TAX ISSUES IN NIGERIAN OIL AND GAS CONTRACTS – a critique of floating, production storage and offloading vessels contracts.

INTRODUCTION

Floating, Production, Storage and offloading vessels are specialised vessels used in the development of offshore and marginal fields located far away from any existing infrastructure. In Nigeria, the focus of the Oil Producing Companies (OPC) is shifting to the offshore and deep offshore fields as most of the fields located onshore and shallow waters are attaining maturity.

In developing these offshore fields, different floating systems can be utilised including FPSOs, SWOPs, SPARs and Semi-Submersible Production Platforms. However, it would appear that of the various types of floating systems in use today, the ship - shaped FPSO currently appears to be the most popular and its use continues to gain wide acceptance in the oil and gas industry. There are currently about 85 FPSOs operating in different parts of the world, out of which at least 10 units are already installed or been sanctioned for use on various projects in Africa.

STRUCTURING THE FPSO CONTRACT

Briefly, there are two main methods of acquiring an FPSO and these are through an outright ownership/purchase/construction of the FPSO or lease. Please note that there are several hybrids between these options. This paper will focus primarily on FPSOs acquired through outright ownership.

Due to the specialised nature of FPSOs, they cannot be ordered off the shelf like conventional ships and are usually built to specification bearing in mind the peculiar characteristics existing at the field where they are to be used. Acquisition usually involves awarding a contract for the construction of a new build FPSO, conversion of a VLCC (Very Large Crude Carrier) into an FPSO or upgrade and redeployment of an existing FPSO.

In structuring the contract, the considerations to be borne in mind primarily are: an offshore field to be developed, the parties/owners of the field where the FPSO is to be used, the contractor to be engaged to construct the FPSO and where alternative financing is required, the banks/financial institutions that will be involved.

CONSTRUCTION CONTRACT

The construction contract will be structured as an EPCI (Engineering, Procurement, Installation and Commission) turnkey contract. The parties would include the host government/concessionaire of the field and the OPCs either in a joint venture, production sharing contract or other arrangement and the construction contractor, who would be awarded the contract for the construction of the FPSO.

The construction contract could be awarded to a single contractor who will in turn engage several subcontractors for different phases of the project but will remain ultimately responsible to the host government/OPC for the execution of the contract. The construction contractor/company will usually be the local subsidiary of a non – resident offshore company, which would be responsible for all aspects of the contract to be executed locally, while the non-resident parent company will be in charge of the offshore portion of the contract.

The key issues relating to the contract including the construction arrangement, pricing and payment, title and risk, completion date, alteration and delays, force majeur, consents and warranties, would be agreed by the parties.

The fabrication of the major parts of the FPSO including the hull and topside facilities, is currently carried on outside Nigeria due to the dearth of available technology and manpower required in Nigeria, while the installation, commissioning and certain other portions of the contract are usually executed locally. Previously, it was possible for the entire fabrication of the FPSO to be done outside Nigeria and the vessel brought into Nigeria and subsequently sold to the OPC. However, in line with the Federal Government's local content policy, which requires about 15% to 30% of all EPC contracts awarded in the Nigerian oil and gas industry to be performed in Nigeria using local Nigerian companies, certain aspects of the contract are mandatorily required to be executed locally.

The construction contract could be structured as a single or split contract. The split contract would be divided into an onshore and offshore package. The offshore content will cover the fabrication and procurement works to be carried on outside Nigeria, while the onshore package will cover the installation and commissioning of the FPSO and all contracts to be performed locally. The contract would involve legal and tax implications and the purpose of this paper is to analyse the tax issues that frequently arise in such contracts. The focus would primarily be on the tax liability of the construction contractor, as the OPC would be resident in Nigeria and ordinarily liable to Nigerian Corporate Tax.

TAX CONSIDERATIONS

1. Companies Income Tax

   Nigerian Companies Income Tax Act (CITA) provides that companies deriving profits from Nigeria are liable to tax to the extent of any income derived from their operations in Nigeria. Foreign companies deriving income in Nigeria but receiving payment abroad will be liable to tax to the extent of any income derived from their operations in Nigeria. Section 13 of the CITA stipulates that profits from such operations are deemed derived from Nigeria under four circumstances:

   - if the foreign company has a fixed base in Nigeria;
   - if it has an agent through whom it conducts business in Nigeria;
   - if it is executing a turnkey contract; or
   - if the foreign company has a relationship with a Nigerian company, which is considered artificial or fictitious by the Federal Inland Revenue Service.

   It is therefore quite clear that the construction contractor will be liable to Nigerian corporate tax in respect of any part of the construction contract performed locally.

   TAX LIABILITY OF THE CONSTRUCTION CONTRACTOR FOR WORKS EXECUTED OFFSHORE

   A question that frequently arises is whether the construction contractor will be liable to tax in respect of fabrication works performed on the FPSO outside Nigeria. Two major factors would be considered in this paper:

   a. whether the construction contract is structured as a single or split contract; and
   b. whether the construction contractor's country has a Double Taxation Treaty with Nigeria. Nigeria has ratified a DTT with several countries including: United Kingdom, Belgium, France, Canada, Romania, the Netherlands, Italy and Pakistan. The DTT between Nigeria and France will be used as a case study.

   a. SINGLE/SPLIT CONTRACT

      i. Single Contract

         If the construction contract is structured as a single contract executed between the OPC and the Nigerian registered company, legally, the non - resident contractor should not ordinarily be liable to Nigerian tax in respect of any portion of the construction contract executed outside Nigeria, since the company will simply be a subcontractor of the Nigerian company and the activity being undertaken will not fall under any of the four headings earlier itemised above i.e fixed base, agency, turnkey contract or artificial relationship. However in practice, the FIRS' give a different interpretation to all four paragraphs. Both the legal and practical approach will now be considered.

Fixed Base

A foreign company's income will be deemed to be derived in Nigeria if the company has a fixed base of business in Nigeria from which it carries on business to the extent that the profit can be deemed to have attributed from the fixed base. A fixed base must be easily identifiable and possess a degree of permanence. The phrase "fixed base" may be interpreted to include facilities such as a factory, an office, a branch, mine or oil and gas well, activities such as construction, building, assembly, or installation and provision of services in connection with the aforementioned activities.

Legally, in order for a company to have a "fixed base" of business in Nigeria, it must be registered to do business in Nigeria. Section 54 of the Company and Allied Matters Act 1990 (the relevant legislation, which regulates the registration and regulation of companies in Nigeria), stipulates clearly that a foreign company intending to carry on business in Nigeria, is required to be incorporated in Nigeria. Accordingly, a non - resident company should not ordinarily be able to possess a fixed base of business in Nigeria, unless registered.

However, the interpretation given by the FIRS is that it is possible for a non - resident company to have a fixed base In Nigeria where it has a sub-contract arrangement with and engages a resident company as its sub-contractor to carry out its business in Nigeria. In such a situation, the FIRS may deem such a company as having a fixed base in Nigeria and assess it to Nigerian corporate tax.

Agency

Under this heading, a non – resident company will be assessable to tax if it operates a trade or business through a person in Nigeria who is authorised to conclude contracts on its behalf or who habitually maintains a stock of goods or merchandise in Nigeria from which deliveries are made by the person on behalf of the company. Such company shall be liable to tax to the extent that the profits are attributable to the business or trade habitually carried out through that person.

The approach adopted by the FIRS is not whether the agent has in fact concluded a contract on behalf of the company but whether the agent in Nigeria could have concluded a contract on behalf of the company and on that basis, assess the nonresident company to tax.

Turnkey Contracts

If a foreign company is awarded a contract to execute a turnkey project involving services, deliveries, installations or construction, such company shall be assessed to tax on a fair and reasonable percentage of the contract. However, where the contract is awarded to the Nigerian registered company, the non-resident company should not be liable to Nigerian tax in respect of the portion of the turnkey contract performed abroad on behalf of its Nigerian subsidiary. However, the approach of the FIRS is to subject the entire contract to Nigerian corporate tax and for purposes of taxation, the non-resident contractor will be regarded as a single entity with the Nigerian registered company.

Group Transactions

This provision confers wide discretionary powers on the FIRS to prevent profit hiding and forms the basis under which the FIRS assess most non-resident companies to Nigerian corporate tax. It comes into operation where the FIRS is of the opinion that any transaction, which reduces or would reduce the amount of any tax payable is artificial or fictitious. In such a situation, the FIRS is given the power to disregard any such disposition and assess the company to tax using their best judgment.

Transactions between companies are deemed artificial or fictitious where one of the companies has control over the other or both are controlled by some other person or company or if the FIRS is of the opinion that the transaction between the companies have not been at arms length. However, the approach adopted by the FIRS is that once the non – resident contractor has a Nigerian subsidiary, then the transaction between both companies will be deemed artificial.

ii. Split Contract

If the construction contract for the FPSO is split and there is a distinct offshore contract executed directly between the OPC and the non-resident construction contractor in respect of works to be carried out on the FPSO outside Nigeria, that contract has no connection whatsoever with the onshore contractor/contact, legally the position should be as applicable under a single contract and the construction contractor should not be liable to tax. However, it is pertinent to note that the FIRS may still deem the non-resident contractor liable to Nigerian tax because of its Nigerian subsidiary on the ground that though there two separate contracts, in its opinion, the relationship between the two companies is artificial or fictitious. For this purpose, the local subsidiary of the non-resident company will be regarded as a single entity with the non-resident company, accordingly, both contracts will be subject to Nigerian corporate tax. However, if it can be proved that the contracts are totally exclusive of each other and there is no connection whatsoever between the companies executing the contracts, the non – resident company might be able to avoid Nigerian tax. However, it should be noted that he onus to disprove would rest squarely on the contractor rather than on the taxman.

b. DOUBLE TAXATION TREATY – NIGERIA/FRANCE

The taxes covered by the Double Taxation Treaty (DTT) between Nigeria and France is listed in Article 2 as income tax, corporation tax, capital gains tax, and petroleum revenue tax. Furthermore, the general principles, which guide the taxation of companies in one contracting state in the other contracting state are the principles of "Permanent Establishment" and "Attribution of Profits" as contained in Article 7 of the DTT, which provides:

> "The profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to that permanent establishment".

Under the DTT, The profits of a non-resident company should only be liable to the taxes stated above in Nigeria if it has a Permanent Establishment in Nigeria and the profits in view are attributable to that Permanent Establishment.

Permanent Establishment

For the purpose of the DTT, Permanent Establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on. This could be a place of management, office, branch, factory etc. Under Article 5(6) of the DTT, a non-resident company would be deemed to have a Permanent Establishment where a person (including a subsidiary, associated company or any other company or personnel) acts on the company's behalf and;

a. Habitually exercises in Nigeria an authority to conclude contracts in the name of the non-resident company unless its activities are limited to the purchase of goods and merchandise for the non-resident company and

b. Habitually secures orders for the sale of goods or merchandise in Nigeria exclusively or almost exclusively on behalf of the non-resident company.

A perusal of the foregoing, without more, indicates that if a subsidiary or an associated company resident in Nigeria habitually exercises the authority to conclude contracts in the name of a non - resident company, whether the contracts are in fact referred to the company for signature or approval or not, the subsidiary or associated company would be deemed to be a Permanent Establishment of the non - resident company and accordingly be liable to tax on the portion of the profits on the contract attributable to the non resident company's activities through the resident company.

However, it is worthy of note that the practice adopted by the FIRS is that all the profits arising from a Nigerian turnkey contract are attributable to the Permanent Establishment. Under this practice, both the party by whom and the place where the contract is performed are irrelevant. The only relevant question is whether the contract emanated from Nigeria contract and if it did, the non - resident company will be liable to tax under Nigerian law.

2. Withholding Tax

Nigerian law provides for tax to be withheld at source from the receiving company or individual by a paying company at various rates, depending on the income generating activity. Such taxes paid and remitted are to be setoff against the company's final income tax liability as assessed by the FIRS. The construction contractor would be liable to withholding tax under Nigerian law when profits arising from any payment due to it would be liable to Nigerian tax as provided in the CITA. Accordingly, if the construction contractor is liable to Nigerian companies income tax, it would be liable to withholding tax on the total contract sum. It should however be borne in mind that in practice, where the contractor is not liable to Nigerian corporate income tax it should not be liable to withholding tax but in order to be exempted from liability from withholding tax, the contractor would need to obtain a tax exemption certificate from the FIRS to prevent the OPC deducting withholding tax at source.

CONCLUSION

The above are some of the numerous challenges, which will be faced by non – resident companies who seek to execute FPSO contracts in Nigeria. A lot of times the practice adopted by the taxman would be at variance with well established legal principles on the subject and in the opinion of this writer that until the FIRS is challenged by a legal action, it would continue to be the practice as the taxman has very wide powers on the manner of tax collection. It is therefore prudent that existing and intending parties familiarise themselves with some of these practices in order to build them into the project cost when submitting tender/bid documents for FPSO contracts in the Nigerian oil industry.

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CONSTRUCTION CONTRACTOR'S TAX LIABILITY WITH RESPECT TO FABRICATION OF THE WORKS CARRIED ON OUTSIDE NIGERIA.

This would depend on how the contract is structured.

1. SPLIT CONTRACT: If the construction contract for the FPSO is split and there is a distinct offshore contract executed directly between the MOC and the non-resident construction contractor and that contract has no connection whatsoever with the onshore contractor, legally the construction contractor should not ordinarily be liable to tax with respect to fabrication works on the FPSO done outside the country as it would not qualify or fall under any of the four categories listed above. However, it is pertinent to note that the FIRS may deem the non-resident contractor liable to Nigerian tax because of its Nigerian subsidiary on the ground that although there two separate contracts, in the opinion of the FIRS the relationship? is artificial or fictitious.

2. TURNKEY CONTRACT: Where one contract is executed, the non-resident construction contractor should ordinarily not be liable to Nigerian tax in respect of the contract to be executed abroad. However, in practice the approach of the FIRS is to subject the entire contract to Nigerian corporate tax if the contract is awarded to one non-resident company and for this purpose the local subsidiary of the non-resident company will be regarded as a single entity with the non-resident company.

WITHHOLDING TAX

Nigerian law provides for tax to be withheld at source from the receiving company or individual at various rates depending on the income generating activity. Such taxes paid and remitted are to be setoff against the company's final income tax liability as assessed by the FIRS. The construction contractor would be liable to withholding tax under Nigerian law when profits arising from any payment due to it would be liable to Nigerian tax as provided in the CITA. Accordingly, if the construction contractor is liable to Nigerian companies income tax, it would be liable to withholding tax on the total contract sum. It should however be borne in mind that in practice, where the contractor is not liable to Nigerian corporate income tax it should not be liable to withholding tax but in order to be exempted fro liability for withholding tax, the contractor should obtain a tax exemption certificate from the FIRS to prevent the MOC deducting withholding tax at source.