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A Critical Analysis of the Federal High Court's Decision in Federal Inland Revenue Service v. Total E & P Nigeria

The Federal High Court (FHC), Lagos Division delivered Judgment on the matter of Federal Inland Revenue Service ('FIRS' or 'the Service') v. Total E & P Nigeria (Total's case) which was brought on appeal by the FIRS, seeking to upturn the Judgment of the Tax Appeal Tribunal - the court of first instance.

Facts of the Case

1. Total E & P Nigeria held 10% interest in Oil Mining Leases (OMLs) 4, 26, 38, 41 and 42. It disposed these assets in the years 2010 and 2011, splitting the sales proceeds between the tangible and intangible components of the sale and computing balancing charge[1] only on the tangible assets.

2. Total had also declared dividends out of its oil and gas profits, without distinct delineation between the profits attributable to oil, and to gas operations.

3. In its tax assessment of the relevant years, the FIRS argued against Total's split of its sales proceeds on its disposed assets (between the tangible and intangible components thereof), contending that it was wrong for Total to compute balancing charge on the sales proceeds attributable only the tangible assets sold. Instead, it ought to have computed balancing charge on the entire sales proceeds, as the assets in question are all described as Qualifying Capital Expenditure (QE) by Paragraph 1 of the Second Schedule to the Petroleum Profits Tax Act (PPTA).

4. The FIRS went further to include Petroleum Investment Allowance (PIA) claimed by Total on these assets as part of the total allowance claimed in computing the balancing charge, which effectively increased the total income of the Company to be assessed and taxed.

5. It purported to charge Tertiary Education Tax (TET) on the balancing charge so computed; its justification for same being that the balancing charge forms part of the assessable profits earned by Total and is therefore subject to TET.

6. The Service also claimed as non-allowable for tax purpose, the interests paid by Total on a loan it had taken from a sister entity, TOTAL FINANCE, on the ground that section(2)(c) of the PPTA precludes related party loans as allowable expense for PPT computation purposes.

Judgment of the TAT

The TAT, after considering parties' submissions, ruled that;

i. Total was liable to pay WHT on dividends attributable to its gas income and would have to rely on the FIRS' diligence and fairness mechanism to determine the portion of dividends attributable to its profits from gas operations.

ii. PIA and Annual Allowance (AA) are distinct from each other and, as such, PIA should not be added to annual allowance for the purpose of computing balancing charge under Paragraph 9 of the PPTA.

iii. Balancing charge does not form part of the assessable profits on which TET may be charged.

iv. Interest paid on Intercompany loans rightly qualify as allowable expenses as long as they conform with the Arm's Length principle that governs related party transactions.

The Tribunal, therefore, resolved the issues of PIA, TET and Interest on intercompany loans in favour of Total, while it resolved the issue of WHT on Total's dividends in favour of the FIRS.

Federal High Court (Appeal)

Thereafter, the Service, dissatisfied with the TAT's ruling, brought an appeal before the Federal High Court, challenging the TAT's decision and seeking the FHC's adjudication on essentially the same issues. A summarized itemization of the relevant issues is provided as follows:

1. Whether the TAT was right to disapprove the FIRS' addition of PIA to the AA for the purpose of balancing charge computation.

2. Whether the TAT was right to rule that balancing charge does not form part of a Company's profits and cannot be charged to TET.

3. Whether the TAT was right to rule that interest on inter-company loans qualify as an allowable expense in Total's final PPT assessment.

FIRS' Argument

In support of its claims on the foregoing issues, the FIRS made the following arguments seriatim.:

1. That paragraph 9 of the 2nd Schedule to the PPTA provides for a balancing charge, and that this charge is to be applied when an upstream petroleum company that has acquired assets, incurred 'Qualifying Capital Expenditure' on the purchase of those assets and enjoys yearly allowances on same wishes to dispose of them through a sale or divestment of interest. The amount of expenditure not yet recovered through allowances must then be subtracted from the proceeds of sale while the remainder is considered part of the Company's income.

   It relied on the provision of paragraph 5 of the 2nd Schedule to the PPTA which provides for PIA to be added to AA, contending that the law makes its expressly clear that PIA must form part of the allowances considered in arriving at the residual QCE to be used in computing the Company's balancing charge.

2. That Section 1(3) of the Tertiary Education Trust Fund Act (TETFA) directs TET to be charged on the assessable profits of a company as determined by the Companies Income Tax Act (CITA) and PPTA

3. That Paragraph 9 of the 2nd Schedule to the PPTA describes balancing charge as the remainder of the sales proceeds of a company's assets after subtracting the amount of QCE not yet recovered and deems it an income of the company.

4. That Section 9(1)(a), (b) & (c) completes this line of argument by providing the items that make up the assessable profits of a company for an accounting year. In particular, section 9(1)(a) which provides *"the proceeds of sale of all chargeable oil sold by the company in that period"*. The Service concluded on the grounds here listed, that balancing charge must form part of Total's assessable profit, liable to TET.

5. That Section 13(2)(c) of the PPTA expressly exempts interest expenditure on related party loans where it provides that sums incurred by way of interest on money borrowed from a second company shall not be an allowable deduction, where both parties are subsidiaries of another company. It was the FIRS' position that the law

specifically exempts from deductibility any interest paid on related party loans by the operation of this Section.

Federal High Court Judgment

The FHC considered the parties' submissions, made pronouncements on the issues earlier detailed and reproduced in the order in which they appear above:

1. The FHC agreed with the FIRS' position on the addition of PIA to AA in the computation of Total's total balancing charge, confirming the FIRS' reliance on Paragraph 5(2) of the 2nd Schedule to the PPTA. It emphasized that the word "shall" used in the provision denotes a compulsion to apply the law without exception and therefore held in favour of the FIRS on this issue.

2. The FHC affirmed the decision of the TAT on the issue of TET on balancing charge, holding that since TET is charged on the assessable profit i.e., the adjusted profits of a company to which balancing charge is not inclusive, Total is not liable to pay TET on the balancing charge.

3. On the issues of deductibility of interest paid on related party loans from total profits, the FHC held in favour of Total, ruling that the provision of Section 10(1)(g) clearly justifies the interest payments as an allowable expense if the related party loan transaction was made in line with the Arm's length principle.

Comments

Our comments on this case will be touching on certain provisions of the PPTA and CITA, summarized below for ease of reference:

a. Paragraph 5 of the 2nd Schedule to the PPTA

This provision, titled *"Petroleum Investment Allowance*", creates an allowance to be enjoyed by a company on qualifying capital expenditure (QCE) incurred in an accounting period.

b. Paragraph 6 of the 2nd Schedule to the PPTA

This provision, titled *"Annual Allowance"*, creates an allowance to be enjoyed by a company on qualifying capital expenditure incurred by it on an annual basis.

c. Paragraph 9 of the 2nd Schedule to the PPTA

This provision creates a balancing charge, to be computed as the difference between the value of an asset on which QCE was incurred at the date of its disposal and the remainder or residue of that QCE after deduction of the allowance enjoyed from it. The balancing charge is to be treated as income of the company that owns the asset.

d. Paragraph 10 of the 2nd Schedule to the Act

This provision defines what the meaning of *"residue"* is at it is used in the computation of balancing charge under the PPTA.

e. Section 9, 10, & 13 of the PPTA

These provisions deal with the *"Ascertainment of profits, adjusted profits, assessable profits and chargeable profits"*, *"Deductions"* and *"Deductions not allowed"* respectively.

f. Paragraph 11 of the 2nd Schedule to the Companies Income Tax Act (as amended) (CITA)

This provision defines what the meaning of *"residue"* is at it is used in the computation of balancing charge under the CITA.

Status of Petroleum Investment Allowance in Computation of Balancing Charge

The Federal High Court's pronouncement touches on some controversial issues in the Petroleum tax space- the issue as to whether PIA should be added to AA in the computation of Balancing charge being one of importance.

Paragraph 5 of the 2nd Schedule to the PPTA[1] provides in (2) that:

"for the purposes of this Act, the Petroleum Investment Allowance shall be added to the annual allowance… and shall be subject to the same rules [that govern annual allowance] under this Act"

This provision, according to the FIRS, would lead one to conclude that the law is settled on the status of PIA in the computation of balancing charge on disposal of asset by a company. A holistic examination of the PPTA on this issue, however, leads us to a different conclusion.

*"Subject to the provisions of this Schedule, where in any accounting period of a company, the company owning any asset in respect of which it has incurred **qualifying expenditure** wholly and exclusively for the purposes of petroleum operations carried on by it, disposes of that asset, the excess (hereinafter called "a balancing charge") of the value of that asset, at the date of its disposal, over the **residue** of that expenditure at that date shall, for the purposes of subsection (1) (a) of section 9 of this Act, be treated as income of the company of that accounting period:" (emphasis mine)*

It is important to note of the emboldened terms contained in the above quoted section because in the very next Paragraph, the PPTA delves into the specifics of what amounts to residue of qualifying expenditure. It goes on to define "residue", used in the preceding paragraph, as *"the total qualifying expenditure incurred by the owner [of an asset]… in respect of that asset, less the total of any **annual allowances** due to such owner in respect of that asset…"* (emphasis mine).

Paragraph 10 of the 2nd Schedule to the PPTA, in defining the term 'residue', limits its scope only to **annual allowances** claimed/claimable by the one who disposes an asset under the PPTA. It is also pertinent to note that the word *"shall"* in Paragraph 10 is used in statute to express a compulsory requirement. This provision clearly excludes PIA, which is defined in paragraph 5 of the 2nd Schedule to the Act as an allowance "due to [a] company [only] for the accounting period in which that asset was first used ".

This Paragraph may be contrasted with Paragraph 6 of the same Schedule to the PPTA that defines AA as an allowance "due to [a] company as ***from*** the accounting period in which such expenditure was incurred"- denoting perpetuity on an annual basis.

It is a trite maxim of legal interpretation that where a general statutory provision exists side by side with a specific counterpart, even in the same statute, the specific provision must prevail over the general. From the foregoing submissions, it can be discerned that the provision of Paragraph 5 of the 2nd Schedule to the PPTA is a general provision regarding the treatment of PIA as regards Annual Allowance. Paragraph 10, however, applies directly and specifically to the provision of Paragraph 9. It stands to reason that the definition of "Residue" (Paragraph 10) holds greater sway over how balancing charge applies to a Company's sales proceeds than Paragraph 5 - a distinction that the FHC did not consider in its judgment.

Even more clarity on the topic can be gained from a juxtaposition of the PPTA's provision regarding balancing charge against that of the Companies Income Tax Act (as amended) (CITA). The CITA's provision on balancing charge is materially similar to the corresponding provision in the PPTA. The CITA goes further in paragraph 11 of its 2nd Schedule, however, to provide that;

(1) The residue of qualifying expenditure, in respect of an asset, at any date shall be taken to be the total qualifying expenditure incurred on or before that date, by the owner thereof at the date, in respect of that asset, less the total of any initial or annual allowances made to such owner, in respect of that asset, before that date.

The express inclusion of any *"initial"* allowances shows the deliberateness of the lawmaker's purpose in drafting these provisions. While the CITA unequivocally makes mandatory the addition of any initial allowances enjoyed by a company in computing the balancing charge, the PPTA noticeably leaves it out. It becomes clear that the FIRS cannot purport to include PIA in the computation of Total's balancing charge without going against the law's express provisions.

It is readily apparent that any action that deviates from the clear and express implication of Paragraph 10 on the computation of balancing charge would be *ultra vires* on the FIRS' part, it would amount to an attempt to impose its own will contrary to the provision of the law.

We submit that PIA should not be added to AA for the purpose of computing a balancing charge on disposal of petroleum assets because the provision (Paragraph 5) that might have empowered the FIRS to do so is effectively overridden by Paragraph 10 of the 2nd schedule to the same Act.

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[1] Statutory provision of the PPTA that creates Petroleum Investment allowance and subjects it to the rules that govern Annual Allowance in paragraph 6.
[1] Statutory provision of the PPTA that creates the concept of a Balancing charge to be computed on the disposal of an asset, in which purchase Qualifying Capital Expenditure was incurred.

Interest on Related Party Loans as Allowable Deductions

The deductibility or otherwise of interest payments on related party loans, the last issue under scrutiny in this paper, finds expression in two separate sections of the PPTA. First, Section 10(1)(g) provides thus:

(1) In computing the adjusted profit of any company of any accounting period from its petroleum operations, there shall be deducted all outgoings and expenses wholly, exclusively and necessarily incurred, whether within or without Nigeria, during that period by such company for the purpose of those operations, including but without otherwise expanding or limiting the generality of the foregoing-

(g) all sums incurred by way of interest on any inter-company loans obtained under terms prevailing in the open market, that is the London Inter-Bank Offer Rate, by companies that engage in crude oil production operations in the Nigerian Oil Industry;

Section 13(2)(c) of the Act, however, provides that;

(2) Notwithstanding the provisions of subsection (1) (d) of section 10 of this Act, in computing the adjusted profit of any company of any accounting period no deduction shall be allowed in respect of sums incurred by way of interest during that period upon any borrowed money where such money was borrowed from a second company if during that period-

(c) both are subsidiaries of another company.

At first glance, these two provisions seem to be in material conflict with each other- the first describing interest paid on related party loans made in conformity with the Arm's Length principle as an allowable expense, while the other expressly disallows same where the loan transaction exists between related parties.

Case law on the subject has up until now established in Nigerian tax jurisprudence that interest payments *should* be an allowable expense in computing a company's tax liability. The Tribunal in *Nigerian Agip Oil Company Limited (Agip) v FIRS* used what was termed as the "expense deductibility test" to arrive at its decision in favour of Agip on this issue, hinging its decision on whether that expense was wholly, exclusively and necessarily incurred to generate the company's profits. The Tribunal also considered the legislative history of the conflicting PPTA provisions and the intention of the lawmakers thereon.

The chronology of the changes made to the PPTA since its enactment reveal that Section 13(2) of the PPTA, originally enacted in 1959 as an anti-avoidance provision, was overlooked by the lawmakers when the Act was amended by Decree 30 in 1999 to introduce section 10(1)(g), which placed emphasis on the use of the Arm's Length principle to prevent the shortchanging of the government on tax due from related party transactions, and made interest payments an allowable expense in conformity with the expense deductibility test.

Conclusion

We are of the view that the Federal High Court's decision on the addition of PIA to AA in computing balancing charge, given in the FIRS' favour, did not critically consider the effect of the maxims of legal interpretation on the PPTA and the addition of PIA to AA in computing balancing charge on a company's earnings from disposed petroleum assets. It is hoped that this issue may be revisited on appeal in a higher court of law that might espouse the more accurate position of the law on this subject.

It is quite possible that the decision of the FHC on whether balancing charge must form part of a company's assessable profits may be challenged on appeal, considering the express provisions of the law on the issue. It is unlikely that the FHC's pronouncement will bring an end to disagreements between the taxpayer and tax authority. The FHC did not fully consider the import of Section 9(1) of the PPTA, what amounts to a company's total assessable profits and provide clarification on same.

Finally, the FHC is commended for affirming the TAT's decision with respect to related party interest on loans in conformity with the Arm's Length principle- as it encourages the free and efficient flow of capital in the Nigerian economy while securing the Government's share of the profits. The responsibility lies with the FIRS to review its assessments on related party loans in line with the Arm's Length principle before determining the deductibility or otherwise of interest payments made thereon.

[4] "Ascertainment of profits, adjusted profit, assessable profits and chargeable profits"

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