A new ruling requires FIRS to accept tax returns prepared by operators of Production Sharing Contracts

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In brief

The Tax Appeal Tribunal (TAT) on 20 March 2015 held that the Federal Inland Revenue Service (FIRS) should consider tax computations prepared by Operators of Production Sharing Contracts (PSCs) in assessing PSC parties to Petroleum Profits Tax (PPT). This is a major shift from the past practice where the Nigerian National Petroleum Corporation (NNPC) solely determines tax payable and lifts tax oil based on its own tax computations.

In detail

Background

The principal legislation guiding the taxation of upstream petroleum companies in Nigeria is the Petroleum Profits Tax Act (PPTA).

A related legislation, the Deep Offshore and Inland Basin Production Sharing Contracts Act (PSCA), was enacted effectively in 1993 and provides a more lenient tax framework for upstream companies operating in designated deep offshore and inland basins.

Under this arrangement, the concession is held by NNPC (or an alternative holder), which engages other companies as contractors to conduct petroleum operations on the contract area. The contractors take on the financing risk of operating the field and are entitled to recover costs and a share of profit when commercial production commences.

One of the contractors is appointed as the Operator, to execute petroleum activities on behalf of the parties to a PSC, perform administrative functions and represent the interests of the NNPC.

In line with the PSCA and the individual PSCs, the NNPC is mandated to submit the tax returns prepared by the Operators for each contract area to the FIRS.

In practice, the NNPC usually amends these returns to the detriment of the contractors resulting in increased government take in the form of tax oil payable to the FIRS.

Facts of the case

The Appellants are four contractors in a PSCA with the NNPC, with the first Appellant being the Operator.

The Operator prepared the 2012 year of assessment (YOA) tax returns for the contract area, and forwarded same to the NNPC for onward submission to the FIRS. These returns were amended by the NNPC before submission.

The appellants were asked to pay tax based on a Notice of Assessment (NOA) issued by the FIRS addressed to the NNPC, in respect of the 2012 YOA returns for the contract area.

The operator objected to the FIRS' assessment, but the FIRS responded that the objection was invalid.

Appellants' position

The position of the appellants can be summarised as follows:

- The NOA contained an incorrect amount as gross proceeds from the sale of chargeable oil.
- The deductible expenses used in the NOA (based on the returns submitted by the NNPC) were understated.
- The FIRS wrongly calculated capital allowances in respect of the contract area. This was calculated on a monthly basis as against on an annual basis as provided for in the PPTA.
- The FIRS wrongly calculated Investment Tax Credit (ITC) in respect of the contract area. In the NOA, ITC was deducted from cost of the assets on which capital allowances were claimed.
- By failing to list the appellants on the NOA and by not serving it to the appellants, the NOA was improperly issued.

The appellants also argued that there was no basis to throw out the objection to the NOA as they are the parties liable for any PPT assessed.

FIRS' position

In response to the above queries raised by the appellants, the position of the FIRS is summarised as follows:

- The appellants did not object to a similar assessment in the past for the 2007 and 2008 YOAs.
- The NOA was issued based on the returns submitted by the NNPC, and that the appellants failed to justify why their returns should be accepted instead of the NNPC's, which is the party empowered to file returns in line with the PSCA.
- The recognised taxpayer is the OML or the contract area itself, and the name and address of the operating entity is clearly stated on the NOA. Therefore failure to list the names of the other contractors on the NOA does not render it invalid.

The ruling

The TAT nullified the assessment raised by the FIRS on the basis that the FIRS did not consider the returns prepared by the appellants, which were significantly different from what was submitted by the NNPC.

The TAT asserted that both the PSCA and the PSC between the NNPC and the appellants vest the appellants with the right to prepare PPT returns for the contract area, while the NNPC had only a responsibility to deliver the returns to the FIRS.

Although the NNPC has the right to participate in preparing the PPT returns, the tax returns prepared by Operator is the foundation for determining tax payable to the FIRS.

It was held that the assessment by the FIRS should indicate the names of the parties to the PSC in line with Section 37(1) of the PPTA and Sections 11 and12 of the PSCA, as they were the affected taxpayers in the scenario.

The TAT also ruled that the parties to the PSC had the right to object to the FIRS' assessment as they were the affected taxpayers.

On the issue of deductibility of expenses, the TAT ruled that the FIRS did not present any evidence that the expenses incurred by the contractors, including non-operator costs, failed the deductibility test of being wholly, exclusively and necessarily incurred for the business. The TAT held that the list of non-allowable expenses in Section 13 of the PPTA does not include these expenses. Therefore, there was no reason for the expenses not to be allowed.

The TAT did not rule on whether the non-inclusion of all the names of the contractors rendered the assessment void, but stated that the NOA should be served on each of the contractors to comply with Section 37 of the PPTA.

The takeaway

The ruling is a step in the right direction as it ensures that the returns prepared by PSC Operators are accepted by the FIRS rather than the amended returns submitted by the NNPC. This should address the typical differences and other issues arising from NNPC lifting tax oil based on its computations. These include:

- The NNPC usually disapproves certain expenses for tax deductibility, such as interest on loans, signature bonus, and non-operator sole costs.
- Capital allowances are calculated by the NNPC on a monthly basis as against on an annual basis as provided for in the PPTA.

- ITC is usually treated by the NNPC as a deduction from asset cost for capital allowance purposes.

The ruling did not specifically give clear guidance on the capital allowance issue and ITC but gives the parties to a PSC the opportunity to make a claim for their valid expenses and capital deductions within the purview of the law. It is however unclear whether the FIRS or NNPC will appeal this decision.

There are considerations as to whether the contractors can now submit tax returns directly to the FIRS in addition to the filing of tax returns by the NNPC. Where this happens, the FIRS will have to honour the returns submitted by the parties in the event of differences with NNPC's version.

In any event, the FIRS will have the opportunity to audit all parties involved and issue additional assessments in the usual way for legally disallowable expenses and other adjustments.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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