

# *Oil and Gas Industry*

Corporate Tax Issues

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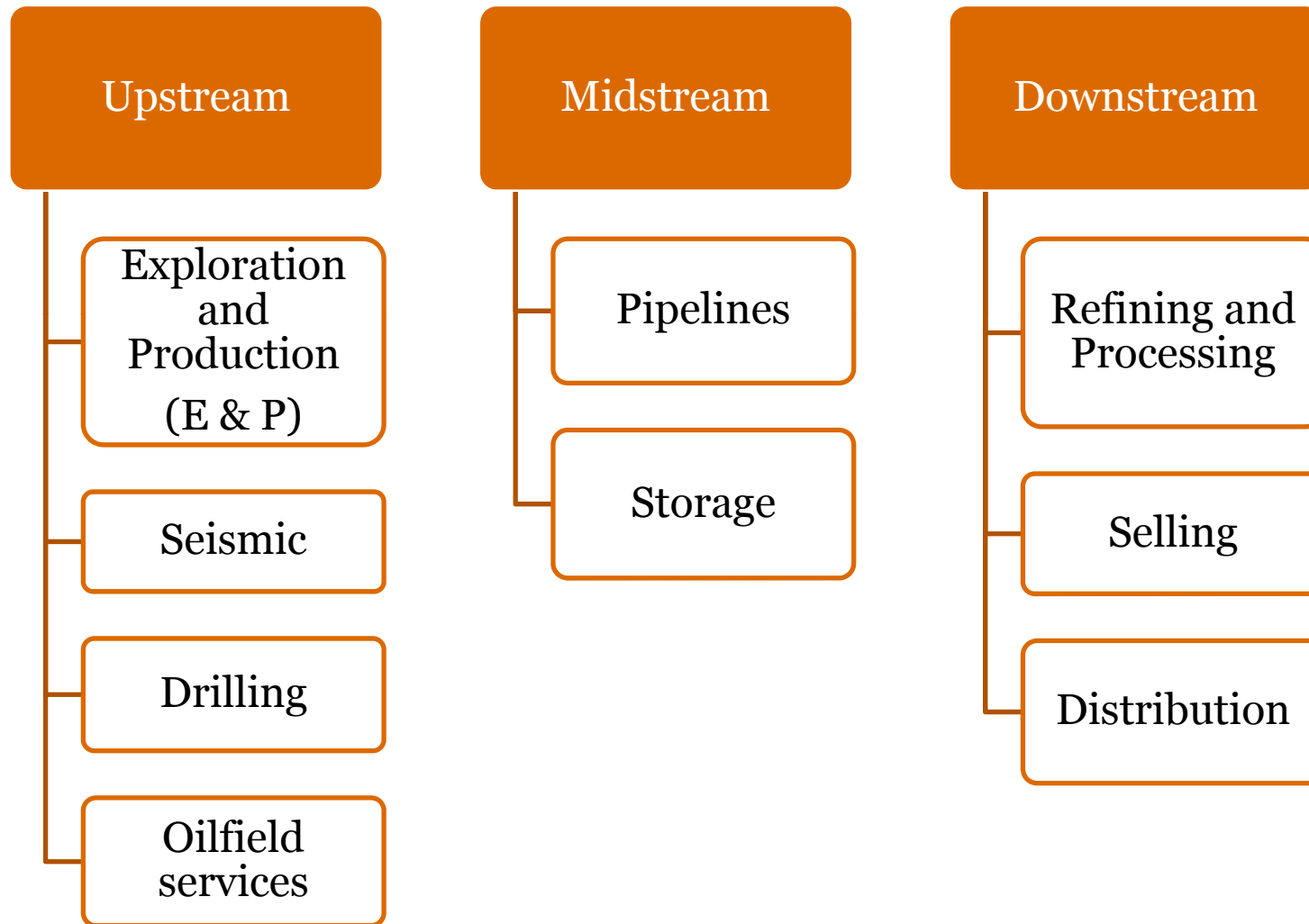
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# ***Agenda***

- Structure of Oil and Gas Industry
- Taxation of Exploration and Production Companies
  - Income Tax Regime
  - Key Issues
- Taxation of Service Providers
  - Income Tax Regime
  - Key Issues
- Q & A

# *Structure of Oil & Gas Industry*

# *Industry Categorisation*



# *Oil and Gas Industry – Tax Framework*

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# ***Oil and Gas Industry - Tax Framework***

- O&G Taxation
  - Due importance to critical role of O&G industry
    - Specific O&G provisions in Income Tax , 1922 , Income Tax Act, 1961 Act (IT Act) as well as Draft Direct Tax Code, 2010 (DTC)
    - Multiple tax incentives
  - Tax laws closely intertwined with policy framework for O&G exploration
- IT Act provisions relevant to O&G taxation
  - Taxation of Exploration and Production Companies (E&P)
  - Taxation of Midstream players
  - Taxation of Service Providers

# ***Oil and Gas Industry - Tax Framework***

- E&P Taxation
  - Taxation of assessee engaged in exploration and production of mineral oil

<b>Section</b>	<b>Scope</b>
42	Special provisions for deduction for business engaged in prospecting of mineral oil
33ABA	Deduction in respect of contribution to Site Restoration Fund
80IB(9)	Tax holiday for businesses engaged in commercial production of mineral oil
293A	Power to Central Government to make exemptions etc in relation to business engaged in prospecting of mineral oil

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## ***Oil and Gas Industry - Tax Framework***

- Special provisions for entities engaged in laying and operating of cross country natural gas or crude or petroleum oil - Section 35AD
- Taxation of Non – Resident Service Providers
  - Taxation of assessee engaged in providing services to assessee engaged in production of mineral oil
  - Relevant provisions section 44BB



# ***Taxation of Exploration and Production Companies***

## **Production Sharing Contracts Tax Regime**

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## ***Oil and Gas Taxation - Perspective***

- National Exploration Licensing Policy (NELP)
  - Policy to encourage private participation in exploration sector
  - Production Sharing Contract (PSC) entered into by private sector companies with government of India (GoI)
    - PSC tabled on floor of parliament
- PSC
  - Contractor permitted by GoI to explore the area and extract the mineral oil as per specified terms and conditions
  - Contractor to bear risks and costs of exploration and development
  - Costs incurred in exploration and development allowed to be recovered by contractor out of income generated by production of mineral oil out of such area.
  - Contractor to pay to GoI the agreed share of profit petroleum on surplus over cost

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## ***Section 42***

- Specific mechanism for computing taxable income of contractors entering into PSC with GoI
- Specific allowances [in lieu of ] or in addition to allowances under normal provisions as specified in the PSC are permitted
  - Expenditure by way of infructuous or abortive exploration in respect of any area surrendered prior to the beginning of commercial production
  - Expenditure incurred for exploration or drilling activities or services or assets used for these activities whether before or after the commercial production
  - Depletion of mineral oil in mining area in respect of the financial year in which commercial production is begun and for such succeeding year or years

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## ***PSC – Tax Provisions***

- PSC
  - Allowability of expenditure
    - Special deduction – 100 percent of exploration and drilling expenses (both capital and revenue allowed)
    - Other expenses (including production expenditure) allowed under normal provisions.
      - Application of sections 40A and 44C of the Act
  - Manner of deduction
    - Allowable expenditure is aggregated till the commencement of commercial production
    - Accumulated expenditure allowed in the year of commencement of commercial production or permitted to be amortized over a period of 10 years

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## ***PSC – Tax Provisions***

- No Ring Fencing of Expenditure
  - All unsuccessful exploration costs in other contract areas can be set off against income in the contract area in which commercial production has commenced.
- Tax Holiday
  - 100 percent tax holiday available in respect of profits earned from production of mineral oils
  - Deduction is available for seven consecutive years from the time of commencement of commercial production
- Site Restoration Expenses
  - Deductibility of Site restoration expenses are allowed up to lower of actual sum deposited in the site restoration account or twenty percent of profits calculated in the prescribed manner.

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## ***Status of members***

- Sec 293A provides the power to the Central Govt to make by notification, an exemption, reduction, modification, in respect of income tax of any of the following persons/ class :
  - Parties to the PSC
  - Facility/ Service providers to above parties
  - Employees of both (a) and (b) above
- Notification 117E dated 8 March 1996 – Modification of the status of parties entering the PSC to provide :
  - They shall not be assessed on income as AOP/ BOI
  - Each party to PSC shall be assessed for its own share of income, in same status in which it entered into the PSC

# ***Taxation of Exploration and Production Companies***

## **Production Sharing Contracts Tax Issues**

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## ***Overriding provisions of PSC over the Act***

- Allowances as mentioned under the PSC are in lieu of (and not in addition to) corresponding allowances provided under the Act
- Provisions of PSC to prevail over provisions of the Act
  - Supreme Court decision in CIT v. Enron Oil & Gas India Ltd ([2008] 305 ITR 75)
    - Deduction in respect of exchange loss allowed



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## ***Farm In***

- Concept - acquisition of stake / participating interest in an existing exploratory/ producing area/ block covered by a PSC
- Farm -in treatment not clarified in either PSC or Income tax Act
- Whether 100% deductible in year of acquisition OR acquisition of right is an intangible asset eligible for depreciation

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## ***Farm Out***

- Taxability of proceeds as per Sec 42(2)
- 3 Scenarios
  - Sale proceeds < expenditure remaining unallowed – Difference is tax deductible from business income
  - Sale proceeds > expenditure remaining unallowed –
    - Difference between expenditure incurred and unallowed – Taxed as Business Income
    - Balance surplus, if any - Taxed as Capital Gains
  - Sale proceeds = expenditure remaining unallowed – No deduction, No tax

***Example: Unallowed Exp. = 70, Expenditure Allowed = 30***

<b>Description</b>	<b>Scenario 1</b>	<b>Scenario 2</b>	<b>Scenario 3</b>	<b>Scenario 4</b>
Sale Proceeds	40	90	150	70
Less: Unallowed Expenditure	(70)	(70)	(70)	(70)
Balance of Sale Proceeds	(30)	20	80	0
Expenditure previously allowed as deduction to be treated as profits from business	0	20	30	0
Balance to be taken as capital gains	0	0	50	0
Excess of unallowed expenditure as reduced by sale proceed to be allowed as expense	30	N.A.	N.A.	N.A.

# ***Taxation of Exploration and Production Companies***

## **Other Provisions and Issues**

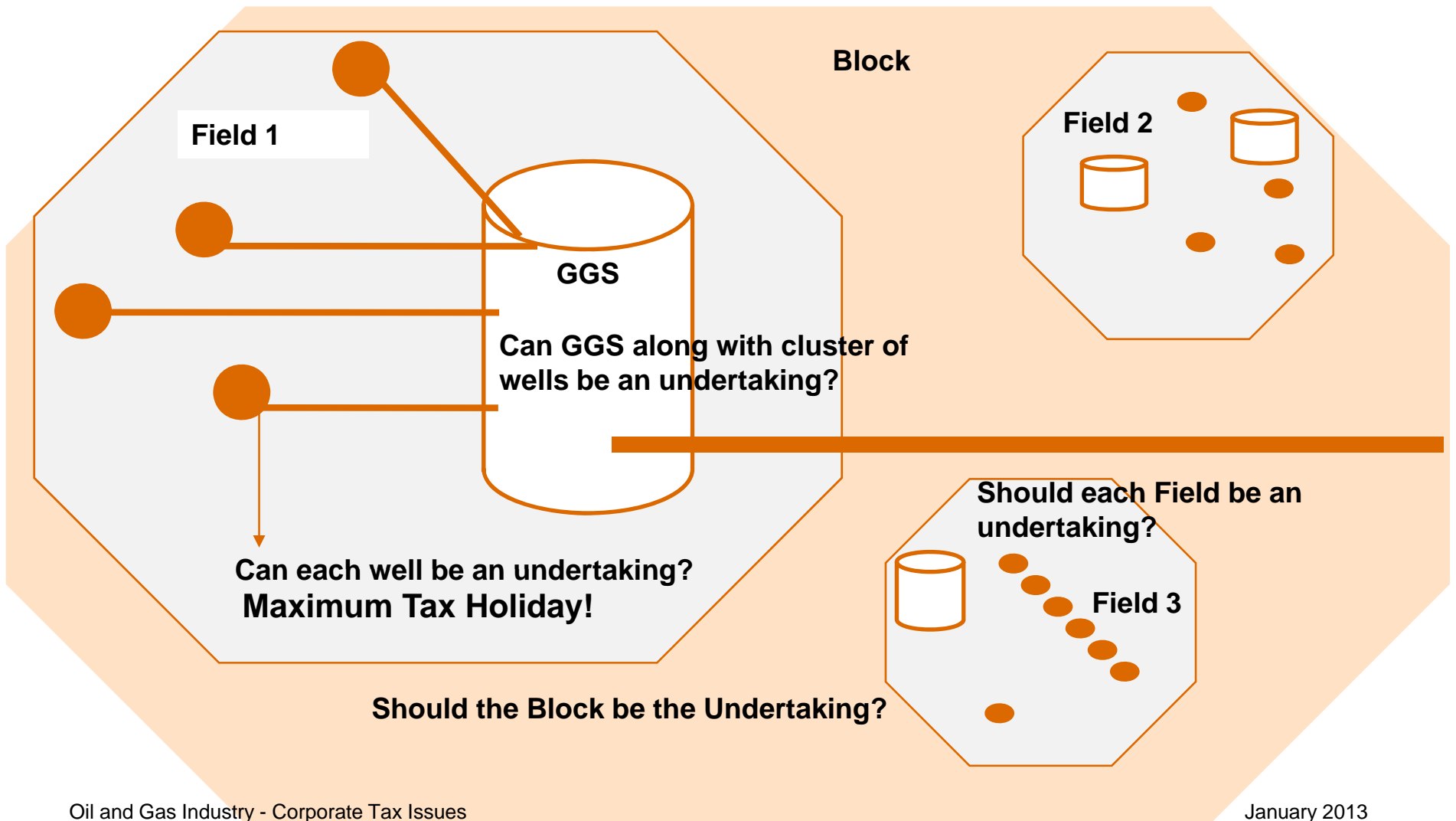
## ***Sec 80IB(9) provides tax holiday to Mineral oil concerns.***

### **Essentials**

- 100% of profits derived by an undertaking engaged in commercial production or refining of mineral oil eligible for tax holiday for a period of 7 consecutive years
- Deduction available from the year in which undertaking commences commercial production
  - North East – Allowed even before April 1, 1997
  - Other parts of India - After April 1, 1997 - limitation introduced



# ***Undertaking can be a Block, Field or a Well.***



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## ***Undertaking must be a business activity taken as a whole.***

- Undertaking – Reference section 2(19AA):
  - "undertaking shall include:
    - a business activity taken as a whole,
- Business Activity taken as whole
  - identifiable profit making apparatus of an enterprise
  - Landmark judgment of the Supreme Court in the case of Textile Machinery Corporation 107 ITR 195 – Relevant take aways:
    - identifiable units being marketable commodities
    - undertaking can exist independently even after the cessation of the principal business of the assessee

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## ***Undertaking judicially well understood to be a functional organization.***

- Question as to what constitutes a separate undertaking, has been the subject matter of litigation before various Courts
- Now judicially well understood.
  - It does not refer to the form of legal organization of a business as proprietorship, partnership, limited company etc; rather, the word refers to the functional organization of a business.



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## ***Undertaking must be capable of independent commercial existence.***

- Judicial precedents- ‘undertaking’ in the context of tax holiday claims u/s 80J, 80HH, 80I etc. - in order to be eligible for tax holiday, the undertaking must be capable of independent commercial existence.
- Demonstrate - Each well is capable of independent commercial existence-  
Tax holiday at well head level
  - Necessary ingredients
    - A well is an entire profit making apparatus
    - The well produces marketable products
    - The well can exist on its own in the absence of other components of the organization
- In case it is difficult to demonstrate above at well head level then subsequent levels need to be examined i.e. GGS, Field, Block

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## ***Mineral oil includes both gas and oil***

- Commercial Understanding
  - Mineral Oil – mixture of hydrocarbons (crude oil, petroleum)
- Section 80IB does not define
- But defined in Section 42, 44BB & 293A
  - “Mineral Oil” includes petroleum and natural gas.
  - Judicial precedents - the term ‘Mineral Oil’ includes:
    - Petroleum in its crude form i.e. well fluid.
    - Products secured or obtained from crude oil by refining
- Amendment in section 80IB(9)
  - Specific provisions for natural gas production under NELP – VIII , CBM-IV blocks

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## ***Investment-linked tax incentive for Pipeline (Section 35AD)***

- 100% deduction on capital expenditure in the year of incurrence, for Companies engaged in “specified business”
  - includes laying and operating a cross-country natural gas or crude or petroleum oil pipeline network for distribution, including storage facilities being an integral part of such network, with operations commencing on or after April 1, 2007
- Capital expenditure excludes land or goodwill or financial instrument
- Deduction under section 80IA for laying and operating a cross country Natural Gas distribution network discontinued

**Cross Country not defined  
Whether available to City Gas Distribution?**

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## ***...Tax incentive for Pipeline***

- Capital asset demolished/ transferred – Business Income  
Subject to higher tax rate as compared to Capital Gains
- Set off of loss only against specified business as defined
- Expenditure capitalised during earlier years would be allowed in  
March 31, 2010

**Investment linked incentive vs. Profit  
linked tax holiday**

# *Taxation of Service Providers*

## Tax Regime

# ***Presumptive Taxation – Section 44BB***

## **Applicability**

Non residents

## **Business**

- 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 oil in India

## **Deemed Income**

10% of gross receipts

## **Alternative option**

Option to claim lower profits and pay tax on net basis subject to maintenance of books and accounts

**Effective tax rate of 4.2%**

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## ***...Scheme of Taxation under section 44BB***

- Key exclusions:
  - If income in nature of Royalty/ FTS receivable from Indian concern (Section 115A)
  - If income in nature of Royalty / FTS receivable from Indian concern and such Royalty / FTS effectively connected to PE in India (Section 44DA)
    - Amendment inserted by Finance Act,2010 with effect from April 1, 2011

# *Taxation of Service Providers*

## Tax Issues



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## ***Issues in Taxation of Service Providers***

- Section 44BB
  - Independent charging section or subject to provisions of sections 4 and 5
- Option of Gross vs Net basis of taxation
  - For each contract separately?
  - Option of adopting different position in each year for same contract?
- Second Leg hire of Equipment
  - Availability of presumptive taxation for hire of equipment where contactor company is not directly engaged in exploration & production of oil & gas?
- Mob/De-mob reimbursements?
- MAT?

# *Direct Tax Code*

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## ***Direct Tax Code – Exploration and Production***

- Similar provisions for E&P companies contained in Eleventh Schedule to the DTC, additional conditions to be satisfied as under:
  - Business of mineral oil or natural gas not to be set up by splitting up / reconstruction of an exiting business or by transfer of machinery / plant previously used for any purpose (in excess of 20%)
- No provision akin to section 293A of IT Act
  - Consortium – Whether taxable as AOP?
  - AOP at each PSC if partners /stakes are different
    - Inter se losses – No set-off
- Grandfathering of existing tax holiday – subject to certain conditions

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## ***Direct Tax Code - Presumptive Taxation***

- Presumptive basis of income @ 14% of gross receipts for service providers in relation to mineral oil or natural gas
  - Effective tax rate increased from 4.223% to 5.67%
- Option to offer to tax ‘Net Income’
- Issues
  - Para 2 to Schedule 14
    - Income to be further increased by excess of amount actually earned by assessee over the amount determined at presumptive rate
  - Whether in substance a Presumptive Taxation ?
  - Minimum Alternate Tax (MAT)
    - Whether MAT applicable when income offered on presumptive basis?

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# ***Thank you***

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