REPORTABLE

IN THE SUPREME COURT OF INDIA

CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NO. 5433 OF 2008

(Arising out of S.L.P. (C) No.16886 of 2008)

Commissioner of Income Tax,
Dehradun & Anr. ... Appellants

v.

Enron Oil & Gas India Ltd. ....
Respondent

J U D G M E N T

S.H. KAPADIA, J.

Leave granted.

2. Respondent-Enron Oil & Gas India Ltd. ("EOGIL") is a company incorporated in Cayman Islands engaged in the business of oil exploration. In 1993, Government of India through Petroleum Ministry invited bids for development of Concessional Blocks. EOGIL offered its bid for the development of concessional blocks. A consortium of EOGIL with RIL was given the contract. Later on, ONGC joined. EOGIL with RIL and ONGC executed Production Sharing Contract (PSC) with Government of India. EOGIL was entitled to a participating interest of 30% in the rights and

obligations arising under the PSC. RIL was also entitled to participating interest of 30%. ONGC was entitled to a participating interest of 40%. EOGIL was designated as the Operator under the said PSC.

3. Vide Notification No. 9997 dated 8.3.1996 under Section 293A of the Income Tax Act, 1961 ("1961 Act"), each co-venturer was liable to be assessed for his own share of income. They were not to be treated as an AOP.

4. EOGIL filed his return of income for Assessment Year 1999-00 declaring its taxable income of Rs. 71,19,50,013 under Section 115JA.

5. During the year, EOGIL debited its P&L account by exchange loss of Rs. 38,63,38,980. The A.O. disallowed this loss on the ground that it was a mere book entry and actually no loss stood incurred by the assessee.

6. The decision of the A.O. was challenged in appeal by EOGIL before CIT(A), who after analyzing the PSC held that each co-venturer in this case had made contribution at a certain rate whereas the expenditure incurred out of the said contribution stood converted on the basis of the previous

month's average daily means of the buying and selling rates of exchange which exercise resulted into loss/profit on conversion. Under the circumstances, according to CIT(A), it cannot be said that the assessee had incurred notional loss. In fact, during the course of proceedings, CIT(A) found that during Assessment Years 1995-96 and 1996-97 assessee had earned profits which stood taxed by the Department. He further found that one co-venturer (ONGC) had gained Rs. 293.73 crores during Assessment year 1997-98 because the Indian rupee had appreciated as compared to foreign currency and the Department had taxed the same but when during the assessment year in question there is a loss on account of such conversion, the Department has refused to allow the deduction for such conversion losses. According to CIT(A), the Department cannot blow hot and cold. Consequently, it was held that just as foreign exchange gain was taxable, loss was allowable under Section 42(1) of Income Tax Act in terms of the PSC. Therefore, CIT(A) allowed as deduction the loss of Rs. 38,63,38,980.

7. Aggrieved by the order passed by CIT(A) the Department carried the matter in appeal to ITAT objecting to the deletion made by CIT(A) on the ground that the loss was only a book entry. It may be noted that before the

Tribunal the matter pertained to Assessment Years 1999-00, 1998-99, 2000-01 and 1996-97. However, for the sake of convenience, the Tribunal focused its attention on the facts and figures given for Assessment Year 1999-00. Before the Tribunal, the Department contended that the assessee borrows in USD and repays in the same currency for the preparation of the Balance Sheet. The loans, according to the Department, were stated at prevalent exchange rates and the loss so arrived at was charged to the P&L account. Therefore, according to the Department, the said loss was a book entry and it was not an actual loss in the foreign exchange caused to the assessee. This argument of the Department was rejected by the Tribunal. It was held that the assessee was a foreign company. It carried out business activity in India. It had to maintain its accounts in rupees for the purpose of income tax, that the PSC had to be read with Section 42(1) of the Income Tax Act, which entitled the assessee to claim conversion loss as deduction, particularly when the said PSC provided for realized and unrealised gains/losses from the exchange of currency. According to the Tribunal, the assessee was maintaining its accounts in rupees and such accounts had to reflect the loan liability under consideration as the loan had been taken for the Indian activity. Therefore, according to the Tribunal, the liability arising as a consequence of depreciation of the rupee had to be considered both for

accounting and tax purposes. Accordingly, the Tribunal refused to interfere with the findings returned by CIT(A).

8. The above concurrent finding stood confirmed by the impugned judgment delivered by the Uttrakhand High Court in ITA No. 74/07 along with ITA No. 76/07 and ITA No. 77/07 decided on 17.1.2008. Hence, this civil appeal.

9. The only question which needs to be considered in this civil appeal is whether the assessee was entitled to claim deduction for foreign exchange losses on account of foreign currency translation? In other words, whether loss arising on account of foreign currency translation is allowable as deduction or not and conversely whether the gains on account of foreign currency translation is to be treated as a receipt liable to tax.

10. At the outset, we quote hereinbelow Section 42(1) of the Income Tax Act, 1961, which reads as follows:

> **"Special provision for deductions in the case of business for prospecting, etc., for mineral oil.**
>
> 42. (1) For the purpose of computing the profits or gains of any business consisting of the prospecting for or extraction or production of mineral oils in relation to which the Central Government has entered into an agreement with any person for the association or

participation of the Central Government or any person authorised by it in such business (which agreement has been laid on the Table of each House of Parliament), there shall be made in lieu of, or in addition to, the allowances admissible under this Act, such allowances as are specified in the agreement in relation –

(a) to expenditure by way of infructuous or abortive exploration expenses in respect of any area surrendered prior to the beginning of commercial production by the assessee;

(b) after the beginning of commercial production, to expenditure incurred by the assessee, whether before or after such commercial production, in respect of drilling or exploration activities or services or in respect of physical assets used in that connection, except assets on which allowance for depreciation is admissible under section 32 :

Provided that in relation to any agreement entered into after 31st day of March, 1981, this clause shall have effect subject to the modification that the words and figures "except assets on which allowance for depreciation is admissible under section 32" had been omitted; and

(c) to the depletion of mineral oil in the mining area in respect of the assessment year relevant to the previous year in which commercial production is begun and for such succeeding year or years as may be specified in the agreement;

and such allowances shall be computed and made in the manner specified in the agreement, the other provisions of this Act being deemed for this

> purpose to have been modified to the extent necessary to give effect to the terms of the agreement.
>
> (2) …
>
> *Explanation.*- For the purposes of this section, "mineral oil" includes petroleum and natural gas."

11. Section 42 is a special provision applicable to oil contracts. It has to be construed in the background of the PSC. There is a difference between Production Sharing Contracts and Revenue Sharing Contracts. PSCs were put in place in order to enable Sovereign Governments to maximize their gains from oil exploration by private corporations. PSC is a regime.

12. Prior to the PSC regime, Governments recovered royalty and imposed tax on revenues from oil exploration. However, in countries like India, where there is a great demand for oil, PSC was devised to give the Governments a stake in oil exploration and development- virtually making it a partner in the process. Under the PSC, Government or its nominee becomes a party. The private parties either single company or a consortium are the other parties to the contract. The consortium consists of an Indian partner and a foreign company. The private parties are generally called as Contractors. These contractors have a defined share which is called as

"Participating Interest". One of the Contractors would be designated as an "Operator", who would have a control over day to day operations. Upfront investments are made generally by the Contractors. For this purpose, the Operator "in this case being M/s EOGIL" would make "cash calls". The operating expenses are also similarly funded. In these Contracts, generally there are three types of costs, namely, exploration costs, which is a capital expenditure, development cost which is also capital expenditure and production cost which is operational expenditure. Under the PSC, costs are recovered from the oil produced until such time as they are fully absorbed. Oil so recovered is called "Cost Oil". Oil in excess of "Cost Oil" is called "Profit Oil". In Profit Oil there is the sharing percentage. The share of each constituent is equal to their participating interest. Similarly, between the Contractors and the Government, the oil produce is shared on the basis of pre-determined shares. In the initial years, generally the Contractors who have made upfront investment in the Project have a lion's share of production as they have to recover their investments made upfront. The contractors in the initial years recover their investments as cost oil, and in the later years most of the oil produced is profit oil and, therefore, the more profit oil is recovered the higher is the Return on Investment (ROI) earned

by the Contractor. With the increased ROI recovered by the Contractor, the percentage share of the Government goes on increasing.

13. The above analysis of the PSC indicates that both the Government and the Contractor are entitled to their "take" in oil and not in money. That is why the contract is called as Production Sharing Contract and for that purpose it becomes necessary to translate costs into oil barrels. This is done by dividing the monetary value of costs by the agreed price of oil. The price of oil generally is bench-marked – x% above Brent Crude quotation, or it may depend on oil market price.

14. In India, oil had to be sold during the years in question by the Contractors to IOC so that it was convenient to have a bench-marked price.

15. If the price of oil increased, the extent of profit oil would also increase and thereby the share of the Government would automatically increase. It is for this reason that PSCs were considered to be a better arrangement for ensuring the Sovereign Governments (owners of the natural resources) the maximum possible "take". At the same time, such contracts ensure that the projects remained attractive enough for foreign

investors. However, due to this kind of structure of the PSC, inherently there has to be frequent conversion from one currency to the other. Cash calls were made in USD; some of the cash calls were required to be converted to INR for local expenses; some of the expenses stood incurred in USD whereas some to be incurred in INR; the sale price of oil was in USD whereas the accounts were drawn up in USD. When some of the expenses were incurred in USD and some incurred in INR, conversion had to be made at the prevalent rates of exchange to bring them all to the contract currency, i.e., USD. Similarly, as stated above, the sale price of oil was in USD. At the time of sale, the INR – USD rate would change from that on the date of the cash calls. Similarly, as stated above, the accounts were required to be drawn up in USD. For that purpose also one had to reconvert the costs from barrels to monetary terms. For the said reasons, clauses 1.6.1 and 1.6.2 of appendix 'C' to the PSC envisaged booking of all currency gains and losses irrespective of whether such gains/losses stood realized or remained unrealized. In case of gains, a part of the credit would go to the Government, and taxes would be payable on the income to the extent of such gains credited. Therefore, in our view, currency gains and losses constituted an inextricable part of the accounting mechanism for expenses incurred on the development and production of oil.

16. Section 42 of the 1961 Act was enacted to ensure that where the structure of the PSC was at variance with the accounting principles generally used for ascertaining taxable income, the provisions of the PSC would prevail. Section 42 provides for deduction on expenditure incurred on prospecting for or extraction or production of mineral oil whereas Section 44 BB contains special provision for computing profits and gains in connection with the business of exploration or extraction or production of mineral oils. The Head Note itself indicates that Section 42 is a special provision for deduction on expenditure incurred on prospecting, extraction or production of mineral oils.

17. PSC is a contract in which the Central Government is not only a party, it is a partner in the process. Such contracts are required to be placed before each House of Parliament under Section 42.

18. Analysing Section 42(1), it becomes clear that the said section is a special provision for deductions in the case of business of prospecting, extraction or production of mineral oils. As stated above, Section 42(1) inter alia provides for deduction of certain expenses.

19. Broadly speaking, Section 42(1) provides for admissibility in respect of three types of allowances provided they are specified in the PSC. They relate to expenditure incurred on account of abortive exploration, expenditure incurred, before or after the commencement of commercial production, in respect of drilling or exploration activities and expenses incurred in relation to depletion of mineral oil in the mining area. If one reads Section 42(1) carefully it becomes clear that the above three allowances are admissible only if they are so specified in the PSC. For example, in the PSC in question expenses incurred on account of depletion of mineral oil is not provided for. Therefore, to that extent, respondent would not be entitled to claim deduction under Section 42(1)(c). Under section 42(1) it is made clear that for the purpose of computing the profits or gains of any business consisting of prospecting, extraction or production of mineral oil, an assessee would be entitled to claim deduction in respect of abovementioned three items of expenditure in lieu of or in addition to the allowances admissible under the 1961 Act. Further, such allowances shall be computed and made in the manner specified in the agreement. In short, an assessee is entitled to allowances which are mentioned in the PSC. According to the Department, translation losses claimed by EOGIL are not

specified in the PSC, hence they cannot be claimed as deduction under Section 42(1).

20. The question which this Court needs to answer is – are the translation losses within the scope of Section 42?

21. In order to answer the above question, we are required to analyse certain provisions of the PSC in question. Article 1 deals with definitions. Under Article 1.21 "Contract Costs" means exploration costs, development costs, production costs and all other costs related to petroleum operations. Similarly, "Cost Petroleum" is defined to mean the portion of the total volume of petroleum produced which the contractor is entitled to take for the recovery of Contract Costs as specified in Article 13. Under Article 13 the Contractor is entitled to recover Contract Costs out of the total volume of petroleum produced. That costs include development and exploration costs. Similarly, Article 1.69 defines "Profit Petroleum" to mean all petroleum produced and saved from the Contract Area in a particular period as reduced by Cost Petroleum and calculated in terms of Article 14. Continuing the analysis of PSC, Article 7 inter alia provides that the contractor shall provide for all funds necessary for the conduct of petroleum

operations. Article 13 deals with recovery of costs, as stated above. Article 15 deals with taxes, royalties, rentals etc. It indicates that Government of India is entitled to get taxes apart from profit petroleum. Article 15.2.1 inter alia provides that in order to compute profits of the business consisting of prospecting, extraction or petroleum production there shall be made allowances in lieu of the allowances admissible under the 1961 Act, such allowances as are specified in the PSC pursuant to Section 42 in relation to three items of expenditure specified under Section 42(1)(a), (b) and (c). Under Article 15.2.1, two allowances are provided for. They are for abortive exploration expenses and expenses incurred after the commencement of commercial production in respect of drilling or exploration activities. In other words, two out of three allowances mentioned in Section 42(1) are provided for in Article 15.2.1.

22. The above analysis shows that Section 42 provides for deduction for expenses provided such expenses/allowances are provided for in the PSC. The PSC in question provides for both capital and revenue expenditures. It also provides for a method in which the said expenses had to be accounted for. The said PSC is an independent accounting regime which includes tax treatment of costs, expenses, incomes, profits etc. It prescribes a separate

rule of accounting. In normal accounting, in the case of fixed assets, generally when the currency fluctuation results in an exchange loss, addition is made to the value of the asset for depreciation. However, under the PSC, instead of increasing the value of expenditure incurred on account of currency variation in the expenses itself, EOGIL was required to book losses separately. Therefore, PSC represented an independent regime. The shares of the Government and the contractors were also determined on that basis. Section 42 is inoperative by itself. It becomes operative only when it is read with the PSC. Expenses deductible under Section 42 had to be determined as per the PSC. This implied that expenses had to be accounted for only as contemplated by the PSC. If so read, it is clear that the primary object of the PSC is to ensure a fair "take" to the Government. The said "take" comprised of profit oil, royalty, cesses and taxes. The said PSC prescribed a special manner of accounting which was at variance with the normal accounting standards. The said "PSC accounting" obliterated the difference between capital and revenue expenditure. It made all kinds of expenditure chargeable to P&L account without reference to their capital or revenue nature. But for the PSC Accounting there would have been disputes as to whether the expenses were of revenue or capital nature. In view of the

special accounting procedure prescribed by the PSC, Accounting Standard 11 had to be ruled out.

23. The question before us still remains as to whether the PSC talks of translation, and if so, whether translation losses could be claimed by EOGIL. In this connection, we need to consider Article 20.2 which inter alia states that the rates of exchange for the purchase and sale of currency by the Contractor shall be the prevailing rates as determined by the State Bank of India and for accounting purposes under the PSC such rates shall apply as provided for in clause 1.6 of Appendix 'C' to the PSC. Appendix is a part of PSC. The purpose of Appendix 'C' inter alia is to prescribe the Accounting Procedure. Clause 1.1 of appendix 'C' provides for classification of costs and expenditures. That classification is warranted as PSC contemplates costs recovery by the contractor(s), who has made initial contribution/investment of funds in foreign currency. The said classification of costs and expenditures is also indicated in appendix 'C' for profit sharing purposes and for participation purposes. Appendix 'C' prescribes the manner in which a contractor is required to maintain his accounts. It stipulates that each of the co-venturer has to follow the computation of income tax under the 1961 Act. Clause 1.6.1 of appendix 'C' refers to currency exchange rates. It states that for translation purposes between USD

and INR, the previous month's average of the daily means of buying and selling rates of exchange as quoted by SBI shall be used for the month in which revenues, costs, expenditures, receipts or incomes are recorded. Therefore, in our view, clause 1.6.1 of Appendix 'C' provides for translation.

24. On reading the said PSC, one finds that it not only deals with ascertainment of profits of individual stakeholders including Government of India but it also refers to taxes on individual shares, calculation of costs against revenues from sale of petroleum, allowances admissible for deduction, taxability, valuation, recovery, conversion etc. In other words, it is a complete Code by itself.

25. The question to be asked is why does the PSC warrant translation?

26. To understand this aspect, we need to reiterate some important facts of this case. In 1993, Government of India, through Petroleum Ministry invited bids for the development of concessional blocks. The respondent-assessee offered its bid for the concession. Accordingly, a consortium of M/s EOGIL and RIL was awarded the contract for development of Panna, Mukta and Mid & South Tapti fields. Respondent was designated as an

Operator. Subsequent to the award of the concession, EOGIL along with RIL and ONGC executed PSC with Government of India. Under the said PSC, each co-venturer remitted money, known as cash call to the bank account of the Operator in USA. The expenditure for the joint venture is made out of the said Account. The Trial Balance was required to be prepared at the end of the month in USD which was then required to be translated on the basis of accounting procedure mentioned in Appendix 'C' to the PSC. Cash call in other words was not a loan. A wrong illustration has been given in the impugned judgment. Cash call was a contribution. It was made by each co-venturer at a certain rate whereas the expenditure against it had to be converted on the basis of the exchange rates as provided for in the PSC, which, as stated above, stated that the same had to be converted on the basis of the previous month's average of the daily means of buying and selling rates of exchange (see clause 1.6.1 of Appendix 'C' to PSC).

27. The above analysis shows that the capital contribution had to be converted under the PSC at one rate whereas the expenditure had to be converted at a different rate. This exercise resulted into loss/profit on conversion. Under the PSC, the respondent had to convert revenues, costs, receipts and incomes. If EOGIL had a choice to prepare its accounts only in USD, there would have been no loss/profit on account of currency

translation. It is because of the specific provision in the PSC for currency translation that loss/profit accrued to EOGIL. Moreover, under clause 1.6.2 of Appendix 'C' to PSC it was inter alia provided that any realized or unrealized gains or losses from the exchange of currency in respect of Petroleum Operations shall be credited or charged to the Accounts. Therefore, it would be wrong to say, as stated by the A.O., that the currency translation losses incurred by EOGIL, during the years in question, was only a notional loss/ book entry.

28. To sum up, the simple question which arises for determination in this civil appeal is whether translation losses are illusory or real losses? According to the Department, they are illusory losses.

29. To answer this question we were required to understand the subject of a Production Sharing Contract (PSC). The State hires the investor(s) as a contractor(s) for the conduct of work connected with the extraction of minerals. The subsoil belongs to the State. It has a monopoly over the use of the subsoil and the removal from it all natural resources. Under the PSC the State grants to the contractor (investor) exclusive rights to conduct activity of exploration envisaged by the contract. A PSC is a civil-law contract. The contractor (investor) carries out the activities envisaged in the contract

(prospecting, search, exploration, extraction etc.) at his own expense and risk. The State does not bear any expenses or risks. If the investor invests in the prospecting and exploration but does not discover any oil, the expended funds is not refundable unless the contract provides otherwise. The State hires the investor as a contractor to perform work for it, but at the expense and risk of the investor. The said work is carried out on a compensated basis, with the State paying the investor not in money, but in terms of a portion of the produced product (oil). This is called as Production Sharing.

30. There are two main systems around the world: royalty/tax systems or production sharing systems. PSCs have become the fiscal system of choice for most countries. Taxes are embedded in the Government share of profit oil. PSC is a complex system. In it, the foreign company provides the capital investment in exploration, drilling and construction of infrastructure. The first proportion of oil extracted is allocated to the company, which uses oil sales to recoup its costs and capital investment. The oil used for this purpose, namely, to recoup capital investment and cost is termed as "cost oil". Once costs have been recovered, the remaining "profit oil" is divided between the State and the company in agreed proportions. The company is taxed on its profit oil. Sometimes, the State participates either itself or

through its nominee as a commercial partner in the contract, operating in joint venture with foreign oil companies. In such cases, the State provides its percentage share of capital investment, and directly receives the percentage share of cost oil and profit oil.

31. As stated above, in PSC, the foreign company provides the capital investment and cost and the first proportion of oil extracted is generally allocated to the company which uses oil sales to recoup its costs and capital investment. The oil used for that purpose is termed as "cost oil". Often a company obtains profit not just from the "profit oil", but also from "cost oil". Such profits cannot be ascertained without taking into account translation losses. Moreover, as stated above, taxes are embedded in the profit oil. If these concepts are kept in mind then it cannot be said that "translation losses" under the PSC are illusory losses.

32. Before concluding, we may point out that on behalf of the Department, great emphasis was placed on clause 3.2 of Appendix 'C' annexed to the PSC which inter alia referred to costs not recoverable and not allowable under the Contract (PSC). In the said clause it was stated that exchange losses on loans or other financing would not be admissible for deduction. We find no merit in this argument advanced on behalf of the

Department. As stated above, "Cash Call" is not a loan. It is a contribution made into the Account of the Operator by each co-venturer in USD. Clause 3.2 of Appendix 'C' refers to loans borrowed by an assessee or loans which are financed on which the assessee has to pay interest. Interest costs incurred by the assessee on such loans is not allowable under clause 3.2 of Appendix 'C' to the PSC. That clause is not applicable for cash call/contribution. It may be noted that PSC is a special regime. It does not come under Accounting Standard 11. Note 12 annexed to the Accounts for the year ending 31.3.1999 refers to carrying costs of fixed assets financed through loans. This Note refers to the P&L account of EOGIL. It is a comment regarding the 2nd tier whereas clause 1.6.1 of Appendix 'C' to the PSC refers to tier 1. If one keeps in mind the concept of PSC being a separate regime and if one keeps in mind the concept of cash call being an investment and not a loan then the entire controversy stands resolved. In this case, we are concerned with foreign currency transaction under which all monetary balances were required to be translated at the exchange rates prevailing as on the last date of the accounting year (balance sheet date) and accordingly the resultant translation gains/losses were required to be recognized which is referred to in Note 1(d) to Schedule R, annexed to the Accounts for the year ending 31.3.1999.

33. For the aforestated reasons, we find no merit in this civil appeal and the same is dismissed with no order as to costs.

……J.
(S.H. Kapadia)

……J.
(B. Sudershan Reddy)

New Delhi;
September 2, 2008.