Services inextricably linked to prospecting, extraction or production of mineral oil eligible for presumptive taxation under the Act

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In brief

The Supreme Court of India (SC) has disposed off a batch of appeals filed by the taxpayer as a representative of non-resident oil and gas service providers with whom it had entered into separate contracts for rendering drilling, seismic surveys, inspection, testing, training, supply and installation of software, data analysis, and other services in connection with prospecting, extraction or production of mineral oil in India.

The appeals involved a common issue: whether the receipts earned by the non-resident service providers under the contracts entered into with the taxpayer for rendering the aforesaid services were taxable under section 44BB of the Income-tax Act, 1961 (the Act) or as fees for technical services (FTS) under section 44D of the Act.

The SC held that the services rendered under the contracts were inextricably linked with prospecting, extraction or production of mineral oil, and hence eligible for presumptive taxation under section 44BB of the Act.

In detail

Facts

The taxpayer[1] entered into separate agreements with non-resident service providers for services to be rendered in connection with prospecting, extraction or production of mineral oil. The tax officer assessed the income earned by the non-resident service providers from these contracts under section 44D[2] of the Act.

On appeal, the lower appellate authorities[3] decided the issue in favour of the taxpayer. However the Uttarakhand High Court (HC) overturned the decisions of the lower appellate authorities. Aggrieved by the HC order, the taxpayer filed an appeal before the SC.

Issue before the SC

Whether amounts paid by the taxpayer to non-resident service providers for providing various services in connection with prospecting, extraction or production of mineral oil were chargeable to tax as FTS[4] or on presumptive basis under section 44BB[5] of the Act?

[1] [2015] 59 taxmann.com 1 (SC) (assessed in a representative capacity on behalf of the different foreign companies with whom it had executed separate agreements)

[2] Section 44D of the Act provides for taxation of royalties/ FTS received by a non-resident under an agreement entered before 1 April 2003 with the Indian government/ an Indian concern

[3] Commissioner of Income-tax (Appeals) and Income-tax Appellate Tribunal

[4] Under section 44D read with section 9(1)(vii) of the Act

[5] Section 44BB of the Act provides for a presumptive tax regime wherein 10% of gross receipts of a non-resident from provision of services in connection with, or supply on hire of plant and machinery for use, or to be used in prospecting, extraction or production of mineral oil in India, is deemed to be its taxable income. *Inter alia*, it excludes income covered by section 44D of the Act.

Taxpayer's contentions

- The eventual test for determining the taxability of the income was the pith and substance of the contract entered into with the taxpayer, i.e., whether the works contemplated or services to be rendered under the contract were directly and inextricably linked with the prospecting, extraction or production of mineral oil.

- The contracts under consideration could be categorised into the following broad categories:

  - Carrying out seismic surveys and drilling for oil and gas
  - Services of starting/ re-starting/ enhancing production of oil and gas from wells
  - Services of prospecting for exploration of oil and or gas
  - Planning and supervision of repair of wells
  - Repair, inspection or equipment used in the exploration, extraction or production of oil and gas
  - Imparting training
  - Consultancy in regard to exploration of oil and gas
  - Supply, installation, etc. of software used for oil and gas exploration

- FTS was specifically defined[6] to exclude "mining and like projects". In this regard, any service in connection with prospecting and extraction was an integral part of mining. The expression "mining", in the absence of any definition under the Act, has to be understood as per the provisions of the Oil Fields (Regulation and Development) Act, 1948[7] read with the Petroleum and Natural Gas Rules, 1959[8].

- After consideration of the provisions of the Mines Act, 1952 and the Mines and Minerals (Regulation and Development) Act, 1957 read with relevant Entries in the Union and the State List in the 7th Schedule to the Constitution of India, the Attorney General had opined that the term "mining or like projects" in Explanation 2 to section 9(1)(vii) of the Act, covered the rendering of services such as: imparting of training and carrying out drilling operations for exploitation or exploration of oil and natural gas.

- The Central Board of Direct Tax (CBDT) accepted the aforesaid view and issued an internal Instruction[9] in this regard. The aforesaid instruction was binding for the tax authorities in the light of the SC decision in the case of K.P Varghese[10].

Revenue's contentions

- The opinion of the Attorney General and the internal Instruction[9] had no relevance in the present case since the payments made by the taxpayer to the non-resident service providers were in the nature of FTS.

- The primary services were not for prospecting, extraction or production of mineral oil but were ancillary services which may have remote connection with such activities.

- If it was held that the HC ought to have examined each agreement or contract to find out its real purpose and intent, the revenue did not have objection to the matters being remanded for examination.

SC's observations and decision

- The terms "mines" and "minerals" were not defined under the Act. On a conjoint reading of the Mines Act, 1952 and the Oil Fields (Regulation and Development) Act, 1948, the drilling operations for the purpose of production of petroleum would amount to a mining activity or a mining operation.

- The pith and substance of the agreement would be the determinative test for the applicability of section 44BB/ 44D of the Act. The contracts under consideration suggest that the services were inextricably linked to prospecting, extraction or production of mineral oil, and the dominant purpose of each agreement was for prospecting, extraction or production of mineral oil, although there could be certain ancillary work contemplated under the aforesaid agreements. Accordingly, the

[6] under section 9(1)(vii) of the Act

[7] A mining lease means a lease granted for the purpose of searching for, winning, working, getting, making merchandisable, carrying away or disposing of mineral oils or for the purpose connected therewith and such a lease includes an exploring or prospecting lease [Section 3D of the Oil Fields (Regulation and Development) Act, 1948].

[8] Under Rule 4 of the Petroleum and Natural Gas Rules, 1959 framed under section 5 of the aforesaid Act, no person could prospect for petroleum except pursuant to a Petroleum Exploration License (PEL) granted under the Rules, and no person could mine petroleum except in pursuance of a Petroleum Mining License (PML) granted under the Rules. It was pointed out that under Rule 7 of the Rules of 1959, a PML entitles the licensee to carry out construction and maintenance in and on such land, works, buildings, plants, waterways, roads, pipelines, etc., as may be necessary for full enjoyment of the PML.

[9] Instruction No. 1862 dated 22 October 1990

[10] K.P. Varghese *v.* ITO [1981] 131 ITR 597 (SC)

SC held that the said services were covered under section 44BB of the Act.

The takeaways

This is a landmark and welcome decision for the oil and gas industry as the SC has clarified that services inextricably linked to prospecting, extraction or production of mineral oil are covered under the presumptive taxation regime under section 44BB of the Act. This decision was rendered in the context of section 44D of the Act (dealing with taxation of royalties/ FTS in respect of contracts entered into with the Government of India or an Indian concern prior to 1 April, 2003). Section 44DA[11] of the Act and section 44BB of the Act were amended with effect from 1 April, 2010 to expressly provide that provisions of section 44BB would not be applicable to cases where provisions of section 44DA of the Act applied. It would be interesting to analyse the applicability of the principles laid down by the SC in the context of specific amendments made in section 44DA of the Act and section 44BB of the Act.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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[11] This section provides that income being Royalty or FTS received by non-resident from the Government of India or an Indian concern pursuant to an agreement entered after 1 April 2003, where such non-resident carries on business in India through a PE situated in India, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such PE, shall be taxed on net income basis.

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