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Legal Brief

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The Decision of the Court of Appeal of Tanzania in Civil Appeal No. 192 of 2018 between *Pan African Energy Tanzania Limited and Commissioner General, TRA,* is a Gigantic Snag to the Upstream Petroleum Industry.

- *Holds that paragraph 1(3) and (1)(1) of the Third Schedule read together with section 17 of the Income Tax Act, 2004, entitles a person to depreciation allowance only upon meeting the two conditions, that is depreciable assets must be owned and employed in the production of the income in question.*
- *That the import of paragraph 1(3) of the Schedule is that, though expenditure incurred in the production of income from the business of natural resource prospecting, exploration and development shall be treated as if it were incurred in the acquisition of that asset hence entitling the person to depreciation allowance on that asset. Such an asset must have been used in the production the income.*
- *The positions of the laws in Australia and India are different from the law applicable in Tanzania.*
- *Both the Appellant and the Court erred by not applying the correct provisions of the law.*
- *The decision fails to appreciate how the upstream petroleum industry operates.*
- *The decision does not take into account the income tax rules as applied to the exploration, development and production of hydrocarbon resources.*

Brief Facts of the Dispute

On 5th July 2018, the Court of Appeal of Tanzania sitting at Dodoma rendered its decision against a Appellant's appeal regarding entitlement to depreciation allowance under section 17 of the Income Tax Act, 2004 (the ITA 2004) read together with paragraphs 1 (1) and 1 (3) of the Schedule to the ITA 2004.

The dispute was prompted by TRA's assessment against the Appellant amounting to USD 9,294,832.00, which was in respect of wells SS 10 and SSW (the Assets). TRA disallowed the said amount for the year of income 2009 which the Appellant had claimed as a deduction on the basis that the same did not meet the conditions for depreciation allowance under section 17 of the ITA, 2004. Aggrieved by TRA's decision, the Appellant appealed to the Tax Revenue Appeals Board (the Board) whereupon the Board ruled that TRA rightly disallowed the amount as the amount did not qualify for deduction on account the fact that the wells were not employed in the production of income for the year of income 2009.

The Appellant was again aggrieved by the Board's decision and appealed to the Tax Revenue Appeals Tribunal (the Tribunal) whereupon the Tribunal was again unsuccessful. Being further aggrieved by the Tribunal's decision, the Appellant appealed to the Court of Appeal on the ground that the Tribunal grossly erred in law by interpreting section 17 of the ITA, 2004 in isolation of paragraph 1(3) of the Third Schedule in so far as oil and gas exploration companies are concerned; and in upholding the Board's decision of disallowing depreciation allowance on the basis of TRA's position.

Appellant's Arguments in Support of the Appeal

In this case, Appellant was resisting the Tanzania Revenue Authority's (TRA's) disallowance of depreciation allowance in respect of expenditure incurred in respect of the exploration, development and production of natural gas. In particular, the expenditure related to the drilling of two wells, SS 10 and SSW. Basically the Appellant advanced the following arguments:

- Appellant argued that section 17 read together with paragraph 1 (3) of the Third Schedule to the Act, entitles the Appellant to the depreciation allowance claimed.
- It was the Appellant's argument that as far as oil and gas industry is concerned, an asset need not be necessarily employed in the production of income during the year of income for depreciation allowance to be granted.
- That since depreciation on the Assets was allowed in the two previous years of 2007 and 2008, the Respondent was not justified in disallowing it in 2009.
- That depreciation ought to have been allowed by virtue of Article 13 of the Production Sharing Agreement (the PSA) between the Appellant and the Government.
- As the Assets were drilled in 2007 as spare wells and were, at the same time, used to analyse data for the purposes of production forecast, the same were employed in the production of the Appellant's income.
- Even if the depreciation allowance was not available to the Appellant for the reason of non-use of the Assets, it was still entitled to claim depreciation allowance because, apart from having been classified under class 4, they also fall under class 7 of depreciable assets as provided for under the Schedule.

TRA's Arguments in Opposition to the Appeal

TRA on its part had consistently argued as follows:

- That for depreciation allowance to be granted, two conditions must be met under section 17 of the ITA 2004: first, an asset must be owned by the Appellant; and second, the asset must have been employed in the production of income during a particular year of income.
- The Respondent thus maintained that, the Appellant failed to satisfy the second condition, in that wells SS 10 and SSW, were not employed in the production of the Appellant's income in the year 2009.
- That the fact that the depreciation allowance was allowed for the previous two years, 2007 and 2008 cannot be used as defence, as the doctrine of estoppel cannot operate against an authority discharging a public duty.
- That entitlement to depreciation allowance cannot be derived from the PSA because, in any case, the same would not override the mandatory provisions of the Act.
- That the argument that the Assets were in use cannot be raised for the first time at the appellate stage as the Appellant did not raise such argument at the Board or the Tribunal levels.

- That the depreciable assets fall under class 4, and that even if they fell under class 7 as argued by the Appellant, it must first satisfy the two conditions under section 17 of the Act, the requirement which was not met by the Appellant.

The Court's Decision

- The Court was of the view that for depreciation allowance to be allowed under paragraph 1(1) and 1(3) of the Schedule, the two conditions under section 17 of the ITA, 2004 must be satisfied; that's to say, the asset must be owned and employed in the production of income during the year of income. The Court stated as follows:

  "From our interpretation of these provisions, which have been relied upon by the learned counsel for the appellant, we are with respect, of the view that as submitted by the respondent's counsel, the same entitles a person dot depreciation allowance only upon meeting the two conditions stipulated under section 17 of the Act. The depreciable assets must be owned and employed in the production of the income in question."

- That it is true that paragraph 1(3) of the Schedule provides that expenditure incurred by a person in the production of income from the business of natural resource prospecting, exploration and development shall be treated as if it were incurred in securing the acquisition of the an asset. The provision goes on to state, however, that such an asset must be "an asset that is used by the person in that production".
- That the position of the law in Australia and India is different from the applicable law in Tanzania because in those countries the law specifically provide for specific method of deduction of depreciation allowance on depreciable assets in the oil and gas sector.
- That the fact that depreciation allowance was not allowed in the 2007 and 2008, does not operate as an estoppel on the part of the respondent because the doctrine of estoppel does not operate against an authority in the performance of a statutory duty.
- As for the purposes of construction of the Assets and the existence of a PSA, the Court was settled in its view that, for an asset to attract depreciation allowance, the same must be used in the production of the income.
- In the Court's view, the conditions stipulated under section 17 of the Act apply generally and therefore assets falling under class 7 of the Schedule are not an exception.

Based on the above reasons, the Court found the appeal to be devoid of merit and consequently dismissed the same with costs.

Our Assessment of the Judgment

We, at FK Law Chambers, are of the view that the decision is not correct on the following respects:

- The decision is incorrect in so far as both the Appellant and the Court had been under the wrong impression that the applicable law is the ITA, 2004. FK understands that, the PSA in question between the Appellant and the Government had specifically stipulated that as regards taxes on income, the applicable law is the Income Tax Act, 1973 (the ITA 1973) as amended from time to time. This point had never been raised at any stage of the submissions by the Appellant;
- The decision is incorrect also in so far as it held that the provisions of the PSA did not override the mandatory provisions of the ITA, 2004. FK understands that the PSA in question has been incorporated in the Register of Tax Agreements under section 143 (2) & (3) of the ITA, 2004. In this

regard, such agreement provided for fiscal stability and stability as to the applicable law, in which case, benefits under a Tax Agreement take precedence over the provisions of the ITA, 2004; and

- Even where the applicable law is the ITA, 2004, the decision is incorrect in so far as it suggests that depreciation allowance in the natural resources sector is only available when the assets in question are used in the production of income. FK understands that this is a very restricted approach as when an asset has been employed in the production of income. The decision seems to suggest that only assets that generate revenues should qualify for depreciation allowance.

Notwithstanding our observations above, we wish to state the decision has been arrived at without a full appreciation of the investments in the hydrocarbons resources. Investments in oil and gas, invariably entail a period of not less than five years for exploration of the resources and undertaking development operations before production can commence. Limiting depreciation allowance to only revenue generating assets in the oil and gas sector, means that International Oil Companies (IOCs) are not allowed to claim either a capital expenditure allowance and/or depreciation allowance, as the case may be, during the exploration and development phases, which is not the case.

Depreciation allowances to IOCs in the oil and gas sector is available from the very beginning when capital is laid for exploration activities. It is not the intention of the legislature to limit deductibility of depreciation allowance only to revenue generating assets in the petroleum sector. It is with this in mind, paragraph 1(3) of the Third Schedule to the ITA, 2004, was enacted to deem such expenditure as being incurred in securing the acquisition of an asset that is used by that person in that production. FK understands that, what is being depreciated here is not the asset, rather the expenditure incurred that is deemed as if it were incurred in the acquisition of the asset. In this regard, the asset in question need not be employed during the year of income for depreciation allowance to be granted. The usage in the context of paragraph 1(3) of the Schedule, is the deemed usage attributable to the expenditure incurred in exploration, development and/or production. The test ought to have been whether such expenditure was incurred wholly and exclusively in the production of a person's income from business.

What the Decision means to the Oil and Gas Sector

The decision has a far reaching impact on IOCs in the exploration and development phases which may find themselves being denied depreciation allowances on the basis that their assets are not employed in the production of income in a particular year of income. This has a huge negative impact to the country's oil and gas fiscal regimes as it makes the regime less attractive to IOCs. An IOC with a producing well in a Contract Area, would not find it commercially prudent that expenditure incurred on exploration and drilling test wells on the same Contract Area should be granted a depreciation allowance on the basis that such test wells are not employed in the production of income in that particular year of income.

FK Law Chambers believes that should this position remain unchanged, it will have a foreseeable negative impact on investments in the oil and gas sector. Investments in the oil and gas sector in Tanzania is already at its lowest level, in which case, the decision is likely to accelerate IOCs' scaling down of their investments in Tanzania. It may be necessary for the Court of Appeal, in a fit case to hold otherwise or a review be preferred, so that the Court is seized with an opportunity to put things right. Alternatively, the Government should take immediate action to move the Parliament to enact a provision providing for clarification on when depreciation allowances to the oil and gas sector should be available.

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