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CRITICAL ANALYSIS OF THE CAPITAL ALLOWANCE REGIME UNDER PETROLEUM PROFIT TAX ACT.

The Petroleum Profit Tax Act Cap 13 Laws of the federation of Nigeria 2004 (PPTA) governs the taxation of the profits of Companies engaged in Petroleum Operations in Nigeria. In arriving at the tax payable by a Company engaged in Petroleum operations, some allowances are given on qualified capital expenditures incurred by the Crude oil producing company (COPC) in the course of petroleum operations. Section 20 of the PPTA provides that chargeable profit will be the assessable profit after deduction allowed by the Act while the 2nd Schedule to the Act provides for the types of Capital allowances available to a COPC. In the light of this, there are legal and controversial live issues surrounding the grant of Capital allowance to COPCs under the Act. To what extent has the PPTA dealt with these issues? This paper will attempt to address some of these issues by critically looking at the relevant provisions of the PPTA and also looking at the business arrangements entered into by the NNPC with the COPC to determine their impact on capital allowance generally.

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1.0 Introduction

Taxation of petroleum profit started in 1959 with the enactment of the Petroleum Profit Tax Act 1959 which was meant to have a retrospective effective date of 1st January, 1958. This Act serves as a foundation for the present Petroleum Profit Tax

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Act, 2004; which was further amended in 2007. The objective of this Act can be gleaned from its preamble which reads:

> "*An Act to impose a tax upon profits from the winning of Petroleum in Nigeria, to provide for the assessment and collection thereof and for purposes connected therewith.*"

In line with its objective, the Act in Section 3 thereon establishes a body known as the Board and saddled with the responsibility of assessment and collection of the petroleum profit tax[2].

The chargeable persons under the Act are companies engaged in petroleum operations as opposed to individuals who are not permitted to go into petroleum operations. In order to fully understand the focus of this paper, two aspects of the oil industry needs to be clearly distinguished—the exploration and mining on one hand and refining and marketing on the other hand. While companies engaged in the later kind of petroleum operations are taxed under Companies Income Tax Act, the Companies engaged in the former type of Petroleum operations are taxed under the Petroleum profit tax act of 1959 as amended[3]

In determining the amount of tax payable by any company involved in petroleum operations, there are certain capital allowances which have been granted by the petroleum profit tax act to be deducted from the assessable profit in order to determine the chargeable profit to be taxed. These Capital allowances have been comprehensively provided for in the Second schedule to the Act.

This paper is divided into four segments; the first segment is the general overview of Capital allowance under PPTA while the second segment interrogates the calculation of petroleum profits and capital allowance under PPTA. The third segment takes a comprehensive critical look at the production sharing contract and the capital allowance regime under PPTA and the last segment deals with the contemporary legal issues arising from the capital allowance regime under PPTA

2.0 An overview of Capital allowance under PPTA

Capital allowance are a form of relief granted to any company engaged in petroleum operations which has incurred qualifying capital expenditure during an accounting[4]

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[2] Taxation of Petroleum Profit under the Nigeria's Petroleum Profit Tax Act Lawal, K. T.

[3] From Section 2 of the petroleum profit tax Act, it is clear that the enactment is only applicable to companies engaged in "Petroleum Operations"--- Which is defined as the drilling, mining and wining of Petroleum". "Refining and marketing activities were excluded from the definition.

[4] Section 2 of the interpretation section of the act defines accounting period to mean a period of year commencing on 1 January and ending on 31st December of the same year or any period commencing on the day the company commences business and ending on 31st December of the same year or any period less than a year being a period commencing on first January and ending of the date the company ceases to be engaged in petroleum operations.

period in respect of fixed assets in use at the end of the accounting period, for the purpose of a trade or business. Capital allowance is granted in lieu of depreciation. Capital allowance under PPTA covers petroleum investment allowance annual allowance, balancing allowance and balancing charges.

Types of Capital Allowance under PPTA

1. Petroleum Investment Allowance (PIA) :

   The Petroleum Investment Allowance is an allowance granted in the first year a qualifying capital expenditure is incurred wholly exclusively and necessarily for the purpose of the company's petroleum operation. What this implies is that such company will be granted a PIA in the year the asset was first used for the purpose of such petroleum operations. The applicable rate depends on the fiscal regime under which the company operates.

   Petroleum Investment Allowance shall be added to the annual allowance as computed under paragraph 6 of the 2nd Schedule to the Act.[5]

The petroleum investment allowance is calculated as follows:
Onshore………………………………………………………….. **5%**

Offshore operations up to and including 100 meters above Continental Shelves……..**10%**

Offshore operations between 100 – 200 meters ………………..………………….... **15%**

Offshore operations beyond 200 meters………………………………………… **20%**

It is instructive to note that whilst Investment Tax Allowances (ITAs) are applicable to both Joint Ventures and Production Sharing Contracts, only oil companies with PSCs before July 1st, 1998 are entitled to investment tax credit (ITC) at the rate of 50% of the qualifying capital expenditure (QCE) incurred by that company either wholly or exclusively or necessarily for the purposes of its petroleum operations.

An oil company that had executed a PSC after July 1st, 1998 is entitled to claim an Investment Tax Allowance (ITA) also at the rate of 50% of the qualifying capital expenditure (QCE) incurred by that company- either wholly or exclusively or necessarily for the purposes of its petroleum operations as an oil company.

Annual Allowance: -

[5] Paragraph 6 of the 2nd Schedule to the Petroleum Profit Tax Act

2. By virtue of **paragraph 6** of the **2nd Schedule** to the Act. It is granted every year on the residue of qualifying capital expenditure incurred on fixed assets. The annual allowance is computed in straight line basis by writing off the cost of the assets equally over 5 years subject to a book value of 1% of the cost of the asset[6]

However where capital allowance has been granted on any asset or any part thereof such asset can only be disposed on the authority of a Certificate of Disposal issued by the Minister or any other person authorized by him[7]

Qualifying Capital Expenditure

a. Qualifying Plant Expenditure

b. Qualifying Pipeline and Storage Expenditure

c. Qualifying Building Expenditure

d. Qualifying Drilling Expenditure

Capital allowance on capital expenditure is claimed on a straight-line basis over a period of five years at the following rates:

i. Year 1 ……………………………………………**20%**

ii. Year 2 ……………………………………………**20%**

iii. Year 3 ……………………………………………**20%**

iv. Year 4 ……………………………………………**20%**

v. Year 5 ……………………………………………**19%**

The balance of 1% represents the residual value of the qualifying capital expenditure. This must be retained for as long as long as the asset has not been sold.

Where the aggregate amount of all allowances due to the company under the provisions of the Second Schedule for the accounting period cannot be deducted under the Section 20(1) either due to insufficiency of or no assessable profits of the accounting period or to the limitation imposed by Section 20(4), such amounts are deductible in the next accounting period[8].

Balancing Adjustments

[6] Paragraph 6(2) of the 2nd Schedule to the Petroleum Profit Tax Act

[7] Paragraph 6(3)of the 2nd Schedule to the Petroleum Profit Tax Act

[8] Section 20(5) of the Petroleum Profit Tax Act

This will generally arise when a qualifying capital expenditure is disposed off or deemed to have been disposed off . It is obtained by comparing the sales proceeds on disposal to the tax written down value of an asset as at the time of disposal. There are two type of balancing adjustments.

1. **Balancing Charge:** - This is obtained when the sales proceeds on disposal of a qualifying capital expenditure exceed tax written down value of an asset at the time of disposal.

2. **Balancing Allowance:** - This is obtained when the sales proceeds on disposal is less than the tax written down value of the qualifying capital expenditure as at the time of disposal. But such excess on the value of the asset at the date of the disposal, over the residue of the expenditure at that date shall for the purpose of (1) (a) of Section 9 of the Act be treated as an income of the company for that accounting period and as such taxable.[9]

3.0 Calculation of Petroleum Profit and Capital Allowance

There is a difference between computation for tax and accounting purposes. Generally, computation for accounting purposes involves aggregating all income and netting off all the expenses in order to arrive at net profit. Prevailing accounting standards exists for treating various components of an account. In preparing Tax Accounts, the provisions of the Tax Laws such as PPTA must be strictly followed.

Ascertainment of the Profits

S. 9(1) states that profits are to be calculated based on petroleum operations within each accounting period and that the profits are to be based on:

i. Proceeds of sale of chargeable oil **sold by** the company during that accounting period

ii. Value of all chargeable oil **disposed of by** the company during that accounting period

iii. value of all chargeable natural gas in that accounting period as determined in accordance with the 4th Schedule to the PPTA; and

iv. All **incidental income** of the company or **income arising** from one or more of its petroleum operations. Profits from transportation of chargeable oil excluded. (s.14)

[9] Paragraph 9 of the 2nd Schedule to the Petroleum Profit Tax Act

In determining the appropriate amount of taxable profits of a company engaged in petroleum operations, the adjusted profits must first be computed. The adjusted profits of a company of any accounting period from its petroleum operations is the balance of the profits earned after the deduction of all outgoings and expenses wholly, exclusively and necessarily incurred for the purposes of those operations during that period.

Adjusted Profits:

This is defined in the PPTA[10] to mean accounting profits less allowable expenses as shown below:

Deductions Allowed for Adjusted Profits

The deductions allowed in computing the adjusted profit of any company of any accounting period from its petroleum operations are 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.

These deductions include:

i) Any rents incurred by the company in respect of land or buildings occupied for its petroleum operations for disturbance of surface rights or for any other disturbance;

ii) All non-productive rents paid by the company;

iii) all royalties paid by the company in respect of natural gas sold and actually delivered to the Nigerian National Petroleum Corporation or sold to any other buyer or customer or disposed of in any other commercial manner;

iv) All royalties paid by the company in respect of crude oil or of casinghead spirit won in Nigeria;

v) All sums paid by the company to the federal government by way of customs or excise duty or other like charges levied in respect of machineries, equipment and goods used in the company's petroleum operation;

vi) Costs for repair of premises, plant, machinery or fixtures or for the renewal, repair or alteration of any implement, utensils or articles employed in petroleum operations;

vii) Proven bad or doubtful debts paid by the company notwithstanding that such bad or doubtful debt were due and payable prior to the commencement of the accounting period;

[10] Section 10 (1) of the Petroleum Profit Tax Act

viii) Expenditure in connection with geological and geophysical surveys inclusive of the drilling of the first two appraisals wells in a particular field including expenditure on cement and casing and well fixtures and any other expenditure including intangible drilling costs in connection with drilling and appraisal or development.

ix) Any contributions to a pension, provident or other society, scheme or fund; and

x) Duties, custom and excise duties, stamp duties, education tax, tax or any other rate, fee or other like charges.

Assessable Profits

The assessable profit[11] of any company for an accounting period is the amount of the adjusted profit of that period after the deduction of losses incurred by the company during any previous accounting period. Also, loss incurred by a company in previous accounting periods by a foreign company now reconstituted as a Nigerian Company (provided such a claim is made within 2 years after the incorporation of the reconstituted company) may be deducted from the adjusted profits to ascertain the assessable profit of the company for an accounting period.

Section 16 (1) provides:

> "*Subject to the provisions of this section, the assessable profit of any company for any accounting period shall be the amount of the adjusted profit of that period after the deduction of – (a) The amount of any loss incurred by that company during any previous accounting period; and (b) In a case to which section 18 of this Act applies, the amount of any loss which under that section is deemed to be a loss incurred by that company in its trade or business during its first accounting period*".

Chargeable Profits and Capital Allowances

The chargeable profit of any company for any accounting period is the amount of the assessable profits of that period after the deduction of all allowances due to the company under the provision of 2nd Schedule to the Act. In other words, it is the amount of assessable profit after deduction of any amount allowed as capital allowance.

It must be noted that in determining the amount of Capital allowance to be deducted pursuant to the above rates for any accounting period, regard must be had to the cap on the amount imposed by the provisions of **Section 20(4)** of the Act to ensure that the amount of chargeable tax on the company for that period shall not be less than 15 per

[11] Section 9(4) of the Petroleum Profit Tax Act

cent of the tax which would be chargeable on the company for that period if no deductions were made under Section 20 of the PPTA for that period

Section 20 (4) provides as follows:

> "The amount to be allowed as a deduction under subsection (1) in respect of the said allowances shall be –
>
> a) the aggregate amount computed under subsection (2) of this section; or
> b) a sum equal to 85% of the assessable profit of the accounting period less 170% of the total amount of the deduction allowed as petroleum investment allowance computed under the second Schedule to this Act for that period, whichever is the less."

Capital allowance is granted to a company engaged in petroleum operations in lieu of depreciation. This includes acquisition of right in or over petroleum deposits, searching for and discovery and testing of petroleum deposits and winning access thereto or the construction of any work or buildings which are likely to be of little or no value when the petroleum operations for which they were constructed ceased to be carried on. Capital allowance may be claimed on the following qualifying capital expenditure, which can be classified into four headings:

Assessable Tax

The provision of Section 21 of the Act provides that the assessable tax for any accounting period of a company shall be an amount equal to 85% of its chargeable profit for that period.

Where, however, a company has not yet commenced to make sale or bulk disposal of chargeable oil under a program of continuous production and sale, its assessable tax for any accounting period during which it has not fully amortized all pre-production capitalized expenditure shall be 65.75 per cent of the chargeable profits for that period

Chargeable Tax

This is calculated as the amount of assessable tax less the certain tax offset[12]. Section 22 (3) provides that in computing the tax payable, the Investment Tax Credit shall be applicable in full to petroleum operations in the contracts such that chargeable tax is the amount of assessable tax less the Investment Tax Credit. The investment tax Credit rate for a company operating Product Service Contract with the Nigerian National Petroleum

[12] Section 22 of the Petroleum Profit Tax Act

Company (NNPC) is 50% flat rate for the contract area[13], regardless of the duration of the contract. The Investment Tax Credit allowance shall be offset against the chargeable tax in accordance with the provisions of the production sharing contract.

4.0 PSCs & Capital Allowance Under PPTA

Nature of the Production Sharing Contract and its Relationship with Capital Allowance

In a PSC, the NNPC engages a competent contractor usually an International Oil Company (IOC) to carry out petroleum operations on NNPC's wholly held acreage. The parties are usually the International Oil Company (IOC) and the national oil company (NOC) The contract area has to be delineated into blocks and authorized for Exploration and Production by the Federal Government. The PSC stipulates the validity period of the contract. The International Oil Company (IOC) must ensure that all commercial discoveries are exploited within the contract period. The (IOC)/contractor in a PSC is responsible for funding the exploration work and bears exploration risk if no oil or gas is discovered. Profit oil is split[14] after royalty, cost recovery and tax oil has been deducted in accordance with the terms of the production sharing contract. [15]

5.0 Critical Legal issues arising from Capital Allowance Under PPTA

Ownership of Capital Allowances (CA) -

Under the PSC regime, the Contractor is under obligation to finance all expenses and costs of the operation. The Contractor was awarded the contract based on its presented financial ability to finance the contract (Block). However, upon arrival of the equipment to Nigeria, the title of ownership of such assets belongs to the License holder/Concessionaire (NNPC). The Contractor recovers all its investments (100% of its cost) as soon as production hit Commercial level through cost oil, Share's the profit with concessionaire in the ratio: 80% to contractor and 20% to NNPC

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[13] Section 22(2) of the Petroleum Profit Tax Act

[14] Section 22(4) of the Petroleum Profit Tax Act provides that Chargeable tax shall be split between the Nigerian National Petroleum Corporation and the Crude oil producing company in accordance with the provisions

[15] Under the NNPC-Ashland PSC, cost oil is 40%; tax oil is 55% and profit oil is shared in the ratio of 65:35. Where production exceeds 50,000 barrels per day, profit oil is split in the ratio of 70:30.

The crucial question here is that who should get tax deductions (either as Capital Allowance or as investment Tax Credit) between NNPC and IOC/the contractor? It is noteworthy that NNPC has the legal right to the fixed assets used for the exploration while the contractor purchases the fixed assets to be used for their operations.

Timing of Capital Allowances-

This is an offshoot of the differences between the license holder and the contractor in respect of their treatment of Capital Allowances. The PPTA provides for capital cost to be amortized in five equal installments of 20% with a 1% retention at the end of the fifth year. On the other hand, typical production sharing contracts provide for recovering capital costs in equal installments over a 5-year period or the remaining life of the contract, whichever is less. There is an argument that the equal installments need not be annually. It could be quarterly or monthly.

Approval from National Petroleum Investment management Services-(NAPIMS) before Deduction Capital Allowance

In practice, before the IOC purchases any fixed asset for the purpose of petroleum operations, they must obtain the approval of NAPIMS whose primary task is to ensure that such asset meets the required standard for Qualified Capital Expenditure. Failure to obtain this approval will not entitle the IOC to deduction of Capital allowance on such asset as provided for under the Act.

This hurdle creates a problem for the IOC as securing such approval most times cause a lot of delay for the commencement of the petroleum operations. They mostly bribe their way through in order to obtain the said approval from NAPIMS.

Qualifying Capital Expenditure Allowable for the purpose of computing Capital Allowance (CA) ---- Treatment of Investment Tax Credit (ITC) –

There is dispute over the method of determining value of Qualifying Capital Expenditure (QCE) Allowable for the purpose of computing Capital Allowance (CA) and its relationship with Investment Tax Credit (ITC). For tax purposes, NNPC reduces the Capital Expense with the value of ITC before arriving at the QCE for Capital Allowances while Contractors maintain 100% of Capital Expenses as the QCE for Capital Allowances. The Deep Offshore and Inland Basin Production Sharing Contract Act and the individual PSCs provide for ITC as a tax offset.

In support of its position, the license holder relies on Decree 24 of 1979 which provides that Investment Tax Credit should reduce the value of QCE for CA. However, by Decree 95 of 1979, the requirement to reduce QCE with ITC was removed. Presently, the Laws of the Federation of Nigeria (LFN) omitted the deletion of Decree 24. Going by the tenor of **Ibidapo v. Lufthansa Airlines**[16], this error does not by itself revive, reenact or re-instate Decree 24.

Can Contractors agree on the Extent of Tax liability with NNPC?

In **Mattschappij B. v. FBIR**[17], it was held that payment of tax or who is entitled to pay tax is an issue of law not of agreement, contract or compromise. Section 8 of PPTA imposes tax on the profit of a company engaged in petroleum operations. This was confirmed by the Supreme Court in **SPDC vs. FBIR**[18]**.** This implies that tax is based on a company's profits. It should be remembered that the relationship between NNPC and the Contractors is not incorporated. In this guise, imposition of tax on the profits of a PSC, an unincorporated entity, legally speaking runs afoul of the provisions of Section 8 of the PPTA.

In view of the fact that the PSC is unincorporated, the further question is which party is entitled to receive a Notice of Assessment from the FIRS?

No certainty in the charging provision of the PPTA

A cursory look at the provisions of Section 8 which provides that:

"There shall be levied upon the profits of each accounting period of any company engaged in petroleum operations during that period, a tax to be charged assessed and payable in accordance with the provisions of this Act."

One would expect, following the above provision, that the PPTA will give an explicit provision which spells out a rate that will be applicable to all business arrangements for petroleum operations. This is however not the case as the provision of Section 22 on chargeable Tax relates only to PSCs. The chargeable tax under section 22 is left at the mercy of content and agreement of the PSC. Subsection 2 of the same provision also puts the rate at 50%..

6.0 Conclusion

16 (1997) 4 NWLR (Pt.498) p. 124

17 (2011) 4 TLRN 97.

18 (1976) 2 FRCR 39 & (1996) 8 NWLR (Pt. 466) 261.

In conclusion an attempt has been made by this paper to look at the types of capital allowance under PPTA and how capital allowance is calculated especially as to what expenses qualify as capital expenditure. The Capital allowance regime under PPTA is however not free from certain challenges which has now become burning issues in petroleum industry. Having explored the issue of ownership of Capital allowance, it is recommended that since NNPC owns the asset used by the Contractor for the exploration operation, it should have exclusive right to Capital allowance and Investment Tax Credit both of which are based qualified Capital expenditure. On the issue of timing of capital allowance, it is recommended that equal installments need not be annually. It could be quarterly or monthly. With regards to the issue of responsibility of tax computation and filing, it is the view of this writer that since NNPC is not an agent of government it is not bound to review, amend or modify the returns as submitted to it by the Contractor. On the issue of the treatment of Investment Tax credit (ITC) the law is settled as shown by the case of Ibidapo v. Lufthansa Airlines[19] that such error of replicating the a provision that had hitherto been removed in a previous decree in the LFN 2004 will not automatically revive, re-enact or reinstate the said decree 24.

This paper has also attempted to probe whether contractors can agree on the extent of tax liability with NNPC. This position was explained succinctly in the case of Mattschappij B. v. FBIR , where it was held that payment of tax or who is entitled to pay tax is an issue of law not of agreement, contract or compromise. Finally this paper looks at the provision of Section 22 of the PPTA and concludes that there is no certainty in the charging provision of the PPTA because the chargeable tax provision of Section 22 is not applicable to other business arrangements other than the PSC only ; plus the fact that the actual chargeable rate is left to the content of the PSC agreement.

[19] Supra (note 15)