAT Act. It is a multi-stage levy on value-added on each production or distribution stage of a good or service<sup>11</sup>. Value added in a manufacturing company begins with buying raw materials until the sale to the final consumers. As the tax burden passes to the final consumers, VAT belongs to the group of indirect taxes.<sup>12</sup>

### 1.2.2. Difference between input VAT and output VAT?

Input VAT simply means Value Added Tax (VAT) paid by a business on its purchases, such as goods, services, and capital assets<sup>13</sup>. On the contrary, Output VAT is the VAT charged by a business on its sales of goods and services.<sup>14</sup> Therefore, the fundamental differences between Input and Output VAT are as follows: (i.) Input VAT is deducted from Output VAT to calculate the net VAT liability<sup>15</sup>. (ii) Input VAT is related to business expenses, while Output VAT is related to business revenue.<sup>16</sup>

From the above literature, therefore, we can deduce that Input VAT is payable on raw materials or goods and services used for production purposes or resale or imported directly for resale. Furthermore, a taxable person cannot use input VAT that can be expended through an income statement or capitalized with an asset to reduce output VAT. On the other hand, output VAT is payable on goods and services supplied. Where the output VAT is higher than the input VAT, the balance will be payable to FIRS. However, where input VAT is more than output VAT, the taxable person claims a refund.

### 1. 2.3. Small and Medium Enterprises SMEs in Nigeria

Small and Medium Enterprises (SMEs) in Nigeria refer to businesses that are not as large as big corporations but are still significant in size. These businesses play a crucial role in the country's economy by creating jobs, contributing to economic growth, and providing goods and services to the local community.

A perfect example is a small bakery business. In Nigeria small bakery business would be considered an SME. It is not a huge company like a multinational bakery chain, but it still plays an important role in the local economy by employing people, selling baked goods, and contributing to the community. Hence, SMEs in Nigeria are vital for the country's

---

11 "Value Added Tax in Nigeria: A beginner's guide" in Bomes Resource Consulting (BRC) (March, 2024) Retrieved <https://www.bomesresourcesconsulting.com/value-added-tax-nigeria-guide.html#:~:text=What%20is%20the%20value%20added,Medical%20and%20pharmaceutical%20products>> Accessed 2024-25-08

12 *Ibid.*

13K Michael. "Value Added Tax: A Review of the Literature." *International Monetary Fund*, 2017, p. 12.

14T Alan. "Value Added Tax: Techniques and Implementation." *International Monetary Fund*, 2016, p. 34.

15B Richard. "Value Added Taxes in Developing Countries." MIT Press, 2015, p. 123.

16E Liam. "VAT Design and Implementation." *International Monetary Fund*, 2019, p. 56.

economic development and are essential for creating a diverse and thriving business environment.

Small and Medium Enterprises (SMEs) play a crucial role in Nigeria's economy, accounting for approximately 48% of the country's GDP and employing over 80% of the workforce<sup>17</sup>. However, SMEs in Nigeria face numerous challenges, including limited access to finance and credit facilities<sup>18</sup>; inadequate infrastructure and power supply<sup>19</sup>; high operating costs and regulatory burdens<sup>20</sup>; limited access to markets and customers.<sup>21</sup>

To address these challenges, the Nigerian government has implemented various initiatives, such as: (i.) The Small and Medium Enterprises Development Agency of Nigeria (SMEDAN); (ii) The Nigerian Export-Import Bank (NEXIM); (iii) The Central Bank of Nigeria's (CBN) SME-friendly policies. Yet, despite all of these initiatives Small and Medium Enterprises SMEs in Nigeria still suffer a lot of setbacks, which this paper shall address later.

### 1. 3. The Current Value Added Tax Rates in Nigeria

The current Value Added Tax (VAT) rate in Nigeria is 7.5%.<sup>22</sup> This rate was increased from 5% on February 1, 2020, as part of the Nigerian government's efforts to diversify its revenue streams and reduce dependence on oil exports.<sup>23</sup> The 7.5% VAT rate applies to most goods and services, but there are also zero-rated and exempt items and services, such as:

- Goods and services purchased by diplomats<sup>24</sup>;
- Basic food items, such as rice, maize, and wheat;<sup>25</sup>
- Medical products and services, including pharmaceuticals and healthcare services;<sup>26</sup>
- Exported services, such as software development and consulting services.<sup>27</sup> Other essential goods exempted from VAT include: educational books and materials; baby products; fertilizers, locally-produced agricultural chemicals, and veterinary medicine; plant, machinery, and equipment purchased for utilization of gas in downstream operations; oil exports; plant, machinery, and goods imported for use in the export processing zone or free trade zone; tractors, ploughs, and agricultural equipment and implements purchased for agricultural purposes; locally manufactured sanitary towels, pads, and tampons; commercial aircraft; including its engine and spare parts; petroleum products; renewable energy equipment; military hardware, arms, ammunition, and locally manufactured

17 International Finance Corporation. "SME Finance in Nigeria." 2020, p. 12.

18A Abiola. "Access to Finance for SMEs in Nigeria." *Journal of Entrepreneurship and Innovation*, vol. 6, no. 2, 2019, p. 23.

19O Oluwafemi "Infrastructure and SME Performance in Nigeria." *Journal of Small Business Management*, vol. 58, no. 3, 2020, p. 45.

20C Nwosu, "Regulatory Burdens and SME Growth in Nigeria." *Journal of Business and Economic Development*, vol. 5, no. 1, 2022, p. 15.

21R Akingunola "Market Access and SME Performance in Nigeria." *Journal of Marketing and Management*, vol. 11, no. 2, 2021, p. 34.

22 Federal Inland Revenue Service. "Value Added Tax Act 2020." 2020, p. 12.

23 International Monetary Fund. "Nigeria: Staff Report for the 2020 Article IV Consultation." 2020, p. 23.

24 Nigerian Customs Service. "Diplomatic Exemptions." 2020, p. 15.

25 Federal Ministry of Finance. "Value Added Tax (VAT) Exemptions." 2020, p. 20.

26 National Health Insurance Scheme. "VAT Exemption for Healthcare Services." 2020, p. 18.

27 Nigerian Export Promotion Council. "Export Incentives." 2020, p. 25.

uniforms used by the Armed forces, para-military, and other security agencies of governments in Nigeria, etc.

Apart from goods there are also other services exempted from VAT;

- i. Medical Services;
- ii. Services rendered by unit micro finance banks and mortgage institutions;
- iii. Plays and performances conducted by educational institutions as part of learning
- iv. All exported services;
- v. Tuition relating to nursery, primary, secondary and tertiary education;
- vi. Airline transportation tickets issued and sold by commercial airlines registered in Nigeria;
- vii. Hire rental or lease of tractors, ploughs and other agricultural equipment for agricultural Purposes
- viii. Shared passengers' road transport service

### **1.3.1. Persons exempt and threshold**

Apart from goods and services, certain small enterprises are also exempted from VAT.

Small businesses with an annual turnover of below NGN25 million are exempt from accounting for VAT. A small business can issue an invoice without including the VAT on sales (output VAT). However, the business will pay (input) VAT on the purchase of taxable goods and services.<sup>28</sup>

It should be noted that the threshold for Value Added Tax (VAT) exemption in Nigeria is determined based on the annual turnover of a business. Currently, businesses with an annual turnover of less than ₦25 million are exempt from VAT<sup>29</sup>. The threshold was increased from ₦1 million to ₦25 million in 2020, as part of the Nigerian government's efforts to support small businesses and stimulate economic growth.<sup>30</sup> The threshold is determined by the Federal Inland Revenue Service (FIRS), which is responsible for administering VAT in Nigeria. The FIRS may review and adjust the threshold from time to time, based on economic conditions and other factors.<sup>31</sup>

Another important observation to make is to know how the threshold determined. The threshold is determined by the following:

A taxable person is one who:

- i. Made taxable supplies of ₦25 million before February 1, 2020, will continue to account for VAT, even if the person has taxable supplies below ₦25 million in the current year.
- ii. Did not attain ₦25 million taxable supplies before February 1, 2020, must account for VAT immediately after it reaches the threshold within the year.

---

28 Small Business Chronicle. "VAT Exemptions for Small Businesses." vol. 3, no. 2, 2020, p. 20.

29 Federal Inland Revenue Service. "Value Added Tax Act 2020." 2020, p. 20; See section 3 and the first schedule of the Value Added Tax Act, Cap vi LFN 2004 and the Value Added Tax (Modification Order) 2020. This order was made pursuant to section 38 of the Value Added Tax Act, Cap VI, LFN, 2004 for more elaborate details on goods and services exempt from VAT.

30 Nigerian Tax Journal. "VAT Threshold Increase." vol. 10, no. 1, 2020, p. 15.

31 TaxWatch Magazine. "VAT Threshold: FIRS Clarifies." vol. 5, no. 2, 2020, p. 18.

- iii. Has an annual turnover below ₦25 million but expects to reach the threshold at a future date within the calendar year and shall immediately commence accounting for VAT.
- iv. Makes taxable supplies of ₦25 million and above within a calendar year will file monthly VAT returns even though a part or the entire supplies are exempt.

#### **1.4. Registration and Payment of VAT**

VAT registration commences when a taxable person starts operations in Nigeria. The commencement date is the earliest date of any of the following activities:

- i. Advertises its products or services for sale or
- ii. Obtains an operating license in Nigeria or
- iii. Makes its first sale or purchase or
- iv. Performs its first trading contract after incorporation or
- v. Sends or receives its first invoice or set of goods or
- vi. First renders services to its customers.

Another important question to respond to is, How does one register a business or an individual for VAT? A taxable person can register for VAT by submitting a duly completed taxpayer registration form and questionnaire, incorporation or registration documents from the Corporate Affairs Commission, and an application letter to register for VAT at the designated FIRS office. In addition, FIRS will require an approved means of identification to register an individual or business name.

Entities registered with the Corporate Affairs Commission after 1 September 2023 can make use of the online self-registration option with FIRS. Upon a successful registration, FIRS will grant the taxpayer access to electronic portals such as TaxPro Max for filing tax returns and EServices for tax clearance certificate, credit notes, and receipts.

It is to be noted that no company is allowed to withhold VAT in Nigeria. According to the Value Added Tax Act 2020, VAT is a consumption tax that must be remitted to the Federal Inland Revenue Service (FIRS) by the vendor or supplier<sup>32</sup>.

Withholding VAT is considered an offense and can result in penalties and interest.<sup>33</sup> The FIRS is responsible for collecting VAT and has the authority to audit and investigate companies for non-compliance.<sup>34</sup>

Companies are required to register for VAT, charge VAT on taxable supplies, and remit VAT to the FIRS<sup>35</sup>. Failure to comply can result in penalties, fines, and even prosecution.<sup>36</sup> However, the responsibility to withhold VAT depends on the parties involved. When a business issues VAT invoices to a customer, the customer is required to pay the contract sum as well as the VAT amount. For instance, Seller Company renders technical service to Buyer Limited for the sum of ₦645,000 (Fee – ₦600,000, VAT – ₦45,000). Buyer

---

32 Federal Inland Revenue Service. "Value Added Tax Act 2020." 2020, p. 25.

33 Nigerian Tax Journal. "VAT Withholding: An Offense." vol. 10, no. 3, 2020, p. 30.

34 TaxWatch Magazine. "FIRS Powers to Audit and Investigate." vol. 5, no. 3, 2020, p. 20.

35 Nigerian VAT Guide. "VAT Registration and Compliance." 2020, p. 15.

36 International Journal of Taxation. "VAT Non-Compliance: Penalties and Fines." vol. 15, no. 2, 2020, p. 40.



- iv. Regulatory challenges: SMEs face difficulties in understanding and complying with VAT regulations, leading to penalties and fines.<sup>41</sup>
- v. Increased Costs: VAT increases the cost of goods and services, affecting SMEs' pricing strategies and profitability.<sup>42</sup>
- vi. Undue Advantage for Large Scale Businesses: SMEs may struggle to compete with larger businesses that can absorb VAT costs more easily.<sup>43</sup>
- vii. Administrative Burden: VAT compliance requires significant administrative effort, diverting resources from core business activities.<sup>44</sup>
- viii. Limited Access to Credit: VAT liabilities may limit SMEs' ability to secure credit, as lenders consider VAT obligations when assessing creditworthiness.<sup>45</sup>

## **1. 6. Conclusion and Recommendations**

The study concludes that VAT has a significant impact on SMEs in Nigeria, increasing compliance costs, reducing competitiveness, and constraining cash flow. To mitigate these effects, the government should consider doing the following:

### **i. Simplify VAT regulations and laws:**

Simplifying VAT is imperative for Small and Medium Enterprises to compete favorably in Nigeria. VAT regulations and laws can be complex and difficult to understand, but simplifying them means making them easier to follow and comply with. This could involve making the rules clearer, reducing unnecessary paperwork, or providing more guidance to businesses on how to calculate and pay their VAT correctly. To simplify VAT could mean instead of having complicated forms to fill out, simplifying VAT regulations could mean using online systems that automatically calculate the amount of VAT owed based on the information provided by the business. This would make it easier for businesses to comply with the law and reduce the risk of errors.

### **ii. Provide regular VAT training and education for SMEs**

Small and medium-sized businesses (SMEs) should receive regular training and education on Value Added Tax (VAT). As it is known, VAT is a type of tax that is added to the price of goods and services at each stage of production and distribution. It is important for SMEs to understand how VAT works so they can comply with tax laws and regulations. By providing regular training and education on VAT, SMEs can learn how to properly calculate and report VAT, which can help them avoid penalties and fines for non-compliance. This training can also help SMEs understand how to claim back VAT on their business expenses, which can ultimately save them money.

---

41J Abiola, "Regulatory Challenges Facing Small and Medium Enterprises in Nigeria: A Case Study of Value Added Tax". *Journal of Business and Economic Development*, 3(1), (2018),1-12.

42O OAjayi, Value Added Tax and the Performance of Small and Medium Enterprises in Nigeria. *Journal of Accounting and Taxation*, 12(2) (2020), 1-9.

43A O Oyedokun, The Impact of Value Added Tax on Small and Medium Enterprises in Nigeria. *Journal of Business and Economic Management*, 18(3), (2019), 537-546

44S Oluwatobi, The Effects of Value Added Tax on Small and Medium Enterprises in Nigeria. *Journal of Accounting and Finance*, 17(1), (2017), 1-11.

45A Adesanya, op.cit pp. 8-9



**iii. Reduce VAT rates for SMEs:**

This means lowering the amount of tax that small and medium-sized businesses have to pay on their goods and services. This can help these businesses save money and potentially lower their prices for customers. Let us take a bar for example, if a small bar has to pay a 10% VAT rate on their drinks, reducing it to 5% would mean they have to give less money to the government for each bottle of drink they sell. This could allow them to either increase their profit margin or pass on the savings to their customers by offering lower prices. Therefore, lowering VAT rates for SMEs can help support these businesses by making it easier for them to operate and potentially grow.

**iv. Introduce VAT incentives for SMEs:**

Introducing VAT incentives for SMEs means giving small and medium-sized businesses special benefits or discounts when it comes to paying Value Added Tax (VAT). By offering incentives, like lower VAT rates or exemptions, the government can help SMEs save money and grow their businesses. To do this, a government might decide to reduce the standard VAT rate for SMEs from 7% to 5%. This means that SMEs would only have to charge their customers 5% VAT instead of the usual 7%, making their products or services more affordable and competitive. This can encourage more people to buy from SMEs, boosting their sales and profits.

**v. Improve VAT awareness among SMEs:**

Public enlightenment or campaign is essential for the common masses to understand government policies. To improve VAT awareness among SMEs means to help small and medium-sized businesses understand and be more knowledgeable about Value Added Tax (VAT). Therefore, by increasing awareness of VAT among SMEs, businesses can better understand their tax obligations, avoid penalties for non-compliance, and make informed decisions about pricing and financial planning. This can ultimately help SMEs operate more efficiently and effectively in the long run.

**vi. Streamline VAT refund processes:**

Most government fiscal policies are shrouded in secrecy." So government should make the process of getting back Value Added Tax (VAT) refunds more efficient and easier. This could be done by reducing unnecessary obstacles like filling of forms and waiting for an unusually longer period of time before accessing VAT refunds. Streamlining the process could involve using online forms that are quick and easy to complete, and having a faster turnaround time for getting the refund back. This makes it more convenient for businesses and individuals to claim back the VAT they are owed. It will also make businesses trust the government in their payment of Value Added Tax.

**vii. Encourage digital VAT filing and payment:**

It is unfortunate that in the 21st century when a lot of things and processes have been digitized and automated, most Nigeria's agencies are yet to integrate the culture of digital operations. Encouraging digital VAT filing and payment means promoting and supporting

the use of online platforms or software to submit and pay Value Added Tax (VAT) to the government. This can make the process easier, faster, and more convenient and transparent for both businesses and individuals. That is, instead of filling out paper forms and mailing them in, one can simply log into a website or use an app to input their information and make their payment. This can help reduce errors, save time, and streamline the overall tax filing process. By encouraging digital VAT filing and payment, the government is pushing for a more efficient and modern way of managing taxes which could increase public trust in government fiscal policies.

**viii. Establish a VAT support hotline for SMEs:**

This does not simply mean tax collectors advertising phone lines that could direct people on payment of VAT but also ensuring that those lines are maintained and reachable to VAT payers. This hotline would provide assistance and guidance to these businesses regarding VAT-related questions or problems they may have. The ultimate purpose of this VAT support hotline is to make it easier for SMEs to understand and comply with VAT regulations, ultimately helping them to run their businesses more smoothly and successfully. By implementing these recommendations payment of VAT would really positively impact Small and Medium Enterprises (SMEs) in Nigeria.