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TAX FLASH NEWS

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CBDT clarifies that farm-in expenditure incurred by the oil exploration and production companies are 'intangible assets' eligible for depreciation

Recently, the Central Board of Direct Taxes (CBDT) has issued a Circular[1] clarifying that farm-in expenditure incurred by the oil exploration and production companies i.e. amount paid for acquiring the Participating Interest (PI) shall not be treated as a cost for acquiring the share in partnership or investment for acquisition of a member's interest in an association of persons or body of individuals. It would be treated as an amount paid to acquire the underlying assets and the amount paid for acquiring the PI, after reducing component of cost attributable to tangible assets would be treated as an 'intangible asset' (being a business or commercial right akin to a licence), eligible for claim of depreciation under Section 32(1)(ii) of the Income-tax Act, 1961 (the Act).

Background

Over the life cycle of an Oil & Gas block, Exploration and Production (E&P) companies generally buy (Farm in) and sell (Farm out) their Participating Interests (PI) in the 'Production Sharing Agreement' (PSC). 'Farm-in' expenditure is incurred when an entity in this line of business acquires a PI from another entity(s) in oil/gas block(s) and becomes part of the PSC entered into with the central government.

The Government of India (GoI) offers exploration and development rights through global bidding for specified blocks in various rounds under the New Exploration and Licensing Policy (NELP), Hydrocarben Exploration & Licensing Policy (HELP), Open Acreage Licensing Policy (OALP) etc. by signing the PSC's with the Oil & Gas companies. The successful oil & gas companies are granted license to explore, develop and carry out production operations in oil & gas blocks and in India under a PSC with the GoI. Typically, owing to the large investments required and the risks involved, multiple E&P companies execute the PSC with the GoI in which each member has its agreed and defined PI.

Section 42(2) of the Act provides that in the event of a farm-out, the unamortised expenditure is allowed as a deduction and the surplus is taxed in the hands of the seller. However, in the hands of the buyer no specific provision has been made in the Act. Thus, while taxability of farm-out is clearly laid, no specific provision has been made regarding treatment of farm-in payment which results into conflict between E&P entities and the tax department.

It is common international practice for the upstream companies to buy (farm-in) and sale (farm-out) their PI in the PSC or similar contracts with the government and thereby to share risk, bring new and niche expertise and technologies. In such transactions, PI are treated as interests in rights, licences and obligation under the PSC. Such farm-in purchase price is accounted as an asset as per guidance note issued by the Institute of Chartered Accountants of India (ICAI). International accounting rules for oil & gas followed in Australia, Indonesia, U.K. etc. also require that such acquisition cost to be capitalised and depreciated. A perusal of the Model PSC's indicates that participating interests are share in rights and obligation to explore, exploit and sell petroleum under the PSC along with related licences, permits etc. A few of the case-laws on this issue also support treatment of acquisition rights in a PSC as intangible asset.

The central government vide Notification[2] had laid down that the persons with whom it enters into agreement for the association or participation in any business consisting of the prospecting for or

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[1] Circular No. 20/2019, dated 19 August 2019

[2] Notification No. G.S.R. 117(E), dated 8 March 1996

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extraction or production of mineral oils on or after the 1 April 1992,-

- shall not be assessed on the income as association of persons or body of individuals consisting of such persons; but

- each of the persons referred to above be assessed in respect of his or its share of income, as the case may be, in the same status in which the person enters into the agreement with the central government.

As persons participating in an E&P contract are assessed individually in respect of their share of income, the sum expended on acquisition of whole or part of such PI in an E&P contract where such acquisition is approved by the GoI, represents the amount paid to acquire the underlying share (expressed as a percentage) being interests in rights, licences and obligations under the E&P contract.

A request has been made to clarify whether ‘Farm-in’ expenditure being in the nature of rights should be allowed to be treated as an ‘intangible asset’ under Section 32(1)(ii) of the Act.

CBDT Circular

Recently, the Central Board of Direct Taxes (CBDT) has issued a Circular No. 20/2019, dated 19 August 2019 clarifying that amount paid for acquiring the PI shall not be treated as a cost for acquiring the share in partnership or investment for acquisition of a member's interest in an association of persons or body of individuals. It would be treated as an amount paid to acquire the underlying assets; and the amount paid for acquiring the PI, after reducing component of cost attributable to tangible assets for purposes of Section 32(1)(i), would be treated as an 'intangible asset' (being a business or commercial right akin to a licence), eligible for claim of depreciation Section 32(1)(ii).

The Circular being clarificatory in nature shall be applicable from the date of applicability of Section 32(1)(ii).

Our comments

Farm-in transactions are unique to the E&P sector since mineral oils embedded in a particular territory in their natural habitat are the property of the state/central government in whose territory/jurisdiction they rest. No person other than such state/central government can carry out the exploration and extraction of mineral oil unless a right to explore and extract mineral oils from the specified areas is granted by the state/central government. Such exploration rights typically rest with the company which enters into a PSC with the government and can be wholly or partly assigned and transferred to other companies subject to approval from the government. The issue whether 'Farm-in' expenditure being in nature of rights should be treated an 'intangible asset' under Section 32(1)(ii) of the Act and would be eligible for depreciation has been a subject matter of debate before the Courts/Tribunal.

The Delhi Tribunal in the case of ONGC Videsh Ltd[3] while dealing with a similar issue observed that the commercial rights of exploration of mineral oils as acquired by the taxpayer falls under the expression of ‘any other business or commercial right of similar nature’ and it is in the nature similar to licence as stipulated in Section 32(1)(ii) of the Act. The right has been granted to the taxpayer by way of licence and the taxpayer became owner of such right, that is, licence to have an access and to carry on the business of exploration and development of mineral oils. Accordingly, the Tribunal allowed depreciation on the farm-in cost, based on the facts of the case. Recently, the Tribunal[4] following its own decision allowed a similar claim in the case of same taxpayer.

Though, the Delhi Tribunal’s decision has provided some relief to the E&P companies, the issue was not resolved completely. It seems the tax department does not allow depreciation on such farm-in expenditure. The CBDT clarification would provide much needed relief to the E&P companies.

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[3] ONGC Videsh Ltd v. DIT [2010] 37 SOT 97 (Del)
[4] DCIT v. ONGC Videsh Ltd (ITA No.3150/Del/2014, dated 1 July 2019)

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