Tax Appeal Tribunal says realisable price should be used for petroleum profit tax purposes

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In brief

There has been a long standing dispute between the Federal Inland Revenue Service (FIRS) and oil producing companies on the applicable price of crude oil to be used for tax purposes. The Tax Appeal Tribunal (TAT) on 23 January 2015 ruled that the realisable price, and not the official selling price, should be used for the tax years during which the relevant Memorandum of Understanding (MOU) between the government and the oil companies remained valid.

It is unlikely that this decision will bring closure to the issue especially for periods not covered by the MOU and for oil producing companies that do not operate under such agreements.

In detail

Background

The Petroleum Profits Tax Act (PPTA) is the guiding legislation for the taxation of all companies engaged in upstream petroleum operations in Nigeria. The PPTA prescribes the method of pricing crude oil for tax purposes.

Section 9(2)(a) requires the value of oil to be determined *"in accordance with the provisions of any enactment applicable thereto and any financial agreement…between the Federal Government of Nigeria (FGN) and the company.."*

Additionally, section 23(5) defines **"posted price"**, in relation to crude oil valuation, as *"the price (of crude oil)… at the Nigerian port of export … established by the company, after agreement with the Government of Nigeria…"*

The above provisions suggest that an agreement between the FGN and an oil company is the basis for determining crude oil price for tax purposes.

The MOU is an agreement reached between the FGN and oil companies in Joint Venture operations with the Nigerian National Petroleum Corporation (NNPC). The aim of the MOU was to secure a profit margin for the oil companies during difficult oil market conditions.

The MOU, first signed in 1986, was revised in 1991 and again in 2000. The 2000 MOU signed between the NNPC (on behalf of the FGN) and major oil companies stipulated that revenue, royalty and PPT computations should be based on Realisable Price (RP) being the amount earned by the oil companies from crude oil sale.

The 2000 MOU was neither officially renewed nor terminated until 17 January 2008 via a letter from the Department of Petroleum Resources (DPR). The letter stated that the RP will be replaced with the Official Selling Price (OSP) as advised by NNPC effective from 1 January 2008.

Facts of the case

In its tax returns for 2006 and 2007, the Appellant used RP in determining the value of chargeable oil which it used to compute tax liabilities for both years. The Appellant maintained that RP was the appropriate methodology (based on the MOU) for ascertaining the value of its oil revenue.

The FIRS rejected the submission, and recomputed the Appellant's tax liability using OSP, which led to higher tax liabilities assessed for 2006 and 2007. The Appellant objected to the additional assessments, and lodged an appeal at the TAT.

Appellant's position

The issue for determination brought forward by the Appellant, was simply a question of the appropriate price to be adopted for ascertaining its revenue for tax purposes.

The Appellant argued that the MOU governed the computation of its PPT returns for 2006 and 2007, as the MOU arose from Sections 9(2)(a) and 23(5) of the PPTA. The Appellant buttressed its case by citing various clauses in the MOU where RP was used in various mathematical formulas for determining revenue, computing royalty and PPT.

FIRS' position

The FIRS argued that there was no agreement between the FGN and the Appellant on the pricing method for computing PPT in 2006 and 2007.

The FIRS contended that the 2000 MOU had been terminated under Clause 7 (of the MOU), which provides that the MOU would be replaced on the establishment of a new fiscal regime. Thus, the FIRS concluded that even if the MOU was valid during the period under dispute, it had been superseded by the relevant provisions of the PPTA which specify OSP as the price for determining the value of chargeable oil.

The decision

In arriving at its decision, the TAT considered the Federal High Court (FHC) judgment of 29 September 2014 (*Mobil Producing (Nigeria) Unlimited v. FIRS*), which held that the DPR letter of 17 January 2008, constituted a new fiscal regime, which effectively terminated the MOU as stipulated by Clause 7 of the agreement. This means the MOU was still valid in 2006 and 2007.

Leaning on the FHC ruling of 29 September 2014, the TAT stated that an agreement could not override a law. However, this situation was unique as the law itself, makes the agreement a condition for ascertaining the pricing mechanism for tax purposes.

The TAT held that an agreement was needed to trigger the provisions of the PPTA regarding oil pricing, notwithstanding the FIRS' contention that the MOU was defunct since 2002 (or 2005 depending on the part of the MOU being considered). Further, the TAT opined that an informal consent (which can be regarded as an agreement) was manifested by the conduct of both parties until the issuance of the DPR letter in 2008, which officially terminated the agreement.

The TAT decided that the RP was the appropriate pricing methodology applicable to the PPT returns for 2006 and 2007.

The takeaway

Although this ruling provides some comfort to affected oil producing companies for the periods in which the MOU remained valid, there are other related issues which have not been addressed.

Generally, the FIRS seeks to use the higher of the OSP and the RP in calculating revenue and issuing tax assessments to upstream companies. This ruling does not prescribe the appropriate basis for crude oil pricing for periods and operations not covered by any MOU.

In most Production Sharing Contracts (PSCs), usually Clause 9 provides that RPs shall be based on the *'FOB sales price for each lifting'* for a maximum period of 9 months. The parties are to meet within 2 months of the end of the trial marketing period of 6 months to discuss and agre the applicable RPs, which should reflect market rates. Additionally, Clause 15.5 of most PSCs provides that the RP established by the NNPC should be used in determining the royalty and tax payable. It is not clear if inaction constitutes consent to continue with original RP.

Let's talk

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

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