LéLaw Thought Leadership Insights

August 2019

Rethinking Deductibility Of Interest On Affiliate Loans By Upstream Companies Under Nigeria's Petroleum Profits Tax Act

(Originally published in the inaugural issue of "Tax Law Journal of Nigeria (TLJN) Vol. 1, April 2012, pp 15- 32").

Thought Leadership by:

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The general deductibility provisions of ***section 10 Petroleum Profits Tax Act***[2] ***(PPTA)***, Nigeria's primary legislation on the taxation of oil Exploration and Production (E&P) companies, prescribes that deductible expenses must be "*wholly, exclusively and necessarily incurred*" in respect of "*petroleum operations*" for the relevant period.

Accordingly, by ***section 10(1)(f) & (g) PPTA***, interest expense is deductible, provided the terms of the underlying loans are competitive, referencing the LIBOR.[3] However, ***section 13 PPTA*** seeks to provide an exception to the general rule by precluding interest on affiliate loans (notwithstanding their competitiveness), from deductibility.

In this article, we analyse the historical evolution *cum* jurisprudential basis *viz a viz* conflict of ***sections 10 & 13 PPTA,*** and conclude that the latter would not be effective to deprive an E&P borrower company of the ability to deduct interest payments on affiliate loans. Consequently, the need to bring the law in line with reality by abrogating the provision becomes inevitable. This is particularly significant in the light of ongoing efforts to radically alter the Nigerian upstream fiscal through the ***Petroleum Industry Bill (PIB)***.

> "In many jurisdictions, a major point of discord between taxpayers and the Revenue is the amount of business expense which is deductible in determining the taxable profits"

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2 ***Cap. P13 Laws of the Federation of Nigeria (LFN), 2004***.

3 London Inter-Bank Offer Rate.

1. Introduction

In many jurisdictions, a major point of discord between taxpayers and the Revenue is the amount of business expense which is deductible in determining the taxable profits. On one hand, the Revenue is zealous to oppose deductions unless expressly allowed by the law whilst on the other, the taxpayer seeks to optimize/reduce his tax liability through the deductions.

Sometimes, the rules surrounding allowable expenses are either ambiguous or complex; often times, in a bid to clarify seeming ambiguity or complexity, the legislator's efforts through various tax (amendment) legislations on allowable expenses, disallowable expenses and the criteria for classifying expenses, could achieve the opposite effect.

The evolution of **PPTA** provisions may provide a ready example in this regard. ***Section 10 PPTA*** on deductions has been severally amended, and on current reading, is inconsistent with ***section 13(2)*** which was an original **PPTA** provision. ***Section 10*** makes the determination of deductibility of expenses dependent on whether such expense was wholly, exclusively and necessarily incurred for petroleum operations[4] and was revenue in nature (not capital), whilst listing (indicative) examples[5] of such deductible expenses to include interest payments on loans. ***Section 13(2)*** on the other hand, makes a blanket disallowance of related party interest loans, notwithstanding the utilisation of the loans for petroleum operations and their competitiveness.

Matters are not helped by legislative changes on deductions sought to be introduced *vide* the ***PIB***. The focus of this discourse is to critically examine these conflicting provisions, and leveraging rules for interpretation of tax statutes, opine on the way forward as far as deductibility rules are concerned.

2. Legislative History of Statutory Provisions on Deductibility of Affiliate Loan Interest

To fully appreciate our arguments that current ***section 13(2) PPTA*** provision has been rendered redundant, such that intra-group loans are clearly deductible under the **PPTA**, it is apposite to set out the legislative history of relevant **PPTA** provisions on deductions, starting with the first legislation in 1959.

A. Petroleum Profits Tax Ordinance No. 15 of 1959 (PPTO)

The **PPT Ordinance No. 15 of 1959** was Nigeria's first enactment on petroleum taxation. ***Section 10(1)(b) PPTO*** provided as follows:

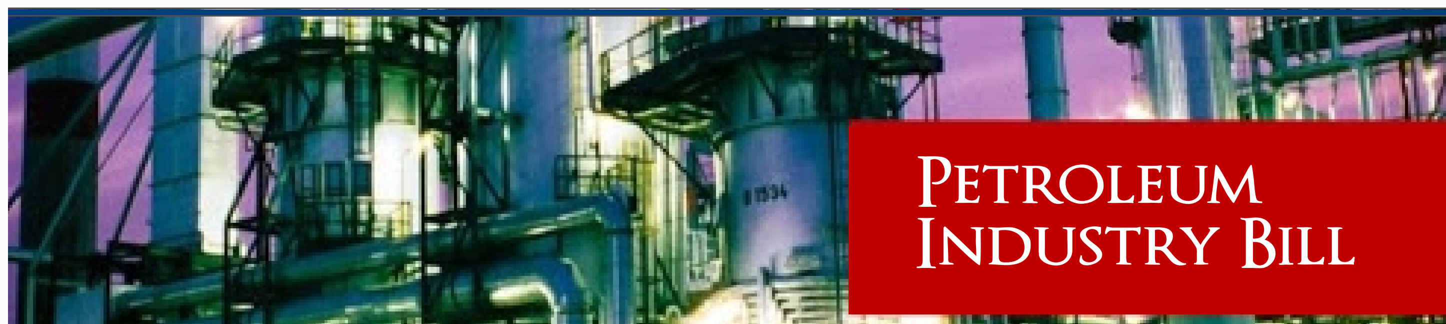
*"in computing the adjusted profits of any company of any accounting period from its petroleum operations, there shall be deducted all outgoings and expenses **wholly and exclusively incurred**, whether within or without Nigeria, during that period by such company for the purpose of the operations, including but without otherwise expanding or limiting the generality of the foregoing...*

*(**b**) sums incurred by way of interest upon **any** money borrowed by such company <u>where the Board is satisfied that the interest was payable</u> on capital employed on carrying on its petroleum operations;"*

However, ***section 11(2)(a) PPTO*** provides that "***notwithstanding the provisions of subsection (1)(b)** of **section 10**, in computing the adjusted profit from 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:*

4 In ***Shell Petroleum Development Company v. Federal Board of Inland Revenue(FBIR) [1996] NWLR (Pt. 466), 256 at 291*** *"wholly and exclusively"* were held to have virtually the same meaning and that they can be said to mean "solely" or *"entirely"*.

5 Rents, royalties, interests, expenses incurred for repairs, bad and doubtful debts amongst others.



(a) either company has an interest in the other company; or
(b) both have interests in another company either directly or through other companies; or
© both are subsidiaries of another company."

Section 11(2)(b) PPTO clarifies that *"for the purposes of this subsection*

(I) a company shall be deemed to be a subsidiary of another company if and so long as an interest is held by that other company either directly or through any other company or companies;

(ii) interest means beneficial interest in issued share capital (by whatever name called); and

(iii) the Board shall disregard any such last mentioned interest which in their opinion is insignificant or remote, or where in their opinion ***that interest arises from a normal market investment and the companies concerned have no other dealings or connection between each other."***

B. Petroleum Profits Tax (Amendment) Decree No. 15 of 1973

Section 3 of **Decree No. 15** amended **PPTA**[6] by changing the deduction test from expenses *"wholly and exclusively incurred"* to *"wholly, exclusively and necessarily incurred."*[7] The addition of *"necessarily"* is meant to further tighten the test, such that it would be insufficient that expenses were wholly and exclusively incurred, but ***they must also be necessary for the purpose of generating income from petroleum operations.***[8]

C. Petroleum Profits Tax Act, Cap. 354 1990, LFN

PPTA, Cap. 354 LFN, 1990 codifies the **PPTA** provisions above as amended as at 1990. These provisions were codified as **sections 10(1)(c), 11(2) &11(3) PPTA Cap. 354**, respectively.

D. Finance (Miscellaneous Taxation Provisions) Decree No. 30 of 1999

Decree 30 amended amongst other tax legislation, the **PPTA**. Thus **section 8(a) Decree 30** amended **section 10(1) PPTA** *"by inserting immediately after paragraph (c), the following new paragraph –*

"(cc) ***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;"*[9]

E. Petroleum Profits Tax Act, Cap. P13 LFN, 2004.

Section 10(1)(f) and **(g) PPTA, Cap. 13 LFN, 2004** provides that *"in computing the adjusted profits 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 the operations, including but without otherwise expanding or limiting the generality of the foregoing…*

(f) sums incurred by way of interest upon ***any money borrowed by such company*** *where the Board is satisfied that the interest was payable on capital employed on carrying on its petroleum operations;*

(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 productions in the*

6 Applicable ***Ordinances*** (equivalent of ***Acts*** before independence), became incorporated into the body of Nigerian law as Acts after independence in 1960.
7 Popularly called the *"WEN"* test. *Cf.* with the test in ***section 24 Companies Income Tax Act (CITA), Cap. C21 LFN, 2004***: to qualify for deductibility, expenses must be *"wholly, exclusively, necessarily, and reasonably incurred"*. Although ***section 10 PPTA*** does not have the reasonableness criterion, in practice the FIRS looks at the reasonableness of expense items and may disallow quantum that they consider excessive.
8 Nigerian courts had the opportunity to analyse the 'necessary' plank of the deductibility test in the cases of ***Shell v. FBIR*** and ***Gulf Oil v. FBIR.*** See ***Kolawole v. Alberto [1989] 1 NWLR (Pt. 98), 382*** - where the legislator uses words different from those originally used, he is to be presumed to have intended a different meaning.
9 This provision is now ***section 10(1)(g) PPTA Cap. P13, LFN 2004.***

Nigerian oil industry;"

Sections 13(2) & ***13(3) PPTA*** utilizes the exact wording of ***sections 11(2)(a)*** & ***(b) PPTO*** reproduced above.[10]

3. Are Affiliate Loans Tax Deductible?

From the provisions reproduced above, ***sections 13(2)*** &***(3) PPTA*** would seem to suggest that affiliate loans are not tax deductible. The principal argument in support would be reliance on the principle of statutory interpretation that in resolving any conflict, specific provision (such as ***section 13(2)***) prevails over general provisions (such as ***section 10(1)(f)***).[11] However, our respectful view is that such position is untenable, and that the more recent provision of ***section 10(1)(g)*** has modified or rendered ***section 13(2)*** redundant for the reasons hereafter set out.

Firstly, *"inter-company"* loans which are deductible as long as they are competitive (benchmarked against LIBOR), are not defined to exclude loans between affiliates. We particularly note that the provision says *"any inter-company loans"*.[12] Indeed, inter-company loans in ordinary financial parlance means loans between related entities.[13] That this is the inescapable import of ***section 10(1)(g)*** is borne out of the fact that ***section 10(1)(f)*** already provides for deduction of *"interest **upon any money borrowed by such company**..."*

Accordingly, ***section 10(1)(g)*** could not have been referring to loans other than between related parties or at the very least, includes loans of such class. Furthermore, ***section 10(1)(g)*** could be regarded as specific provision on inter-company loans; therefore, the conflict would be between two specific provisions – in which case, the interpretation which accords more to reason will be preferred.

Secondly, although ***section 13(2)*** directly contradicts ***section 10(1)(g)*** by excluding related party interest from deductibility, the latter would prevail, being later in time.[14] ***Section 10(1)(g)*** was enacted by the legislature with the full knowledge that ***section 13(2)*** exists. The legislative intention, therefore, must have been a whittling down of ***section 13(2)***.[15] Any other construction renders ***section 10(1)(g)*** nugatory – and inconsistent with the rule of interpretation that the legislature never intends to legislate or make a law to exist in a vacuum.[16]

Thirdly, the ***section 13(2)*** caveat (*"**notwithstanding** the provision of..."*)[17] specifically refers to affiliate loan interest (i.e. it only qualifies ***section 10(1)(f)***), leaving ***section 10(1)(g)*** unaffected.[18] If the intention were otherwise, ***section***

10 But with consequential number references; thus ***section 13(3) PPTA Cap. P13 LFN, 2004*** begins with *"for the purposes of subsection (2) of this section."*

11 Per the Supreme Court (SC) in ***A-G Federation v. Abubakar [2007] 10 NWLR (Pt.1022), 1 at 148*** - the principle of law expressed in the Latin maxim *"generalia specialibus non derogant"* is to the effect that where a special provision is made to govern a particular subject matter, and a general provision is made in respect of the same subject matter, the special provision is excluded from the operation of the general provision. As we show subsequently, this rule would not apply because ***section 10(1)(g)*** is also specific on inter-company loans and was later in time to ***section 13(2) PPTA***.

12 In ***Texaco Panama Incorporated v. SPDC [2002] 5 NWLR (Pt. 759), 209 at 230,*** it was held that ***'any'*** is not meant to be restrictive or limited in its application. It includes all things to which it relates or of the thing mentioned. In construing the word any..., its generality should depend on the setting or context and the subject matter of the Act bearing in mind that the word any can be employed to indicate "all", "every" or "some"... it can also mean an unlimited or unmeasured amount or number. We have assumed any as used in this legislation refers to all types of loans from affiliates. "Inter" is defined in the 8th ***Edition of Black's Law Dictionary (page 826)*** to mean 'among' and 'Company' is defined in ***section 2 PPTA*** as *' anybody corporate incorporated under any law in force in Nigeria or elsewhere'. Cf.* with ***section 650 Companies and Allied Matters Act (CAMA)*** definition: *"... a company formed and registered under this Act or, as the case may be, formed and registered in Nigeria before and in existence on the commencement of this Act."*

13 ***PPTA*** does not define inter-company loans. However, it has been defined as *"a loan in which both the lender and the borrower are divisions of the same corporation."* See http://financial-dictionary.thefreedictionary.com/Intercompany+Loan (accessed 13. 09. 2011).

14 However a Nigerian commentator has stated: *"as we may have realized now, there is no one rule of interpretation that is superior to the other, each case is decided on its own merit. In fact it has been suggested that there could be a blend of various rules of interpretation"* Sylvester Imhanobe, ***'Legal Drafting and Conveyancing'*** (2002) at 161. In ***Abubakar v. A-G Federation [2007] 3 NWLR (Pt.1022), 601 at 636***, the CA opined: *"in construing the provisions of a statute where the words are clear and unambiguous, it is the words used that prevail and not what the court says the provisions mean. However, where a literal interpretation... will result in absurdity or injustice, the court may seek internal aid within the body of the statute itself or external aid from statutes that are in pari materia with the statute being construed in order to avoid the absurdity of injustice."*

15 In this instance, to get the import of these provisions, one may have to rely on the mischief rule of interpretation. See ***Agbetoba v. Lagos State Executive Council [1991] 4 NWLR (Pt. 188) 664 at 690:*** in construction of statutes it is of assistance to keep constantly in mind the purpose of the provision and the mischief sought to be prevented; accordingly, the words thereof should be construed to give effect to such purposes. In line with this principle set by the SC in ***Abioye v. Yakubu [1991]5 NWLR (Pt.190), 130 at 200,*** for the interpretation of all statutes in general four things are to be considered, viz: (a) what was the common law before the law was made; (b) what was the mischief or defect the new legislation sought to cure; (c) what remedy did the parliament approve to cure the defect; and (d) the true reason for such remedy.

16 In ***Kolawole v. Alberto [1989] 1 NWLR (Pt. 98), 382,*** the SC held that where the legislator uses words different from those originally used, he is presumed to have intended a different meaning. The SC further held that *"**the rule that a meaning should if possible be given to every word in a statute implies that unless there is good reason to the contrary, the words add something which would not be there if the words were left out**"*. Rather than argue that because the exclusion provision was earlier in time and did not contemplate ***section 10(1)(g)***, the better view is that since the legislature was aware of ***section 13(2)*** when it enacted ***section 10(1)(g)***, if it had intended ***section 13(2)*** restriction to apply, this would have been expressly stated.

17 In ***Nigerian Deposit Insurance Corporation v. Okem [2004] 10 NWLR (Pt .880), 107*** at ***182,*** the SC held that *"when the term 'notwithstanding' is used in a section of a statute, it is meant to exclude an impinging or impeding effect of any other provision of the statue or section so that the said section may fulfill itself."*

18 Pursuant to the *expressio unius est* ***exclusio*** *alterius* rule (whereby the specific mention of one class of things implies the exclusion of those items not mentioned). See for instance, ***Military Governor of Ondo State v. Adewunmi [1988] 2 NWLR (Pt. 82), 280.***

13(2) would have accordingly been amended to include ***section 10(1)(g)***. Such amendment would have been preposterous anyway, since it would have meant there is no need for ***section 10(1)(g)*** as it currently stands.

Fourthly, the apparent contradiction between ***sections 10(1)(g)*** and ***13(2)*** seem to inform the FIRS practice (at least post 1999), of allowing deductibility of related parties' loan interest. It is actually believed that the retention of ***sections 13(2) & (3) PPTA*** in our statute books is a legislative oversight, because ***section 10(1)(g)*** has effectively repealed the former.[19]

Fifthly, and reinforcing the above view is the major mischief that ***section 13(2) & (3)*** sought to cure: thin capitalisation and transfer pricing.[20] With the addition of ***section 10(1)(g)*** on competitive rates, the restriction under ***section 13(2)*** becomes superfluous. This is because the amount deductible would be the same irrespective of the source of the loan, and the lender is not thereby enjoying any transfer pricing advantage (at least from Nigerian perspective) by reason of its relationship with the borrower. The lender, whether related or not, would be subject to the same withholding taxes (WHT) on the interest income.[21] It is also instructive to note that the ***PPTA*** is not totally bereft of provisions to combat the issues of thin capitalisation and transfer pricing outside ***section 13(2)***. ***Section 15 PPTA*** subjects 'artificial transactions' between related parties that are not made on 'arm's length' basis to adjustment and appropriate tax treatment by the Revenue.[22] This test is subjective and must be cognizant of the circumstances to evaluate the substance of the 'arm's length transaction'.[23]

The rule should not be a one size fits all as it would be false to assume that all loans granted by affiliates are principally to take advantage of the deductibility of

19 See *Joseph Arogundade*, ***'Nigerian Income Tax & Its International Dimension'*** *(2005)* at 255, "***one area of apparent contradiction is the allowance of interest on inter-company loans…In practice, it would be difficult to implement the restriction to third party loans.***" According to Arogundade, "*this is in view of the ambiguity introduced by the word 'any' in paragraph (g) of section 10(1). It is not clear whether the word means, 'any type of inter-company loans, including intra-group loans'. In that case, section13(2) is rendered redundant.*" In the 2nd edition (2010), Arogundade states in part at 217, "*the PPTA provides for the allowance of interests if the underlying loans are for the purpose of petroleum business and if the interest meets the conditions in… section 10[(1)(g)] of the PPTA.*"

20 Thin capitalization is a process whereby a parent funds it subsidiaries mainly by debts as opposed to equity. It is a problem from a tax perspective because the returns on equity capital and debt capital are treated differently for tax purposes. The returns to shareholders on equity investment are not deductible for the paying company, being distributions of profit rather than expenses of earning profits. On the other hand, the returns to lenders on debt, most commonly in the form of interest, are normally deductible for the payer in arriving at profits assessable to corporation tax. In effect, where there are no restrictions on such structure, the subsidiary will be stripped of its profit and invariably the revenue accruing to the government will be eroded. Transfer pricing refers to the analysis, pricing and adjustment of charges between related parties for goods and services i.e. the price charged by one part of a group for products and services it provides to another member of the group. Transfer pricing, according to the , OECD Transfer Pricing Guidelines, "are significant for both tax payers and tax administrations because they determine in large part, the income and expenses and therefore, taxable profits of associated enterprises in different jurisdictions" in the present circumstance, considering that the interest on loans are generally deductible, this shifts taxable income from Nigeria to the country where the lender is domiciled, These are the mischief the Nigerian government was trying to curb by the introduction of ***section 13(2)***.

21 Albeit lender may enjoy lower WHT rate (7.5%, vs. generally applicable rate of 10%), if resident in a double taxation treaty country with Nigeria, but that does not defeat the premise of our argument, as the lower WHT rate has no connection with the lender's relationship to the borrower. Also, the FIRS need not be bothered that "*the result would be to shift taxable income out of Nigeria to some other country where the group has allowable tax losses into which the profits would sink without trace*", Gbadebo, ***'An Analysis of Nigerian Petroleum Taxation'*** *(1989), p. 369*. This is because, the large amounts of money required to fund operations within the industry cannot be sourced in Nigeria, despite the provisions of the *Nigerian Oil and Gas Industry Content Development Act 2010* which mandates companies in the Nigerian oil and gas industry to source at least 50% of their funds in Nigeria.

22 This sort of provision has been interpreted to cover the interest rates on loans as well as the quantum of loans/amount of permissible debt (albeit we maintain that there are no thin capitalization rules in the Nigerian oil and gas industry, unlike for example the financial services, especially banking sector). This is in line with the 'arm's length debt test' used to determine excess debt under Australian laws. Also, Vaan Raad (ed), **'Commentary on ARTICLE 9 OECD and UN Model Double Tax Agreements'**, (2007/8 ed), vol. 1, p. 169, states: "*the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular contribution to equity.*" This supports the view that arm's length provision also cover the amount of permissible debt as same may be re-characterized in the event that the loan was excessive. The snag with this interpretation (on determination of the quantum of an arm's length loan), is that it increases compliance cost for the taxpayer. This may require an audit to discover whether or not there is a scheme to transfer profits to another jurisdiction through interest payment. It should also be noted that the gearing ratio may be high for reasons other than tax planning as the transaction may be determined by business or strategic considerations or the type of business. In essence the subjective test increases compliance costs of the tax payer and also administration costs for the Revenue. To combat the issues relating to determining the quantum of related parties' loan, the subjective test may be beefed up by objective rules relating to thin capitalization which should be well balanced in setting the ratio of debt to the equity invested in the company.

23 It is instructive to note however that finding comparable loans is not always easy. While the high liquidity and transparency of the financial markets in certain cases make finding comparables for financial transactions/interest on commercial loans easy, this is usually not the case with sourcing for less transparent transactional information e.g. third-party mark-ups on services or manufacturing costs. Nonetheless, there are other established ways of determining whether or not the arms' length principle has been utilised.

interest. Risks have to be factored into the equation.[24] Undoubtedly, petroleum operations are capital intensive[25] and it is not commercially feasible to finance the entire project through shareholders' equity, therefore debt financing and incidental costs become inescapable.[26]

Sixthly, if the intention was merely to include the requirement for competitive interest rates without relaxing the restriction of ***section 13(2)*** on deductibility of affiliate loan interest, then the amendment would have been to only ***section 10(1)(f)***.[27] It is also instructive to note that whilst ***section 10(1)(f)*** opens with "*sums incurred by way of interest*", ***section 10(1)(g)*** speaks of "***all*** *sums...*" The legislator must have intended the effect of the clear wording of the latter provision.

Seventhly, applying the ***section 13(2)*** restriction to ***section 10(1)(g)*** will strain the language of the statue to catch affiliate loan interest – which we maintain is unnecessary. It is settled that in construing tax legislation, there is no room for trying to arrive at a conclusion which seeks to achieve the same result that would have been inevitable if the legislature had thought of it, or used appropriate words.[28]

Eighthly, and a corollary of the foregoing are the rules that conflicts in tax statute should be resolved in favour of the tax payer rather than the government (which enacted the legislation) and also that where the law confers a benefit and burden which are mutually exclusive, the beneficial construction is to be preferred.[29]

Ninthly, there is a presumption against legislative absurdity. Also, provisions of the law should not be read in isolation.[30] Where a Nigerian company has access to funds obtained by its foreign parent at concessionary rates (due to the parent's stronger bargaining power or credit rating), such that the interest rate may be lower than generally applicable market rates, ***section 13(2)*** would still seek to disallow such interest! This result becomes more ludicrous when one appreciates that there are often local capacity funding issues given the capital intensity of oil and gas projects.[31]

Tenthly, the increasing default of Nigerian National Petroleum Corporation (NNPC) (since the 1990s) on its Joint Venture (JV) operations cash calls to its E&P partners as a result of public budgetary pressure meant that such E&P companies were forced to 'carry' NNPC and shoulder *the entire financing burden* of the JV

24 According to Hossein Rasavi, project risk in the oil and gas industry, may be classified as political risks and commercial risks. Commercial risks include cost overruns, delays, shortfall in project revenues caused by uncertain sales and prices while political risks include expropriation of asset, civil unrest and foreign exchange issues, lack of well-established legal and institutional framework amongst others. See generally, Rasavi, ***'Financing Oil and Gas Projects in Developing Countries', (1996), p. 2.***

25 Not least in the Nigerian deepwater frontier, which attracted substantial investment since the mid-1990s, after the 1993 PSCs were signed.

26 There are increased funding obligation on the NNPC's E&P partners due to NNPC's default in cash calls; the capital intensiveness of the projects, the volatility of the market and the high risk amongst others. Also, E&P companies have developed a propensity not to finance these projects from their internal cash resources due to *the volatility in oil prices, and large environmental costs which have squeezed the International E&P companies' budget as well as the desire to share the risks involved in the funding.* See generally, *Hossein Rasavi*, ***'Financing Energy Projects in Emerging Economies'*** (1996), *p. 3*. Funds can be raised through loans and bond issues from offshore banks and international monetary organizations like the World Bank, Export Credit Agency and other Multilateral credit agencies. See also *Adedolapo Akinrele*, ***'Nigerian Oil and Gas Law'*** *(2005), p. 64* on the challenges in raising finance for such transactions thus "*the success rates of exploration drilling are generally low and in many cases long periods of time (often many years) will elapse before discoveries can be developed. Due to the difficulties of securing loan financing which is premised on predictable repayment projections, explosion financing comes almost exclusively from equity funding, primarily through risk sharing between co-venturers.*" The author further recognized the fact that the non-resident parent of the local subsidiary, through internal sources, secured borrowings for its unspecified working capital on the strength of its corporate balance sheet. Such parent company on lends to the companies involved in petroleum operations in Nigeria.

27 In that case, such combined ***section 10(1)(f)*** would have read thus: "*sums incurred by way of interest on any inter-company loan obtained under terms prevailing in the open market, that is the London Inter-Bank Offer Rate, or interest upon any interest borrowed by such company, where the Board is satisfied that the interest was payable on capital employed in carrying on its petroleum operations.*"

28 In ***Ahmadu v. Governor of Kogi State [2002] 3 NWLR (Pt. 755), 502, at 522***, the Court of Appeal (CA) held that: "*a law which imposes pecuniary burden is under the rule of interpretation subject to the rule of strict construction. All charges upon the subject must be imposed by clear and unambiguous language because in some degree they operate as penalties. Thus, the subject is not to be taxed unless the language of the statute clearly imposes the obligation. The language of the statute must not be strained in order to tax as transaction which had the legislature thought of it, would have been covered by appropriate words. In a taxing legislation, therefore, one has to look merely at what is clearly said. There is no room for any intendment. There is not equity about tax, no presumption at all and nothing is to be implied.*"

29 In ***Pole-Carew v. Craddock [1920] 3 KB 109*** (cited in Maxwell *on the Interpretation of Statutes* (12th ed.) at 102, "*where an Act of 1790 ... exempted ferry proprietors from assessment to any 'tax... whatsoever' in respect of the ferry, it was held that the exemption extended to income tax even though that tax was first imposed considerably after 1790.*"

30 The provisions of a statute are not to be read in isolation. ***Obayuwana v. Governor of Bendel State and Ors. (1982) 12 S.C 147.***

31 These views have been corroborated by Dr. Gbadebo at 369 - 370: "*a local subsidiary engaged in petroleum operations almost invariably has to obtain funds from outside the host state for the necessary capital investment in those operations. Commercial prudence suggests the creation of sources of soft loans within the international financial centres for the funding of the group's international petroleum operations. Into this gap steps the affiliated loan which may be obtained by the group on the local company's behalf on terms more favourable than those which would attach if the local company sought the loan itself. Having been obtained, the benefits of the loan are transferred through an 'affiliated' company intra-group to the local company... Theoretically, the tax planners of the local company (the relevant taxpayer under the PPT Act) have a strong argument in maintaining that their duty is to minimize the loan cost to the company of capital borrowed for investment in its Nigerian petroleum operations. The argument is even stronger if the rate of interest on the affiliated loan is lower than that which would attach to a loan at the reasonable commercial rate. It is illogical to allow deduction of a greater amount simply because it is non-affiliated interest under section 10(1)(b) but to disallow deduction of the lesser amount of proper affiliated interest under section 11(2)... The only instance in which the disallowing provision is tenable in operation is, it seems to me, in instances of overcharging i.e. when the affiliated loan interest is higher than the reasonable commercial rate. Even in such an instance full disallowance is extreme. A more reasonable approach would be to disallow the excess above the amount of interest payable at the reasonable commercial rate.*"

operations.[32] If they discharged such enlarged burden through affiliate loans whose interest are non-deductible, definitely the operator would be entitled to allocate NNPC's share of the disallowed interest to NNPC.

However, since the 1990s government has defaulted in paying its cash calls and has limited its budgetary funding of petroleum operations. NNPC's cash call default was the primary reason that from the early 1990s, Government changed its participation model in the upstream sector from JV to Production Sharing Contracts (PSCs), where the Contractor bears all the financing risk and can *only* recoup its investment *if* there is production (through Cost Oil and Profit Oil allocations).[33]

Indeed, to incentivize exploration and development of Nigeria's deep offshore as a strategic plank of Government's policy imperative for increasing the nation's proven oil and gas reserves as well as production, favourable fiscal regime was put in place as documented in PSCs signed with Nigerian subsidiaries of international E&P companies (especially the 1993 PSCs) and codified in the ***Deep Offshore and Inland Basins (Production Sharing Contracts) Act***.[34]

The ***section 10(1)(g) PPTA*** provision was one of the amendments to formalize the incentives that Government guaranteed to such E&P companies, who thereafter committed massive investments to bring Nigerian deepwater production onstream. It would therefore be most incongruous to argue that effect should not be given to ***section 10(1)(g)***.[35]

A typical PSC grants the contractor the right to finance petroleum operations from external sources under the terms and conditions approved by the NNPC which approval shall not be unreasonably withheld. The interests incurred from such external source finance could be deducted as cost oil in which case the restriction would be of no effect. However, deduction of interests may not be allowed as a cost recovery expense[36] but a tax deductible and in this case the restriction becomes an issue as it disallows interest on affiliate loans.

Where interests fall under tax recoverability and the restriction is interpreted strictly, NNPC will be able to deduct the interest payable on the loans as the Contractor's parent company is not its affiliate however, the Contractor will not be able to deduct such interest thereby imposing a greater burden on such contractor.

Lastly, but not the least important, is the pragmatic approach that Nigerian Courts have taken in construing ***section 10 PPTA*** deduction cases. In ***Gulf Oil Co. Nigeria Ltd v. FBIR***,[37] the CA following the *locus classicus* established by the SC in ***Shell v. FBIR***,[38] held that charges and commission paid by the appellant to the Central Bank of Nigeria

32 This hit a critical stage in 1993 when the FG closed the NAPIMS escrow account where the funds to funds the cash calls were kept: *Akinrele (supra), p. 64*. According to him, cash call defaults *"… necessitated the recourse by the operator to alternative funding sources to make up for NNPC's default in call contributions as provided under the Joint Operating Agreement"*. Issues around Nigeria's federal system of government where the three levels of government compete for available revenue are also not irrelevant. For example, *Uwais CJN* in his concurring judgment in ***Attorney General of the Federation v. Attorney General of Abia State and 36 Ors (No. 2) [2002] 6 NWLR (Pt. 764), 542 at 760 - 761*** held that: *"it has transpired also that other deductions are being made from the Federation Account for ….funding joint venture contracts and [NNPC] priority projects… All the deductions are not provided for by the 1999 Constitution. All these deductions are carried out as first line charge on the Federation Account. All the deductions are not provided for by the 1999 Constitution…"* The lead judgment, *per Ogundare, JSC* unequivocally held at *p. 689* that: *"funding of joint venture contracts … cannot by any stretch of construction come within 162(3) of the Constitution which provides for the distribution for the Federation Account among the three tiers of government… All these charges on the Federation Account are inconsistent with the Constitution and are, therefore, invalid."*

33 To address the cash call default problem, NNPC has recently entered into Modified Carry Agreement (MCA) with it JV partners, stating that would be the preferred mode of financing its cash calls, going forward. According to NNPC, *"Modified Carry Agreement is a financing agreement whereby the … NNPC's E&P partners will advance loan to NNPC for the purpose of investing in upstream projects… The financing agreement signed today is a modification of the existing Carry Agreement. The … MCA introduces greater level of transparency and accountability with repayment and compensation being on ``Cash-basis'' not oil. In the deal, the NNPC would allow the three companies to take capital allowances as allowed by the … PPT to recover 85 % of the principal loan. By taking the allowance, the IOC's are reducing the taxable profit that they ought to have paid. The remaining 15% plus eight per cent interest would be paid in cash from the increased production from which the investment was made. If for any reason, the oil field where the investment was made could not produce, then payment of the 15 % plus the eight per cent interest would be stopped. The signing of the agreement was as a result of a successful negotiation between the four oil giants involved, that is the NNPC, SPDC, TOTAL and NAOC."*. See ***NNPC Signs Modified Carry Agreement with IOCs:*** http://dev.nnpcgroup.com/PublicRelations/NNPCinthenews/tabid/92/articleType/Article_View/articleId/178/NNPC-signs-Modified-Carry-Agreement-with-IOCs.aspx, **(accessed 20.09.2011).**

34 ***Cap. D3 LFN, 2004.*** These include 50% PPT rate (instead of 85% (65.75% until pre-production capitalized expenditure is fully amortized) for JV operations, 50% investment tax credit or allowance on qualifying capital expenditure for pre and post 1 July 1998 PSCs respectively, and sliding royalty scale culminating in 0% royalty on production from water depths beyond 1,000 metres, etc. See generally ***sections 3, 4, 5 PSC Act*** and ***21 PPTA*** respectively.

35 A typical PSC grants the Contractor the right to finance petroleum operations from external sources subject to NNPC's approval of the terms of the financing, which approval shall not be unreasonably withheld. The PSCs contemplate that the interests (as well as the loan itself) would be cost recoverable (***section 10(1)(g) PPTA*** being the test for tax deductibility, whatever the source of the loans). See also Sivana Tordo, ***'Fiscal System for HydroCarbons'*** *(2007)*, p. 12: *"normally, interest on loans are deductible from taxable income and qualify for cost recovery."*

36 There are no rules setting out the details of expenses that may be fully cost recovered nor delineating expenses that may be cost recovered or tax deductible.

37 ***[1997] 7 NWLR (Pt.514), 698.***

38 ***[1996] 8 NWLR (Pt. 468), 256.***

(CBN) as result of Federal Government's (FG) directive that the appellant's PPT be paid into an account abroad, instead of in Nigeria, were expenses wholly, exclusively and necessarily incurred within the meaning of ***section 10(1) PPTA***.[39]

In ***Shell v. FBIR,***[40] the FBIR had disallowed expenses incurred on currency exchange losses, CBN commissions and educational scholarship expenses[41] in Shell's PPT Returns for 1973 on the ground that they were not directly related to petroleum operations and not listed as examples of deductible items in ***section 10 PPTA***.[42] Shell, dissatisfied with the FBIR's ruling, objected and appealed to the Body of Appeal Commissioners (BAC) which confirmed FBIR's position.

Upon appeal to the FHC, Shell succeeded on only two items: exchange losses and CBN commissions. Upon cross-appeal by both Parties[43] to the CA, the decision of the FHC was reversed, and that of the BAC re-instated. In upholding Shell's appeal,[44] the SC held *inter alia* as follows:

Once there is a contractual or statutory obligation (in this case the former) for a company engaged in petroleum operations to perform, such obligation is *'wholly, exclusively and necessarily'* for the purpose of operations of the company. *"The lis in this case is not the tax or debt assessed but the loss incurred by the appellant in sourcing the pound sterling for the payment of the tax. Such expenditure is necessary for the purpose of the appellant undertaking its operations… This is also because the Appellant could not have incurred the exchange losses but for Exhibits 1,2,3 and 4 which stipulate payment of the tax otherwise than in local currency. Similarly, if the Federal Government had been paid the tax in Naira and Shell were to purchase pound sterling equivalent to the amount paid it would have incurred the exchange losses."*[45]

The payment of tax to the FG by a petroleum mining company is incidental to the company's business of petroleum operations.[46] "*The next question is whether the expenses were incurred 'wholly, exclusively and necessarily'. According to ordinary dictionary meaning the words 'wholly' and exclusively have the same meaning. They can be said to be mean 'solely' or 'entirely'. The dictionary meaning of the word 'necessarily' is the same as of the words 'inevitably' and 'unquestionably'.*[47] ***Therefore was the payment of the Bank Charges solely and inevitably incurred for the petroleum operations of the appellant?"***[48]

Non deductibility of affiliate loan interests incurred by E&P companies in JV petroleum operations with NNPC, on funds borrowed to cover NNPC's cash call default, would be most unfair. As stated above, funding oil and gas obligations require huge capital which can only be raised by debt or equity. Where the interests incurred in respect of intra-group loans are not deductible, the other options would be third party loans and equity.

39 Per Arogundade (at 143), in the ***Gulf Oil*** case at the Federal High Court (FHC), **Belgore J** held that *"the three conditions must be present as one is not alternate to the other. These words connote the same ideas but with fine distinctions. He went on to define each of the words: 'wholly' as meaning 'entirely'; exclusively as meaning 'substantially or even solely'; and 'necessarily' as meaning 'appropriately or inevitably'".*

40 See *fn 4* above.

41 The **educational scholarship expenses** were incurred pursuant to requirements of the ***Petroleum Drilling and Production Regulations***. The **foreign exchange losses** were incurred in effecting the agreement that Shell pay its taxes in pounds sterling (instead of in Naira) to CBN's account in England using the exchange rate in the agreement. Although the ***PPTA*** expressly disallows any amount incurred as income or profit tax, the losses incurred in effecting the tax payment were incurred pursuant to its obligations under the contract. The **CBN Commission** was incurred further to a directive and agreement with the FG to make such payment.

42 FBIR argued that the *"WEN" test is not applicable to the deductible items (exchange losses and CBN charges) because "… they were expenses incurred after profits had been earned and after completion of the petroleum operations of the appellant. Nor were they incurred in the course or as a result of or within or during the business activities of the appellant."*

43 Shell appealed against the disallowance of scholarship expenses whilst the FIRS appealed against FHC's finding that exchange losses and CBN commissions were deductible.

44 The litigation spanned a period of 23 years.

45 At p. 286.

46 The Court affirmed at 290, that: "*the definition of the phrase 'all operations incidental thereto' in section 2 PPTA cannot be circumscribed to 'drilling, mining, extracting or other like operations'. To do so would be to do violence to the true meaning of the definition of 'petroleum operations' and push the esjudem generis rule of construction too far… In my view there is no distinct genus in the definition for the phrase 'and all operations incidental thereto' to allow the rule of esjudem generis to apply…*"

47 *Cf.* with Arogundade's review of cases: (a) ***Fed. Comr of Taxation v. Snowden & Wilson Pty Ltd, (1958) 99 CIR 431***: "*clearly its operation [i.e. of the word 'necessarily' is to place a qualification upon the degree of connection between the expenditure and carrying on of the business … the expenditure must be dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business.*" In the same case, another judge stated: "*the relation between the expenditure and the carrying on of the business is clear. The expenditure was incidental to the carrying on of the business. It was … necessarily incurred because the exigencies of the business imperatives demanded that it should be so incurred.*" (b) Reasoning in ***Moffat v. Webb, 16 CIR 120*** which equated 'necessary' with 'obligatory'.

48 At *291, para B*. In view of the Court, the agreement with the FG varying currency and mode of paying PPT made arguments that the expenses (exchange losses and CBN charges) were incurred after completion of petroleum operations/profits have been earned and therefore not deductible, inappropriate. But for the agreement, the expenses could have been regarded not as expenses incurred to earn profit, but out of profit. Also, the provision of ***section 11(1)(f) PPTA, Cap. 354 LFN, 1990*** (now ***section 13(1)(f) Cap. P13***) disallowing "*any amounts incurred in respect of any income tax, profits tax or other similar tax whether charged within Nigeria or elsewhere*" did not affect the Appellant's case.

However, the time and efforts involved in obtaining third party loans or raising equity will be unreasonable, considering the strict timelines prescribed for complying with funding obligations under the applicable operating contracts.[49]

4. The *Companies Income Tax Act* (*CITA*) Analogy

At the outset, we concede that CITA provisions do not apply to E&P companies[50] but may provide guidance. CITA places no restriction on the deductibility of interest provided the underlying loan was incurred *"wholly, exclusively, necessarily and reasonably"* for the business and the interest was competitive.[51] *Prima facie*, an affiliate loan interest with competitive or better than market terms would not be regarded as artificial or fictitious transaction. The pragmatic view of the courts on deductions in CITA context is exemplified by ***Western Soudan Exporters Ltd v. FBIR.***[52]

In ***Western Soudan*** *"the question was whether monies given or rather advances made to middlemen for the purchase of produce, part of which advances could not be recovered or were recovered, though subsequent advances were made to the same middlemen, could be said to be 'expenses incurred for that period by that Company wholly, exclusively and necessarily in the production of their profits?"*

The Lagos High Court, *per Taylor CJ*, analysed erstwhile ***section 27 CITA (now section 24)***, stating that the sub-paragraphs *"are but examples"*: *"the main point in* ***section 27*** *is that all expenses incurred wholly, exclusively and necessarily in the production of those profits are deductible."*

The Court also noted subsequently that *"evidence was led that the advancement of money to such men was a custom and indeed a necessary one of the trade; and that it acted as an incentive to bring in more produce."*[53] The BAC had earlier ruled against allowing the amounts as bad debts largely because *"operations were carried on, on the basis of expecting not to recover part of the amounts advanced."* In reversing the BAC, the Court was further noted that *"no particular meaning should be attached to this phrase"* because bad debts is a fact of business life.[54]

5. The *PIB* Perspective

The executive and legislative arms of the government in recognition of the incongruence of the **PPTA** in relation to deductibility of inter-company loans, have sought to bring the situation in line with reality by providing in ***section 384 PIB***[55] that interests on inter-company loans or other debts can be deducted from profits to arrive at taxable profits provided the loans were obtained *" under terms prevailing in the* ***open market****, where the Service (Federal*

49 Refer to the constraints of obtaining debt financing from third parties above as well as the time constraint in the JOAs. It should be borne in mind that the rationale for high debt financing is not restricted to tax planning but could include the type of business involved.

50 Except probably for income that is not incidental to petroleum operations, for example interest income.

51 See ***sections 22 & 24(a) CITA***. Interest on related party loans would be subject to the general WHT provisions of ***section 78***. The ***Personal Income Tax Act*** (which imposes tax on individuals) also does not prohibit related party loans or restrict deductibility, although the anti-avoidance provision of ***section 17 PITA*** may be strictly construed where the individual is in effect seen as contracting with himself vide transaction *"which reduces or would reduce the amount of any tax payable"* and is therefore deemed *"artificial or fictitious"* for example transactions between settlor and trust of which settlor is trustee and beneficiary or the trust is controlled by the settlor.

52 ***(2010) 3TLRN 138***.

53 The Court favourably considered ***Reid's Brewery Co. Ltd v. Male 3 TC 279***, where: *"the appellants carried on the trade of brewers, that in addition… they carried on a business which they had taken over … from their predecessors, which is called the business and branch business of bankers and money lenders, and that that was in accordance with the custom and usual practice of manufacturing brewers."* In ***Re Frank Mills Mining Co. [1883] ChD 51***, the statement of *Jessel M.R.* in reference to business account that 'you cannot properly put down a single debt as an asset without some consideration of the circumstances of the debtor.' Whereas, *Lord Buckmaster* had stated in ***Gleaner Co. v. Assessment Committee [1922] 2 AC 169*** that: *"there must, in every profit and loss account, be an examination of the debts and a careful distinction between those that are good, doubtful and bad."*

54 The Court came to its decision based on the following grounds, that: (a) the advances were made wholly, exclusively and necessarily for the purpose of purchasing produce to generate profits for the company; (b) the advancement of money to such men was a custom, and indeed a necessary one of the trade; (c) attempts were in fact made to collect some of the advances or debts; and (d) all the witnesses for both sides agreed that the accounting principle of the appellant (the taxpayer) was good. The Court had remarked obiter in its judgment that *"… surely every reputable company or business concern conducts its business always bearing in mind that certain … sales or credits, … may or will be unrecoverable."*

55 Although there are various versions of the ***PIB***, the authors relied on the ***PIB, Vol. 8 No. 21 dated July 27 2011.***

Inland Revenue Services [FIRS]) is satisfied that the sum was payable on capital employed in carrying on upstream operations."

Additionally, the ***PIB*** did not retain the current provision which disallows interest on inter-company loans, therefore, the to the extent that the ***PIB*** seeks to repeal all the extant legislations in the petroleum industry (including the ***PPTA***), the prohibition on deduction of interest on inter-company loans will be completely eradicated.[56]

In the 2011 Class House of Representations version of the ***PIB*** (Committee Recommendation), ***section 330(1)(n)*** provides in similar terms as current ***section 10(1)(f) PPTA*** but for *"upstream operations"*, whilst ***section 330(1)(o)*** expressly provides that *"all sums by way of interest upon any loan, including inter-company loans…"* would be deductible where the terms are competitive and FIRS is satisfied that the capital was employed in carrying on upstream operations.[57]

Although the ***PIB*** (version in *fn 56, supra*) did not set a threshold for the amount deductible or, or define the term *"open market"*, the FIRS could still rely on the arm's length principle and other generally acceptable principles to regulate unacceptable transfer pricing.

In all, if the ***Vol. 8 No. 21 PIB*** version is enacted into law, the conflicts and other issues surrounding the deductibility of interests on inter-company loans would be put to rest and consequently, capital raising will become easier for E&P companies thereby giving room for increased productivity in the industry.

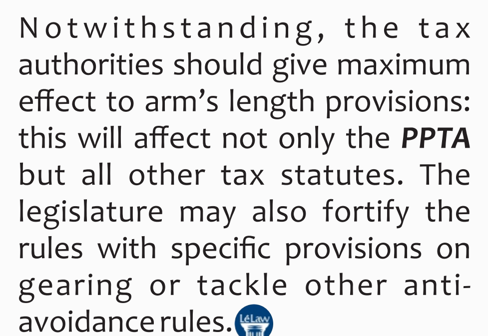
Conclusion

Writing in the context of erstwhile ***section 11(2)(a) PPTA***, a learned commentator stated: *"there appears to be no reason why the interest deduction should not be allowed only to the extent that the rate of interest on it does not exceed a reasonable commercial rate. The PPT Act is rather severe in disallowing totally interest paid to an affiliate: the **UK Code (Oil Taxation Act 1975, section 13)** allows interest paid from the inside of the ring fence to the outside to a related party but only at the normal commercial rate, i.e. you cannot overcharge."* [58]

Further, Dr. Ogunlami opined at *p.368, "in my view, the defect in **section 11(2)** is in its non-application of commercial criteria to the sums incurred by way of interest upon money borrowed from the relevant company or companies."* He argued forcefully that *"in terms of pure tax theory, the use of the affiliation test is a 'red herring'".*

It seems clear from the foregoing that ***section 10(1)(g)*** which is later in time modifies ***section 13(2)*** to the extent that interests on loans will be deductible (whether or not from related parties) if the interest rates are market (LIBOR) related.[59] The executive and legislative arms of government have also realized the incongruence in the ***PPTA*** and sought to align the relevant provisions in the ***PIB***; a realization that the restriction in ***section 13(2)*** has outlived its usefulness.

Notwithstanding, the tax authorities should give maximum effect to arm's length provisions: this will affect not only the ***PPTA*** but all other tax statutes. The legislature may also fortify the rules with specific provisions on gearing or tackle other anti-avoidance rules.



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56 Note however another version of the ***PIB***, viz the Inter-Agency Team (IAT) Redraft forwarded under cover of Government Memorandum, as *"a comprehensive proposal to amend the **PIB** submitted in 2009"* has more stringent, even conflicting proposals. Under the IAT redraft, ***section 345(1) PIB*** (Deductions Allowed) has made deductibility conditional *"to the extent they [expenses and outgoings] are reasonable given operational and market conditions at the time incurred and are verified and approved by the Service in accordance with procedures established by the Service…"* This may even be worse that the present conflict between ***sections 10(1) & 13(2) PPTA*** because it seems to give wide discretion to the FIRS. Even more worrisome is ***section 346(0) IAT Redraft*** which lists amongst disallowable expenses ***"any sums for interest, financing charges or other charges related to money borrowed or equity raised including the explicit or implied interest component of any leasing agreements." Section 346(q)*** **IAT Redraft** also disallows 20% of all expenses incurred outside Nigeria, apart from its ***section 346(p)*** that disallows *"all general, administrative and overhead expenses incurred outside Nigeria."*

57 Note however that ***section 331(1)(n)*** of this ***PIB*** version also disallows 20% of offshore expenses, expect where same relate to procurement of goods and services which are not locally available in the desired quantity and quality, subject to the approval of the Nigerian Content Development and Monitoring Board.

58 Gbadebo K. N. Ogunlami, ***'An Analysis of Nigerian Petroleum Taxation'***, *(1989) PhD Thesis submitted to University of Dundee, p. 367.*

59 It has been held that a modification provision of a statute can be achieved by an extension as well as by a narrowing of the original provision. See ***Attorney-General of Anambra State v. Attorney General of the Federation* [1993] 6 NWLR (Pt. 302), 691.**

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