TRANSFER PRICING REGIME AND PETROLEUM PROFITS TAX ACT:

TIME FOR LEGISLATIVE INTERVENSION

BY

CHUKWUMA, WILLIAM AMECHI, ESQ

Abstract

The current study focuses on the impact of transfer pricing regulation on the Nigerian oil sector. Transfer pricing is a term that encompasses the setting, analysis, documentation and adjustment of charges made between related parties for goods, service or use of property including intangible property. It relates to the system of setting prices for the transfer of goods, services and intangibles between parties under the same entity or between related entities which operate in a more than one tax jurisdiction. Transfer pricing is also a legitimate practice for associated companies to adopt in the pricing of interrelated sales within a group as means of optimizing economic performance. The present study examines therefore the influence of transfer pricing regulation on the extant petroleum profit tax legislation, highlighting as it were, the defect(s) of the present law which, in every respect seems to enthrone and sustain capital flight against Nigeria. The study ends with a proposal on the way forward.

Key Words: *Transfer Pricing Regime, Multinational Enterprises, Petroleum Profit Tax Act, Organization for Economic Cooperation and Development.*

1.1 Transfer Pricing and the Petroleum Profit Tax Act (PPTA)

1.1.1 Concept of Transfer Pricing.

Transfer pricing is a topical issue in taxation. The interest in the issue goes beyond taxation and strategic business planning of the Multi National Enterprises to politics[1]. The interest of the taxman lies in ensuring that the transfer prices for inter group transactions within his jurisdiction reflect the open market situation and where they (the transfer prices and the open market prices) diverge, he has to make appropriate adjustments. The Multi National Enterprises as taxpayers, see transfer pricing as the method for measuring the transfer among members within the group. Governments are interested in transfer pricing because of its revenue potential and its possibility of providing avenues for tax fraud.

Principally, the political interest lies in the fact that what a country loses through the shift of profits is a gain to another country to which the

Chukwuma, William Amechi Esq., is a Lecturer in the Department of Private and Public Law Chukwuemeka Odumegwu Ojukwu University, Igbariam, Anambra State email:wilychuma@yahoo.com. Tel: 08037158467.

1. J.A. Arogundede, Nigerian Income Tax and Its International Dimension. P. 58.

profit is shifted[2]. Governments therefore see the need to put in place appropriate laws and machinery on regular basis to protect the revenue interest and check any tax fraud.

It is conventional to view transfer pricing and international tax fraud as two separate problems. Transfer pricing may be used to perpetuate fraud as observed in the UN Manual[3] that the Multi National Enterprises have become increasingly sophisticated in using transfer prices to minimize their taxes. It is in this sense that transfer pricing becomes an avoidance scheme. In principle, it is an accepted business practice for related companies to set mechanisms for pricing internal transactions among the associated members. Problems arise when such mechanisms result into pricing different from what is considered the arm's length price. This may arise from practical problems outside the scope of the Multi National Enterprises. This is different from the problem of tax avoidance in the sense that tax planning device is used to minimize or escape tax. Under the Nigerian domestic laws and the tax treaties, the two issues are not viewed as the same either. For transfer pricing cases, the laws[4] provide for adjustments to reflect arm's length principles. For avoidance cases, the laws provide for the rejection of the books of the taxpayer and to substitute turnover tax for the tax based on the company's returns. In the case of the tax treaties, the effects are the same, it involves re-writing of the books in the case of transfer pricing and the rejection of the books in the case of tax avoidance.

1.1.2 Multi National Enterprises and Transfer Pricing

This practice among MNEs of adjusting prices of goods as they move around their global operations is commonly referred to as transfer pricing and described in the Nigerian tax laws as artificial or fictitious transaction when not at arm's length[5].The word 'multinationals' arouses fears in the minds of many Nigerians, more for political than economic reasons. The very big ones among the Multi National Enterprises are reputed to have hijacked the *decision-making* apparatus of developing nation-states, this is also evident even in developed countries[6].

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2. Ibid.
3. Manual For The Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries: ST/ESA/NAD/SER.E/37/2010, Pp. 58.
4. Companies Income Tax Act CAP C21 LFN 2004 (as amended 2007), section 22; Personal Income Tax Act CAP P8, LFN 2004 (as amended 2011), sections 15 & 17.
5. Supra.
6. K. Roger, , How MNEs Overcome Economics of Developing Nations, "The Financial Times",13th August, 2003, Pp. 29-31..

The same publication of The Financial Times observed:

> The Irish sometimes fret about the fact that foreign firms account for almost half of their country's employment and two thirds of its output; and Australians point nervously to the fact that the ten biggest industrial multinationals each has annual sales larger than their government's tax revenue[7].

Back home in Nigeria, the impression created of MNEs especially in the oil sector, is that of commercial octopuses with narrow economic interest and who tolerate no competition. The House Committee on Petroleum had once publicly shared this very view[8].

Be that as it may, the main area of interest in this study is the way these groups of companies arrange their transactional affairs within the group and the tax implications of such arrangements on the Nigerian economy. The members of a group, commonly referred to as related or associated, transact business across many national frontiers and are to be accountable to the tax authorities of each of these countries for the tax arising from the income attributable to the business carried on in the relevant tax jurisdiction. The study now moves over to examine various transfer pricing methods available in international taxation.

2.1 Transfer Pricing Methods

The domestic law does not make any specific provision for transfer pricing method. However, it is necessary to differentiate between pure transfer pricing problem and tax avoidance for the purpose of application of Nigerian tax laws. CITA[9] provides for adjustments where the internal pricing diverges from the open market prices.

The section[10] authorizes the Board to:

> Disregard any such disposition or direct that such adjustments shall be made as respects liability to tax as it considers appropriate so as to counteract the reduction of liability to tax effected, or reduction which would otherwise be effected, by the transaction.

Both PPTA and PITA[11] have similar provisions for necessary adjustments. The provisions apply to all persons, residents or non-residents which provides for the substitution of the turnover tax. On this issue, the

7. Ibid.
8. J.K. Adams "House of Reps accuses MNEs of frustrating Government Oil Policies", The Guardian Newspaper, January 14, 2004, Centre – Spread.
9. Companies Income Tax Act CAP C21, LFN 2004 (as amended 2007), section 22..
10. Op cit.
11. Ibid.

Nigerian tax treaty is in *pari materia* with the OECD Model[12], which provides:

> Any profits which would, but for those conditions, have accrued to one of the enterprises, but by reasons of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Both the domestic tax laws and the tax treaties provide for adjustments where the transfer price diverges from the arm's length price. There are yet no specific internal regulations on the mode of application of the required adjustments in Nigeria as the existing authority, cited above, for such adjustment are in general terms. There is now a growing consensus towards the acceptance of some methodology for the application of arm's length price for transactions between associated enterprises.

Basic to the methodology is availability of comparables. The domestic laws and the tax treaties provide for the substitution of open market prices where there is divergence between the prices for transactions between related persons and the open market prices. These are prices charged for transactions between independent parties under similar circumstances as those between the related parties. This selection of prices implies the availability of transactions between independent parties which are comparable to those transferred between associated companies.

3.1 Impact of Transfer Pricing on the Oil Sector.

The tax problem of the oil sector is as complex as the industry itself. The complexity is created by the dominance of the MNEs in the operations of the various sub-sections – oil production, oil servicing, oil marketing, transportation, gas production and utilization. The books of the MNEs are not kept in Nigeria but in their head offices[13]. The Board has no access to these books and cannot therefore determine or compare the prices for the various transactions as they feature in the furnished financial returns for conformity with arm's length principles. Further, under the production sharing contract agreements, the contractor keeps the books for both the company and the NNPC, the concession holder[14].

The Board does not audit the books. This creates the problem of

12. Organization for Economic Cooperation and Development, Article 9..
13. Op. Cit.
14. Op Cit

determining the actual Nigerian profits from these contracts. The explanation that the NNPC approves the expenses does not provide a feasible solution. Approval does not guarantee conformity of prices/margins with arm's length principles[15]. Where the financial returns are made up mainly of invoices in respect of third-party transactions, claims can always be verified. A different situation arises where most of the invoices are in respect of internal transfers the pricing of which may not reflect the open-market situation.

Under the prevailing situation in the sector, Article 9 of the tax treaties provides that:

> Any profits which, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed according.

This provides for adjustments to counter any shift of profits resulting from the transfer pricing arrangements within the MNEs.

Similarly, CITA[16] provides that:

> Adjustments shall be made as respects liability to tax as it considers appropriate so as to counteract the reduction of liability to tax affected, or reduction which would otherwise be effected, by the transaction and any company concerned shall be assessable accordingly.

The domestic tax laws and the tax treaties do not view transfer pricing as tax fraud though the result is the shifting of profits from one tax jurisdiction to the other. They both provide for adjustments to correct the discrepancy created by the pricing method. The main problem is that the open-market price provided for by the laws and the treaty is not easily determinable.

For practical purposes, therefore, there are no standards on the ground presently[17] to re-write the books of the MNEs in this sector. Assessments are therefore invariably based on the computations submitted by these companies and the value added by the Board in the form of additional assessment is bound to be relatively low. This calls for the adjustment provided for by the statute.

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15. Organization for Economic Corporation and Development Model, Ibid.
16. Companies Income Tax Act, Supra
17. The Present Study calls for urgent legislative intervention to address this ugly tide which has continued to impede the envisaged socio-economic transformation of the country through robust tax policy.

Government policy has further complicated the tax problem in the sector with the creation in the industry of various fiscal regimes and packages of tax incentives[18].

Since the same MNE is investing in both operations through different subsidiaries or affiliates, it is possible for profits to be shifted from the JVC operations to the PSC operations through the pricing of the MNE so as to transfer higher income from the Nigeria operation. Further, there is considerable amount of incentives granted to the gas industry[19]. Income can be shifted to the gas operation from the petroleum operation through the pricing policy of the MNE so that the MNE has higher overall returns on its Nigerian investment. This is a reduction in the revenue that would have, but for the arrangement, accrued to the Nigerian government.

In the industry, there are internal transfers for various services like rental of rigs, sale of spares, hire of services, payment for intangible drilling and others. Though the NNPC is to approve the budget and audit the accounts, the information is not shared with the FIRS. The objectives of the two bodies may not necessarily be the same. The objective of the NNPC is the successful execution of the projects and this may be different from the tax objective of FIRS. The tax objectives is to ensure that the prices charged by an MNE for the intra-group transfers of materials, services and intangibles whether under the JVC, the PSC or the Sole-Risk reflect the arm's length principles. The pricing objectives of each MNE may also be different from this tax objective. This explains the seeming laissez-faire approach to the tax policy in the sector.

In the servicing sub-sector, the pricing method is generally the cost-plus arrangement for the Nigerian subsidiary. The margin varies between 4 and 15%[20]. The concern is that neither the allocated costs nor the margin may reflect the actual costs or the benefits to the subsidiary.

Ordinarily, this would have called for audit and the adjustment provided for by the statute or the tax treaties. Global standard has been mapped out to monitor and nip in the bud tax frauds accentuated

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Petroleum Profit Tax Act CAP P13 LFN, 2004, Sections 8 and 9. For instance, the fiscal incentives available under the PSC regime (the generous capital allowances, the tax rate of 50%, the lower royalty rates of the JVC.

Petroleum Profit Tax Act CAP P13 LFN, 2004, section 9 (1) (c), & Fourth Schedule to the Act. For instance, the LNG currently enjoys a tax holiday. An MNE operating in the petroleum and gas sub-sectors can shift income from the petroleum operation (which is taxable at 85% of profit) to gas operation (which is exempted from tax).

Tax Notes International Vol. 27, No. 9,, P.72

through transfer pricing[21].

This is a reflection of how far Nigeria needs to go. To date, none of these prerequisites is in place and they need to be installed before Nigeria can think of embarking on transfer pricing adjustments. To these deficiencies must be added the need for equipment and the capacity building. In this regard, the advice of the Group of Experts for the Negotiation of Bilateral Tax treaties between Developed and Developing Countries becomes instructive:

> The manipulation of transfer prices is now considerably more sophisticated than it was in the recent past. To protect their source and residence jurisdictions, a developing country must develop in its tax department a similar sophistication. Part of that sophistication is to be able to recognize when an MNE has set its transfer prices in accord with emerging international standards[22].

The study moves to revisit a land mark case involving the NNPC and FIRS to highlight their divergent objectives on tax matters.

4.1 X-Ray of Legal 'War' Between NNPC Versus TAT & 3 Ors.

The applicant, Nigerian National Petroleum Corporation (NNPC) was joined as a party in this tax matter before the Tax Appeal Tribunal (TAT), it challenged the jurisdiction of the TAT to determine the tax appeal. Alternatively, it sought an order striking it out as a party to the tax appeal before the TAT. The TAT dismissed the objection to its jurisdiction and granted the alternative prayer thereby striking out NNPC as a party to the tax appeal. Dissatisfied, NNPC applied to the Federal High Court (FHC) Lagos Division for an order of certiorari to quash the decision of the 1st respondent (TAT) and an order of prohibition to prevent the respondents from continuing the proceedings. One of the issues formulated by the respondents for the determination of the Federal High Court, Lagos Division was whether the Tax Appeal Tribunal has jurisdiction to determine the tax appeal brought before it.

In arguing this issue, the NNPC through its counsel contended

21. M. Gianmarco, "France Aggressively Pursues Transfer Pricing Adjustments", Tax Notes International, Vol. 27, No. 9, P. 1031. In his article, the author articulated the prerequisites for establishing a transfer pricing regime. These include: Establishment of transfer pricing rules. An aggressive of audit policy; Development of audit teams specializing by industry; Promulgation of law to provide for documentation requirements to address: Inter-company flows (mapping) – financial flows, joint-venture flows; Functional and risk analysis; Transfer pricing method; and Economic analysis.

22. QECD 2004 study Group, "Toward Pragmatic Transfer Pricing", Public in the Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, ST/ESA/PD/SER.E/37/207.

that by virtue of the provisions of Section 251(1)(a), (b), (n) and (f) of the 1999 Constitution, matters or disputes relating to taxation are within the exclusive jurisdiction of the Federal High Court (FHC). They argued that any other body exercising adjudicatory powers over such lacked the jurisdictional competence to entertain any suit on such matters. It went further to submit through its counsel that the provisions of paragraph 11(1) and (2) of the Fifth Schedule to the Federal Inland Revenue Service (Establishment) Act, FIRS(E)A which confers adjudicatory powers on the 1st respondent (TAT) over matters and disputes in respect of taxation violated the express provisions of section 251(1) of the 1999 Constitution and are therefore void. They further based their argument on decided authorities of Stabilini Visioni[23] Ltd v FBIR and Cadbury (Nig) PLC v FBIR[24]. However the 2nd and 3rd respondents through their counsel countered that the decisions sought to be relied upon by the NNPC to wit: *Stablini Visioni v FBIR[25] and Cadbury (Nig PLC) v FBIR[26]* are distinguishable as they are based on the provisions of paragraph 24(1), second schedule and section 20(2) & (3) of the Value Added Tax (VAT) Act[27] which had placed the VAT Tribunal and the Federal High Court (FCH) on equal footings as courts of co-ordinate jurisdiction by allowing appeals from VAT Tribunal to go directly to the Court Appeal. They argued that, that was a usurpation of the powers of the FHC as granted in Section 251(1) of the 1999 Constitution and was therefore void. They distinguished that from the provision of the FIRS (E) Act which established TAT as an administrative Tribunal through which taxpayers (and FIRS as well) could attempt to resolve their disputes with FIRS (or FIRS against the tax payer) before appealing to the FHC. They therefore submitted that the establishment of the TAT and the subsequent powers conferred on it do not derogate from the jurisdiction of the FHC but rather serves as a condition precedent to bringing an action before the FHC.

The FHC held validating the jurisdiction of TAT, that TAT was not a court of law, but an administrative tribunal established by statute to solve taxation disputes between taxpayers and FIRS.

5.1 Summary and Conclusion

Most Commonwealth Countries had the type of the general provision we have in our laws to deal with transfer pricing problems.

23. (2004)2 CLRN 269; (2009) 13 NWLR (pt 1157) 200; 1 TRLN 1.
24. (2010) 1 CLRN 215; (2010) 2 NWLR (pt 1170\9) 561.
25. Supra.
26. Supra.
27. Chap VI Law of the Federation of Nigeria (LFN), 2004.

They have had to amend the laws and have introduced sweeping rules to deal with thin capitalization and transfer pricing problems. In 1988, the White Paper on Tax Reforms in Canada brought a change to the law. South Africa also had an amendment to the Income Tax Act in 1995. These changes were necessary to deal with the complexities of the problems. This aspect of the analysis is as a proposal to tap from their experience. The Canada Income Tax Act introduced measures in sections 18(4) to 18(8) to restrict interest payable by a Canada resident to a non-resident where both are related and are found not to be dealing at arm's length. Section 18(5) of the Act restricted the ratio of the loan to the Canada company's equity to three to one. Interest payment would be allowed for loans within that ratio. The excess interest was not deductible. Section 31(3) of the 1995 Income Tax Act of South Africa has similar limitation. The ratio of the debt to fix capital should not exceed three to one for the interest to be allowable. The need to bring similar restriction to Nigerian tax laws has not been in dispute. To the best of my knowledge, the Board had received proposals for a restriction. The problem is the basis. As the law currently stands, such a restriction through administrative measures would amount to an illegality.

There are two main problem areas:

(a) The provision in Companies Income Tax Act CAP C21 LFN 2004 (as amended 2007), section 22, is of general application to "any transaction" which limits its applicability to meet the special case of a loan transaction but would require amendments to apply directly to financial transactions; and

(b) Every interest is deductible without restriction once it meets the omnibus condition of being for the purpose of the business, it is not capital in nature and it is not specifically

(a) disallowed by a provision of the Act. Exceptions have to be built into the law to allow for restrictions.To introduce a restriction would therefore require a legal backing. The two examples of Canada and Sough Africa have been cited to show what needs to be done in the circumstance.The starting point is the enabling law for the restriction. The CITA, PITA and PPTA would have to be amended to give powers to the relevant authorities to introduce the restrictions. That would not end the story as the internal rule to specify the details of mode of application as guide to the tax administrators and practitioners must follow.