Consideration for offshore activities in connection with exploration, prospecting and production of mineral oil is taxable in India

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In brief

In a recent decision, the Authority for Advance Rulings (AAR) held that the entire consideration earned by the Applicant towards providing Floating Production Storage and Offloading (FPSO) facility (including offshore activities pursuant to additional scope of work) was taxable in India at 10% deemed profit rate as per the provisions of section 44BB of the Income-tax Act, 1961 (the Act).

In detail

Facts

- The Applicant[1] was a tax resident of Norway, and was engaged in the business of providing FPSO facilities, a kind of floating production system used in the offshore oil and gas industry.
- The Applicant entered into a contract on 9 May 2007 (Original Contract or Order) with Reliance Industries Ltd (RIL) for providing FPSO at the assigned oil and gas field. The consideration for this activity was on day rate release rental basis.
- The Applicant offered the consideration for providing FPSO facility, and the fees towards mobilization of the vessel as per the Original Contract, to tax in India, as such consideration was for supplying plant and machinery on hire used or to be used in prospecting, extraction or production of mineral oil in terms of section 44BB of the Act, at 10% deemed profit rate basis.
- Later, on 27 July 2008, the Applicant signed a 'Change Order' with RIL to facilitate some additions in the scope of work of the Original Contract, such as fabrication and installation of new living quarters on board the FPSO facility, procurement, and installation of Heating, Ventilation and Air Conditioning system (HVAC), mobilising the commissioning team, extending dry-docketing, expediting deliveries of topside modules and timely installation of buoy and moorings in India.
- The Applicant did not offer to tax in India the consideration received as per the Change Order, except the consideration towards installation of buoy and moorings, which were offered under section 44BB at 10% deemed profit rate.

Key issues/ arguments raised before the AAR

The Applicant approached the AAR and sought a ruling on the taxability of offshore activities carried out pursuant to the Change Order. Broadly, the Applicant raised the following points in connection with taxability of activities pursuant to Change Order:

- The consideration under the Change Order was in the nature of business profits, and not technical services or royalty.
- It needed to be ascertained whether the consideration under the Change Order were capital receipts or revenue receipts.
- Change Order was a contract independent of the Original Contract. Therefore, consideration under both

[1] [TS-773-AAR-2015]

contracts could not be held to have identical tax treatment, i.e., taxable under section 44BB of the Act.

- The entire scope of work (except installation of buoy and moorings) was performed outside India, and therefore, the consideration received could not be said to have accrued or arisen in India, relying upon the ruling of the Mumbai Income-tax Appellate Tribunal (Tribunal) in the case of McDermott ETPM Inc[2].
- Consideration towards offshore activities could not be said to be attributable to the Permanent Establishment (PE) of the Applicant in India, on the premise that the work had been carried out outside India. Article 23 of the Indo-Norway Double Taxation Avoidance Agreement (tax treaty), which assumes the existence of PE and taxability in India if any Norway resident carried on any activities in connection with exploration or exploitation of the sea bed and sub-soil, did not apply to consideration towards the Change Order.
- In case the consideration towards offshore activities was deemed to be taxable in India, then income should be computed under section 44BB of the Act, as the activities performed were an integral part of the provision of the FPSO, and were thus, in connection with extraction and production of mineral oil and gas at the assigned gas fields.
- The consideration attributable to mobilisation of FPSO under the Original Order, to the extent of the distance travelled outside India, was not taxable in India. Only the mobilisation revenue attributable to the distance travelled by the FPSO in Indian territorial waters should have been taxable in India, though initially, the Applicant offered such revenues to tax in India fully under section 44BB of the Act.
- Consideration towards installation of buoy and moorings in India was not in the nature of Fees for Technical Services (FTS) as per section 9(1)(vii) of the Act (as it would fall in the exclusion as 'mining or like project') and therefore, it would fall within the ambit of section 44BB of the Act.
- The insurance receipt could not be deemed to accrue or arise in India, since the same had been received outside India pursuant to an insurance policy signed outside India. Accordingly, such receipts were not taxable in India even under section 44BB of the Act.

Revenue's contentions

- The Original Agreement provided for changes to be made as per RIL's specifications. The Change Order was thus with respect to obligations already contemplated in the Original Contract. There was, therefore, no reason that taxability under both contracts should be different.
- RIL's interest was limited to 'use of the vessel' and therefore, any compensation paid, whether as lump sum consideration, or in instalments, could only represent lease rentals, i.e. royalty.
- Activities pursuant to the Change Order were inextricably linked with prospecting, extraction or production of mineral oil, and hence, the income from it would be governed by section 44BB of the Act. The Supreme Court decision in Oil and Natural Gas Corporation Limited (ONGC)[3] was relied on.
- The Applicant had installed buoy and moorings in India to fulfil its obligations. Other consideration received under the Change Order was also on account of the applicant fulfilling the same obligations as contained in the Original Order. The consideration towards installation of buoy and moorings in India under the same Change Order had been offered to tax under section 44BB of the Act, and therefore, the Applicant could not claim different tax treatment for the other scope of work under the same Change Order, even if the work was performed outside India. It relied on the High Court (HC) of Uttarakhand's decision in Sedco Forex International Inc.[4].
- Amounts received by the Applicant under the Change Order were revenue receipts falling under sections 5 and 9 of the Act, as well as under Article 7 of the India-Norway tax treaty.
- It asserted that the Applicant had a PE in India under Article 23 of the tax treaty, because the Applicant was carrying on activities in India in connection with exploration or exploitation of sea bed or sub-soil.
- Lastly, the Applicant had already offered the entire mobilisation fee as per the Original Order to tax under section 44BB of the Act, and therefore, the claim that the income attributable to the distance travelled outside India's territorial waters was not taxable in India, was an afterthought.

AAR Ruling

- The Applicant did not raise any specific ground in the application as to whether the consideration under Change Order was a capital receipt. Therefore, the AAR could not give a ruling on this question. The AAR nevertheless held that the receipt should be revenue in

[2] 303 ITR 445 [Approved by Bombay HC – ITA No. 1328 of 2011)

[3] Civil Appeal No 731 of 2007 (unreported)

[4] Sedco Forex International Inc. *v.* CIT [2008] 299 ITR 238 (Uttaranchal)

nature, as the Applicant itself had admitted this to be a business receipt.

- Since the Change Order emanated from the Original Contract, it was clear that the Change Order was nothing but a modification to the Original Order. There was no way the Change Order could be seen in isolation. The work under the contract was to prepare the FPSO, and chartering the same on lease rental basis to extract, receive, process, store and offload crude oil and natural gas from the development area in India. Therefore, the entire consideration received by the Applicant had to be taxed under section 44BB of the Act.
- The Applicant had already offered the consideration received as per Original Contract to tax under section 44BB of the Act, without making any distinction either about the location of work performed on the FPSO, or on the basis of distance travelled outside and within India. Hence, there was no reason to give a different treatment to consideration received under the Change Order, or for distance travelled outside India.
- There was no scope under section 44BB to split revenue attributable to activities in and outside India, as the income was offered to tax on a deemed profit basis. The AAR relied on judicial precedents[6]. The Mumbai Tribunal[7] decision relied on by the Applicant was distinguished.
- The Applicant's contention that consideration received as per Change Order was not taxable under the India-Norway tax treaty, was not acceptable, as work envisaged as per the Change Order was inextricably linked to the main work of providing the FPSO to RIL, viz., exploration or exploitation of sea bed or sub-soil.
- Lastly, insurance reimbursements were not taxable in India, as they were received outside India under an insurance policy obtained and signed outside India.

[6] Sedco Forex International Inc. *v.* CIT [2008] 299 ITR 238 (Uttaranchal); Geofizyka Torun Sp.zo., *In re* AAR No. 813 of 2009; and Bergen Oilfield Services AS, *In re* AAR No. 857 of 2009

[7] McDermott ETPM Inc. *v.* DCIT 303 ITR 445 [Approved by Bombay HC – ITA1328 of 2011)

The takeaways

- This Ruling appears to suggest that consideration for activities in connection with exploration/ production of mineral oil should be taxed under section 44BB at deemed profit of 10% irrespective of whether the activity was performed within or outside India. However, this proposition needs be seen in the light of facts of this case.
- The AAR held that the consideration under the Change Order and mobilisation revenues for distance travelled outside Indian territorial waters would attract same taxability as applied to the Original Order, i.e., deemed profit rate of 10% under section 44BB of the Act.
- The AAR found that scope of work under the Change Order was inextricably linked to the Original Order, and consideration under both Orders were of the same nature. It therefore held that the consideration under the Change Order would attract the same taxability as was applied to consideration under the Original Order. This finding of fact led the AAR to negate the Applicant's contention that Article 23 of the India-Norway tax treaty did not apply to consideration under the Change Order.
- Though this Ruling is fact specific and does not have binding effect for other taxpayers, yet it has persuasive value insofar as it deals with the proposition that section 44BB even covers activities performed outside India. Having said that, the judgement in the Sedco Forex case[4] (relied upon by the AAR in this Ruling) may support the legal proposition held in this case, and may have implications on other non-resident oil & gas players too.
- It may be pertinent to refer to the landmark SC judgement in Hyundai Heavy Industries Co. Ltd.[8], where the SC had characterised section 44BB as a mere computational provision, and wherein onshore revenues towards installation and commissioning of offshore platforms were held to be taxable under section 44BB, but in the same breadth, offshore revenues were held to be not taxable in India.
- Since the judgments of the Uttarakhand HC in Sedco Forex[4] and other cases are pending before the SC, a final verdict from the SC will set this controversy at rest.

Let's talk

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

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[8] CIT *v.* Hyundai Heavy Industries Co. Limited [2007] 291 ITR 482 (SC). Also see Ishikawajma Harima Heavy Industries Ltd *v.* DIT [2007] 288 ITR 408 (SC) wherein it was held that where activities under a contract had been performed at different places, principle of apportionment could be applied to determine which fiscal jurisdiction could tax a part of the transaction.

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