

Circular No. 20 /2019

**Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes**

New Delhi, dated 19th August, 2019

Subject: - Clarification regarding treatment of Farm-in expenditure incurred by the Oil Exploration and Production(E&P) Companies - reg.

Over the life cycle of an Oil & Gas block, 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. A request has been made to clarify whether 'Farm in' expenditure being in nature of rights should be allowed to be treated an 'intangible asset' under clause (ii) of section 32(1) of the Income-tax Act, 1961('Act').

2. 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), Hydrocarbon Exploration & Licensing Policy (HELP), Open Acreage Licensing Policy (OALP) etc. by signing the Production Sharing Contracts (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.

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

4. 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. International accounting rules for Oil & Gas followed in Australia, Indonesia, UK etc. also require that such acquisition cost to be capitalized and depreciated. A perusal of the Model PSC's {as per the website of the Director General of Hydrocarbon (DGH)} 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.

5. The matter has been examined in the context of the above. In this regard, it is relevant to mention that earlier vide Notification No. G.S.R. 117(E) dated 08.03.1996, in exercise of its powers under section 293A of the Act, Central Government 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 extraction or production of mineral oils on or after the 1st day of April, 1992,-

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

6. Thus, 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 'Participating Interest' in an E&P contract where such acquisition is approved by the Government of India, 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.

7. In view of the above legal position, it is hereby clarified as under:-

- i. amount paid for acquiring the 'Participating Interest' shall not be treated either as 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, rather it would be treated as an amount paid to acquire the underlying assets; and
- ii. the amount paid for acquiring the 'Participating Interest', after reducing component of cost attributable to tangible assets for purposes of clause (i) of sub-section (1) of section 32, would be treated as an '**intangible asset**' (being a business or commercial right akin to a licence), eligible for claim of depreciation for purposes of clause (ii) of sub-section (1) of section 32 of the Act.

9. This circular being clarificatory in nature shall be applicable from the date of applicability of clause (ii) of sub-section (1) of section 32 in the Income-tax Act, 1961.

10. Hindi version to follow.

- Sd -
Rajarajeswari R.)
Under Secretary (ITA.II), CBDT

(F. No. 225/34/2019-ITA.II)

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