Nigeria - Deductibility of Expenses in Computation of Profits

This article analyses the reasoning behind a recent decision of the Supreme Court in which the court appears to have extended the range of expenses that may be deducted in computing profits.

Under the Petroleum Profits Tax Act of 1959 an oil company, in computing its taxable profits from petroleum operations, is entitled to deduct all outgoings and expenses which are "*wholly, exclusively and necessarily*" incurred by such company for the purpose of such petroleum operations.

In 1973 the Federal Board of Inland Revenue [FBIR] disallowed the deduction of certain expenses claimed by Shell Petroleum Development Company of Nigeria Limited. The expenses in question fell into three broad categories, namely,

- currency exchange losses,
- Central Bank commissions, and
- educational scholarship expenses.

Dissatisfied with the FBIR's ruling, Shell Petroleum appealed. Over the next 23 years the appeal worked its way through the Body of Appeal Commissioners, the Federal High Court and the Court of Appeal until it reached the Supreme Court. As the Court of Appeal had held that the expenses were not deductible, the decision of the Supreme Court was anxiously awaited by all parties.

In September 1996 the Supreme Court handed down its decision in the case of *Shell Petroleum v. Federal Board of Inland Revenue*. It held that where there is a statutory or contractual obligation to incur an expense then such an expense is deductible even where it is not directly related to the taxpayer's 'petroleum operations'. Since in the instant case statutory obligations existed, the Supreme Court held, reversing the Court of Appeal, that Shell was entitled to deduct all three categories of expenses.

Background

Under the Petroleum Profits Tax Act the petroleum profits tax due from oil producing companies is assessed in Nigerian currency and is paid in Nigeria. In 1968, however, the Federal Ministry of Finance, on behalf of the Federal Government of Nigeria, sent a directive to all the oil producing companies operating in Nigeria in respect of the procedure for payment of royalties, petroleum profits tax and rents to the Federal Government. According to the directive the companies (including the Appellant, Shell Petroleum) were advised that from then on

" ..... *all payments due to the Federal Government of Nigeria from your company in respect of the three items mentioned above should be made to the account of the Central Bank of Nigeria with the Bank of England. As the amounts due are normally expressed in Nigerian Pound, the payer/company must ensure that enough Sterling is made available to make Nigerian Pound equivalent of the amount due from the company.*"

Subsequently, this directive was reduced into agreements between each company and the Federal Government. The agreements contained a formula for determining the currency exchange rate to be applied by the companies in making their lodgments at the Bank of England. Obviously, should there, at the time of payment, be a difference between the exchange rate applicable under the agreement and the rate prevailing in the currency markets, an 'exchange gain or loss' would arise in the hands of the oil company. It was the

'exchange loss' arising in the 1973 operating year that the Appellant sought to deduct from its income.

By virtue of the Petroleum Act 1969 the entire ownership and control of all petroleum in Nigeria is vested in the Federal Government of Nigeria. Consequently, all licences and leases for the exploration, prospecting or mining of petroleum are granted by the Federal Government. The Petroleum Act also provides that:

"If he considers it to be in the public interest, the Minister may impose on a licence or lease .... special terms and conditions not inconsistent with this Act ....."

and that

"The Minister may revoke any oil-prospecting licence or oil-mining lease if in his opinion the licensee or lessee ..... has failed to comply with any provision of this Act or any regulation or direction given thereunder or is not fulfilling his obligations under the special conditions of his licence or lease .....".

Clearly, if it was to retain its licences and leases and thus remain in business, the Appellant was bound to comply with the directives it received from the Federal Government.

Sometime in 1972 the Appellant received another directive from the Federal Government to the effect that a "commission" of 0.5% was to be paid to the Central Bank of Nigeria in respect of all sterling lodgments into the account of the Federal Government with the Bank of England. The Appellant sought also to deduct this 'commission' from its income.

Finally, in compliance with provisions of the Petroleum Act 1969 and the Petroleum (Drilling and Production) Regulations 1969, the Appellant instituted an educational scholarship scheme. Under the scheme university scholarships were awarded to deserving Nigerians with no obligation whatsoever on awardees, whether to become employees of the Appellant or to perform any other duty. The Appellant also sought to deduct from its income the amount expended on scholarships.

Exchange Losses

The Petroleum Profits Tax Act 1959 [PPTA] provides for the imposition of tax on the chargeable profits of companies that are engaged in petroleum operations in Nigeria. "Petroleum operations" is defined under the PPTA as -

"the winning or obtaining and transportation of petroleum or chargeable oil in Nigeria by or on behalf of a company for its own account by any drilling, mining, extracting or other like operations or process, not including refining at a refinery, in the course of a business carried on by the company engaged in such operations, *and all operations incidental thereto* and any sale of or any disposal of chargeable oil by or on behalf of the company".

The Appellant was engaged in petroleum operations and was therefore liable to tax on its profits in accordance with the PPTA. The Respondent had therefore issued a Notice of Assessment on the Appellant in respect of the tax due for 1973. This tax was payable in Nigerian currency to the Respondent (the FBIR) in Nigeria. If the Appellant had paid the sum levied it would have discharged its obligations under the law. At the direction of the Federal Government and in pursuance of the agreement between it and the Federal Government, the Appellant settled its tax liability by paying pounds sterling into the account of the Central Bank of Nigeria with the Bank of England in London. The amount of sterling to be paid was determined by using the exchange rates provided for in the agreement. The Appellant, however, had to purchase the sterling in the open market at whatever rates prevailed. Due to differences between the contractual exchange rates and the open market exchange rates, the

Appellant, in purchasing sterling in 1973, had to spend a greater sum in Nigerian currency than the sum it had been levied as tax. This additional expense the Appellant sought to deduct from its profits since according to section 10(1) of the PPTA:

"[in] computing the ..... 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 those operations ..... ".

The Respondent rejected the Appellant's claim for deduction on the ground that the expense was not incurred in the course of petroleum operations but in the course of payment of tax and was therefore not deductible in accordance with section 11(1) of the PPTA. Under section 11(1) the deduction of certain expenses is disallowed. Dis- allowed expenses include the following:

- "any disbursements or expenses not being money wholly and exclusively laid out or expended, or any liability not being a liability wholly or exclusively incurred, for the purpose of those operations"

- "any amounts incurred in respect of any income tax, profits tax or other similar tax whether charged within Nigeria or elsewhere".

The Supreme Court felt that ordinarily, in view of section 11(1) of the PPTA, the exchange losses would not have been deductible. In the instant case, however, the losses arose because the Appellant had come under obligation, pursuant to another law, namely the Petroleum Act, to pay its tax in an unusual manner. The Appellant being also bound by the Petroleum Act and had no choice but to comply with the instruction to pay its tax in sterling.

Also, it had been admitted in the course of argument that in a previous year when the Appellant had realised "exchange gains" these gains had been added to its profit in the computation of the tax payable by it.

The Court therefore concluded that the Appellant was entitled to deduct, for the purpose of computation of petroleum profits tax payable by it, the 'exchange losses' it incurred in making payments to the Government in pound sterling in London.

Central Bank Commissions

By a letter dated 16th March 1972 the Federal Ministry of Finance, on behalf of the Federal Government, directed the Appellant and other oil companies to pay a commission of 0.5% in respect of sterling lodgments into the account of the Central Bank of Nigeria with the Bank of England in London. Consequently, each time the Appellant made sterling lodgments in respect of its tax liability this commission also had to be paid. In 1973 the Appellant, for the purpose of computation of petroleum profits tax for the year, claimed a deduction in the amount of the commissions paid by it that year. The Respondent rejected the claim on the ground that it was not deductible under the PPTA.

The Supreme Court, in finding for the Appellant, expressed the following opinion:

"The directive given to the Appellant to pay the bank charges did not come from the Central Bank of Nigeria but from the Federal Government. If it had come from the former, the Appellant could have rightly queried such demand as it had no account with the Central Bank of Nigeria and the Bank had not performed any services on its behalf. In paying the Bank charges the Appellant merely carried out the directive of the Federal Government. .... The Appellant had no choice than to comply and this it did. ....."

"The Appellant is expected to receive directives from the Federal Government from time to time in the course of its business which is "petroleum operations." Clearly this is *incidental* to such operations. .... The payment of Bank charges to the Central Bank of Nigeria which had not rendered any service to the Appellant but simply because the Federal Government had so directed ..... was, therefore, incurred in the course of the Appellant's ..... petroleum operations."

The Court went on to hold that:

"in the light of the aforesaid, ... the Bank charges qualify for deduction under section 10 subsection (1) as claimed by the Appellant."

Scholarship Expenses

The Petroleum Act 1969 provides for the "Nigerianisation" of the labour force of the oil industry. Regulations 26, 27 and 28 of the Petroleum (Drilling and Production) Regulations 1969 made pursuant to the Petroleum Act 1969 contain provisions for putting into effect this policy of "Nigerianisation".

These regulations provide that:

"26(1) The licensee of an oil prospecting licence shall within twelve months of the grant of his licence, and the lessee of an oil mining lease shall on the grant of his lease, submit for the Minister's approval, a detailed programme for the recruitment and training of Nigerians.

"27. Any scholarship schemes prepared, and any scholarships proposed to be awarded, by the licensee or lessee (whether or not related to the operations of the licensee or lessee or to the oil industry generally) shall be submitted for the approval of the Minister."

"28. Once a programme under regulation 26 of these Regulations or a scholarship scheme under regulation 27 of these Regulations has been approved by the Minister, it may not be varied without his permission."

The Appellant in compliance with its obligations under these regulations established a scholarship scheme which was approved by the Minister and in pursuance of which it awarded scholarships. It sought to deduct from its income the expenses incurred by it in respect of the scholarships awarded.

The Respondent, while admitting that the Appellant had a legal obligation to award scholarships, had contended that the provisions of the law do not provide that expenses incurred thereby were deductible. In dismissing the Respondent's contention the Supreme Court held that:

"Once there is a statutory or contractual obligation, and in this case it is the former, for a company engaged in petroleum operations to perform, such obligation is 'wholly, exclusively and necessarily' for the purpose of the operations of the company."

The Respondent had also contended that, as the Appellant would not employ all those to whom scholarships were awarded, the expenses incurred on scholarships could not be said to be 'wholly, exclusively and necessarily incurred' for the purpose of its petroleum operations. The Court found this contention "rather strange and absurd" because, in the Court's view, not all those awarded scholarships would measure up to the required standard upon completion of their studies. According to the Court:

"Some [awardees] would fail their final examinations, some might even drop out of their institutions before the end was reached and some might only just make it at the end of their courses. No one would expect an oil company to employ any of the above classes of scholarship awardees. Given the specialised nature of the oil industry only the awardees with good grades would be employable. Must an oil company be deprived of its rights to deductions under section 10 (1) of the Petroleum Profits Tax Act in respect of expenses incurred by it in carrying out its statutory obligations by awarding scholarships, merely because some seeds feel by the wayside? I rather think not."

"Since the purpose of the scholarship scheme was in furtherance of its petroleum operations, the Appellant was entitled to deduction of its scholarship expenses under section 10 (1)."

Conclusion

It is submitted that the Supreme Court was right in adopting the broader view that expenses which arise from a statutory obligation should be deductible regardless of whether the expenses are directly related to the earning of income. The decision extends the range of expenses that are deductible and will therefore be welcomed by all tax payers. Also, it will be received with great relief by the other oil companies whose cases, arising from similar facts, were at various stages of appeal.

Finally, it is heartening that the court has once again played commendably the role of impartial arbiter between the Revenue and the tax payer. It is clearly unfair for the Revenue to collect taxes on exchange gains in one year and then refuse in another year to allow exchange losses to be deducted.