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Key Direct Tax issues in O&G sector

November 2020

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Key sector statistics and key developments

- India' oil consumption during FY 2019-20 was 233.2 MMT; out of which **207.1 MMT** was imported and only 29.5 MMT was produced domestically
- As on 31 March 2018, India's total oil reserves were 594.49 MMT
- As for natural gas, India's consumption in FY 2019-20 was 53.1 BCM; out of which, **27.4 BCM** was imported and balance 25.7 was produced indigenously
- As on March 31, 2018; India's total reserves of natural gas stood at 1,339.57 BCM
- India has set target to reduce 10% of energy import dependency by 2020 and has introduced set of measures incentivizing domestic production
- Introduction of **Hydrocarbon Exploration & Licensing Policy (HELP)** to stimulate new exploration activity for oil, gas and other hydrocarbons
  - As part of this change, the government endeavored to make a policy shift from the extant Production Sharing Contract (PSC) model, based on Pre-Tax Investment Multiple (PTIM) and cost recovery, to Revenue Sharing Contract (RSC) model for licensing of hydrocarbon acreages
  - Open Acreage Licensing Policy (OALP) - In OALP, a bidder can also apply to the government seeking exploration of any block, thereby not restricting exploration activity only to blocks put on tender by the government.
  - Uniform licensing system covering exploration and production of all hydrocarbons, i.e. oil, gas, coal bed methane (CBM), etc., under a single license and policy framework
  - National Data Repository (NDR) – NDR under the aegis of DGH provides seamless access to India's E&P /seismic data to investors through digital medium, with a view to harness the potential of India's large basinal area
  - Concessional royalty regime for deep water and ultra-deep water areas

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Oil & Gas – Industry Segments

Upstream

- Segment of oil & gas business dealing with
  - Exploration
  - Development
  - Production
- Sector Constituents:
  - Oil & Gas Exploration companies
  - Oilfield exploration service providers

Midstream

- Segment which involves transporting commodities such as crude oil, petroleum products, natural gas, through pipelines
- Sector Constituents:
  - Pipeline infrastructure players
  - Terminal operators
  - Storage facility providers

Downstream

- Segment which includes refining, processing, storage, transportation, distribution, marketing and sale of petroleum products and natural gas
- Sector Constituents:
  - Entities engaged in refining and processing
  - Marketers and distributors

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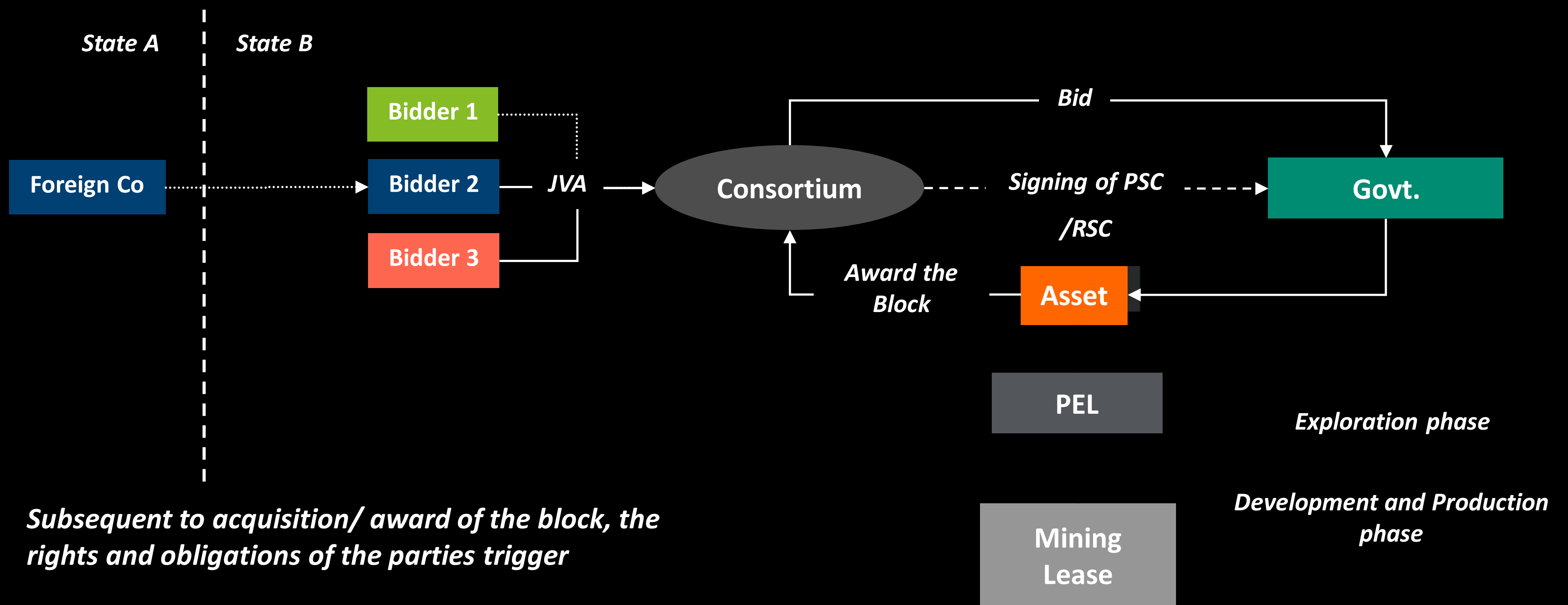
Upstream Sector – Contracting Structure



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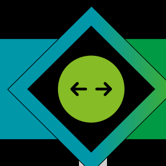
Key income tax aspects for upstream sector – Special provisions for computation of business profits from petroleum operations

Section 42(1) of the IT Act



- Special provision for computing taxable income of contractors entering into PSC /RSC with the Government
- Admissible deductions for determining taxable profits of a business consisting of **prospecting for, or extraction or production of mineral oils** wherein PSC /RSC is entered into with Government of India and such PSC /RSC has been laid before each House of Parliament
- Provides that the special provisions contained in the PSC /RSC will be considered **in lieu** of or in addition to the provisions of (Indian) Income-tax Act, 1961 (**IT Act**) in respect of the following allowances:
  - Expenditure by way of **infructuous /abortive exploration** in respect of areas surrendered prior to commencement of commercial production
  - After beginning of commercial production, to expenditure on **drilling or exploration activities or services or physical assets** used in that connection whether incurred before or after commencement of commercial production; and
  - Depletion of mineral oils in the mining areas in the year of commercial production /succeeding years

Relevant Article of the Model RSC /PSC

- **Article 16 of Model RSC** – All expenditure incurred by the RSC Participant on exploration, development and production shall be allowed as deduction under section 42 of the IT Act
- **Article 17 of Model PSC**

Type of expenditure	Deduction
Exploration and drilling expenditure	Cost (both capital & revenue) shall be accumulated and deductible from the year of commercial production
Production and Development (other than drilling) expenditure	As per provisions of the IT Act
Unsuccessful exploration cost where other unit has not yet started commercial production	Cost shall be aggregated and deducted at 100% p.a. on commencement of commercial production
Unsuccessful exploration cost where the other unit has started commercial production	Cost shall be deductible at the rate of 100% p.a beginning from the year in which such cost was incurred

- Option to amortize drilling and exploration expenditure over 10 years from date of first commercial production
- Other allowances to be dealt with as per the IT Act

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Key income tax aspects for upstream sector – Operations

- Interplay of PSC /RSC with domestic tax law (IT Act)
  - Deduction of development (other than drilling) and production expenses under section 42 – Whilst RSC allows all expenditure incurred on exploration, development and production as deduction, section 42 has remained unchanged to cover only exploration and drilling costs
  - Deduction of unsuccessful exploration expenditure – There is uncertainty regarding deduction of unsuccessful exploration expenditure under section 42, in absence of explicit mention in Article 16 of Model RSC
  - Manner of deduction of expenses under RSC - RSC does not provide for the manner of deduction of expenses /computation of income, as against the PSC provisions, creating ambiguity regarding the amount and year of deduction, etc.
- Date of setting up of business – In case expenses are not accumulated under section 42, certain pre-commencement expenses may not be eligible for deduction and potentially be a sunk cost for the contractor in absence of clarity on date of setting up of business

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Key income tax aspects for upstream sector – Farm-in (Entry)

- When an entity acquires participating interest in an existing asset, it is termed as farm-in by the party
- Tax determination on farm-in
  - Capitalisation of consideration paid for acquisition of farm-in interest, depending on the form of consideration payout [lump sum, production linked, etc.]
  - Expenditure incurred for acquiring participating interest eligible for tax depreciation as 'intangibles' (being a business or commercial right akin to a license) @ 25 percent [ONGC Videsh Ltd vs DIT [2010] 37 SOT 97 (Del); CBDT Circular 20/2019 dated 19 August 2019]
  - Commencement of exploration activities would imply that the asset has been put to use; thus, depreciation on capital cost incurred in acquiring the participating interest can commence from the year of commencement of exploration activities
  - Tax withholding on consideration payable to a non-resident for farm-in – to depend on taxability of transferor on farm-out (business income vs capital gains) – *discussed subsequently*

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Key income tax aspects for upstream sector – Farm-out (Exit)

- Section 42(2) of the IT Act provides for taxability of capital sums received on account of transfer of E&P business or participating interest in a PSC /RSC

Condition	Tax treatment
'Capital Proceeds' on transfer < 'Expenditure remaining unallowed'	• Excess of 'Expenditure remaining unallowed' will be allowed as deduction in year of transfer
'Capital Proceeds' on transfer > 'Expenditure remaining unallowed'	• Excess of capital proceeds, to the extent such excess does not exceed the difference between 'total expenditure incurred for business or to acquire interest there in' and the amount of 'expenditure remaining unallowed', will be chargeable to tax as 'business income' in year of transfer • In such case, no deduction of 'Expenditure remaining unallowed' is allowed in the year of transfer /subsequent years

- In case of amalgamation or demerger of E&P business, the amalgamated /resulting company shall continue to get the deductions [as provided in section 42(1)] which were available to the amalgamating /demerged company

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Key income tax aspects for upstream sector – Farm-out (Exit)

Illustration

The illustration depicts the various situations (stated earlier) in a tabular form

Particulars	Situation 1	Situation 2	Situation 3
Expenditure incurred (A)	10,000	10,000	10,000
Expenditure remaining unallowed (B)	6,000	6,000	6,000
Proceeds of transfer (C)	5,000	7,000	15,000
Amount allowable as deduction (B-C)	1000	NIL	NIL
Excess of proceeds over expenditure remaining unallowed (D) = (C-B)	NIL	1,000	9,000
Amount taxable as income from PGBP (E)	NIL	1,000	4,000
Balance amount (D-E) - Taxable as capital gains ? *Mosbacher India LLC vs ADIT [2017] 183 TTJ 1 (Chennai - Trib.)*	NIL	NIL	5,000

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Upstream sector – Taxation of oilfield service providers

SECTION 44BB – OVERVIEW OF PROVISIONS

- Section 44BB of the IT Act contain special provisions for taxability of non-resident oilfield service providers in India. The provisions are applicable to non-residents (corporate and non-corporate) engaged in the business of:
  - providing services or facilities ‘in connection with’ or
  - supplying plant and machinery on hire used, or to be used, in

  prospecting for, or extraction or production of, mineral oils
- Taxation on **deemed profit** basis - 10 percent of gross revenues deemed as income; **effective tax rate – 4.368 percent on gross basis**
- Extensive litigation on nature of services covered within ambit of section 44BB – matter put to rest vide the Supreme Court decision in case of ONGC vs CIT (Civil Appeal No. 731 of 2007)
- In case income is offered to tax under section 44BB, non-resident is not required to maintain books of accounts /have them audited for income-tax purposes
- Option to claim lower profits available in case where income is less than 10 percent of gross receipts, subject to maintenance of books of accounts and audit thereof
- Section 44BB shall not apply to income in nature of royalty or Fee for Technical Services (FTS) taxable under specific provisions of the IT Act [section 44DA /115A of IT Act]
- Minimum Alternate Tax (MAT) to not apply in case of foreign companies where their income comprises solely of profits and gains from business referred to in section 44BB of the IT Act

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Key income tax aspects for upstream sector – Oilfield services

- 44BB vs technical services (specific vs general)
- Taxation of statutory levies, like GST and customs duty, under section 44BB
- Reimbursement of expenses
- Mobilisation / demobilization expenses
- Applicability of MAT
- Applicability to second level or sub-contractors

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Key income tax aspects for midstream sector

- No specific provision governing taxation of mid-stream operations, in which case normal provisions of the tax law apply
- Investment linked incentive for pipeline infrastructure (section 35AD of the IT Act) – Deduction of capital expenditure incurred in laying and operating a cross-country natural gas, crude or petroleum oil pipeline network for distribution, including storage facilities
- Transportation of Crude oil /LNG by non-residents
  - Vessel Owner – Taxability of receipts in India ? Equipment royalty ?
  - Vessel Charterer (Time charter /Voyage Charter): Applicability of section 172 /44B of the IT Act or Article 8 of relevant Double Taxation Avoidance Agreement ? Hire of ship vs freight for carriage of goods?

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Key income tax aspects for downstream sector

- No specific provision governing taxation of downstream operations, in which case normal provisions of the tax law apply
- Lower corporate tax rate of 17.16% u/s 115BAB?
- Tax holiday u/s 80-IB(9) had sunset date of March 2012

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