

IN THE HIGH COURT OF UTTARAKHAND AT NAINITAL

Income Tax Appeal No.18 of 2010

Commissioner of Income Tax,
Dehradun.

.....Appellant

Versus

Oil & Natural Gas Corporation Ltd.

.....Respondent

with

Income Tax Appeal No.23 of 2010

Commissioner of Income Tax,
Dehradun.

.....Appellant

Versus

Oil & Natural Gas Corporation Ltd.

.....Respondent

Mr. Hari Mohan Bhatia, Advocate for the appellant.

Mr. Rupesh Jain and Mr. Udhoyg Shukla, Advocates for the respondent.

Dated: 21st May, 2015

Coram: Hon'ble K.M. Joseph, C.J.
Hon'ble V.K. Bist, J.

K.M. Joseph, C.J. (Oral)

The appeals, two in number, are related to the assessment year 2006-2007. Following are the substantial questions of law, which have been raised:

- “1. Whether the ITAT has erred in law, in holding that the expenditure incurred on Dry Docking expenses are revenue in nature?
2. Whether the ITAT has erred in law by holding that payment made on account of royalty to State Govt. calculated on international price instead of discounted sale price in the nature of allowable business expenditure?”

2. As far as substantial question of law no.1 is concerned, we have already answered the same against the Revenue in I.T.A. Nos. 19 of 2010, 20 of 2010, 21 of 2010 & 22 of 2010 and we answer the same against the Revenue as we see no reason to take a different view.

3. Then, we proceed to consider the second substantial question of law, which relates to the payment of royalty. The respondent assessee is engaged in oil exploration. For the assessment year in question, namely, 2006-2007, noticing the reports in the Economic Times that royalty is being paid at the rate of 29% to the State Governments by the assessee, the Assessing Officer issued notice calling upon the appellant to explain how despite the injunction contained in Section 6A of the Oilfield (Regulation and Development) Act, 1948, the assessee could have paid 9% extra. The reply of the assessee is as follows:

“Payment of Royalty

“In response to this, the assessee submitted that the payment of royalty on crude oil is governed by Oilfield (Regulation and Development) Act 1948 and Petroleum and Natural Gas Rules 1959. The Royalty is payable to State Government in case of Onshore Production and to Central Government in case of Offshore payment. Section 6A of the (Regulation and Development) Act 1948 provides that Central Government shall not fix the rate of royalty so as to exceed 20% of sale price at wellhead. The Methodology of determination of wellhead price was advised by new scheme of royalty on crude oil effective from Apr’98, vide MoP&NG’s resolution dated 17 Mar’03, which was notified vide Gazette Notification dated 16 Dec’04

(copy enclosed as Annexure-VII). MoP&NG, vide letter no. P-20012/2897-PP dated 30 Oct'03 conveyed the decision of the Government that the revenue of State Governments in terms of royalty on crude oil will not be affected by discount on ONGC's crude oil (copy enclosed at Annexure-VIII). As replied in point 2(i) of our letter dated 30-08-2005 (referred in your query dated 13-03-2007), the royalty is paid on onshore production to State Governments as per the instructions of Central Government. Accordingly, the same treatment has been made in Accounts and in determination of taxable income."

Further it is submitted that payment of Royalty is to Central Government & State Government and is a matter between ONGC and respective Government. No provision of Income Tax Act, 1961 stipulates that only 20% of royalty payable is allowable. In our view payment of the entire amount of royalty is, an expenditure incurred by ONGC wholly and exclusively for the purposes of its business, the same having been made to secure a valuable business right viz., the right to receive its share of production from various fields and is entirely as per direction of Government of India (refer letter No. P-20012/2897-PP dated 30-10-2003 enclosed at Annexure-VIII). The entire amount of royalty paid by ONGC is, therefore, fully deductible in computing the taxable income of ONGC. Kind reference is also invited to reply at point No. 2.2 above and to our letter dated 14-09-2005 submitted in this regard.

In response to query raised vide order sheet entry dated 20-03-2007, the assessee furnished the break up of the royalty for crude oil and natural gas along with bifurcation in offshore and onshore.

(Rs. in crore)

Particulars	Crude oil	Natural Gas	Total
Onshore	2181.96	130.46	2312.42
Offshore(incl. JV)	1776.78	530.65	2307.43

Total	3958.74	661.11	4619.85
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(ii) Onshore Royalty (Provisional) on Pre Discount Prices as well as on Post Discount Prices:
(Rs. in crore)

Particulars	Royalty based on pre disc. Price	Royalty based on post disc. Price (provisional)
NG-IOCL	1005.52	562.83
SG-IOCL	639.42	399.08
Eastern Region-IOCL	80.38	49.77
Eastern Region Other Refineries	268.76	268.76
RJY-HPCL-Onshore	68.89	34.66
Cauvery-CPCL	118.99	118.99
Total	2181.96	1434.09

The assessee further contended that the amount of royalty was payable as per the govt. orders and paid by ONGC on the basis of pre-discount price and provisional amount of royalty computed on post discount price in case of on shore production. Royalty on crude oil for onshore production is being paid by the respective projects/assets of ONGC to the concerned State Govt. In order to work out the impact of royalty on crude oil between pre discount & post discount prices, essentially the information from these projects/assets is necessary.”

4. The Assessing Officer was not inclined to accept the explanation offered by the assessee and the Assessing Officer disallowed the royalty paid in excess of 20%. The Assessing Officer actually taxed the difference in royalty paid between the pre-discount and post-discount price. The Appellate Authority in appeal,

however, accepted the contention of the assessee and found that all the ingredients for allowing royalty as revenue expenditure were present and it could not be said to be hit by the explanation given in Section 37 and allowed the appeal in this regard. Revenue carried the matter in further appeal before the Tribunal. The Tribunal proceeded to hold as follows:

“17. The facts are noted by the AO in para 12 of the assessment order. As per these facts, the assessee is to pay royalty to the relevant State Governments with regard to onshore production of oil and for the offshore production, the royalty is paid to the Central Government. The Government had determined lower rates for the purpose of supply of crude oil to various Government oil companies such as HPCL, BPL etc. As per new scheme of royalty on crude oil effective from April, 1998 notified by the Government as per Gazette notification dated 16-12-2004, it was decided that the revenue of State Governments in terms of royalty on crude oil will not be affected by discount on ONGC's crude oil. ONGC has paid royalty on Onshore production to State governments as per these instructions of the Central Government. The AO has noted in the same para that royalty based on pre discounted price paid to State Governments during this year amounted to Rs. 2181.96 crores but if the same royalty is calculated based on post discount price (provisional), the royalty payable comes to only Rs.1434.09 crores. It was held by the AO that royalty paid to concerned State Governments on the basis of Onshore production is to be allowed to the extent of the amount payable on the basis of post discount price. The reasons given by the AO is that since royalty is payable at maximum rate of 20% of the sale price at wellhead, any payment in excess thereof is infraction of law and hence, not allowable. On this basis, he made disallowance of Rs. 747.87 crores, being the difference in the royalty amount paid on pre discount price and payable based on post

discount price. One more reason is given by the AO. This reason given is that when reduced price is taken into account for sales, royalty paid on extra price is not allowable. Being aggrieved, the assessee carried the matter in appeal before Id. CIT(A), who has deleted this disallowance and now the revenue is in appeal before us.

18. It is submitted by learned counsel for the assessee that the royalty payment at pre discount price of oil paid to State Governments is as per the instructions and guidelines of Central Government and hence, it cannot be said to be a payment by infraction of law. He supported the order of learned CIT (A) whereas learned DR supported the assessment order.

19. We have considered the rival submissions. We find that the reasons for making payment of royalty to State Governments for onshore productions based on pre discount price has been explained by the assessee before the AO and it has been submitted that the said payment is as per the guidelines and instructions of Central Government. In view of this factual position, we are of the considered opinion that the AO is not justified in holding that such payment of royalty to State Governments is not allowable, being the payment by infraction of law. The payment of royalty is as per the guidelines and instructions of Government. Such payment cannot be said to be infraction of law. Second reason given by AO is that as per the Government policy, ONGC is not allowed to increase the price fixed by the Government and the resultant net recovery leads to decrease in sale revenue of the assessee. The excess payment of royalty to State Governments is on this decreased amount of sale revenue and since such extra sale revenue has not been taken to the credit of profit and loss account of the assessee, payment of royalty thereupon cannot be allowed as expenditure. We find that this objection of the AO is also without any basis because it is a Government policy to make the sales at reduced price but royalty payable to State

Government is on pre discount price. We are of the considered opinion that for this reason also, the payment of royalty cannot be disallowed. Considering all these facts, we find no reason to interfere in the order of CIT (A) on this issue and we uphold the same. This ground of revenue is rejected.”

5. Feeling aggrieved by the same, the Revenue is before us.

6. We heard learned counsel for the Revenue Shri H.M. Bhatia and Shri Rupesh Jain on behalf of the respondent.

7. Learned counsel for the Revenue Shri H.M. Bhatia would submit that what the Appellate Authority and the Tribunal have vouchsafed for the respondent assessee is in the teeth of Section 37 of the Income Tax Act (hereinafter referred to as the ‘Act’), inasmuch as, the said provision expressly prohibits claiming of any expenditure as revenue expenditure if *inter alia* the item is one which amounts to commission of offence or one which is prohibited by law. He does not have a case that the payment of the excess royalty, which is involved in this case, amounts to an offence, but he would firmly contend that the excess royalty paid by the respondent assessee is prohibited by Section 6A of the Oilfield (Regulation and Development) Act, 1948. He would submit that the Appellate Authority and the Tribunal have laid store by certain Government of India notifications/communications and he would submit that it is trite that should there be a conflict between

an order and a statutory provision, the latter will prevail over the former. If that be so, in appreciating the contention under Section 37 of the Income Tax Act, since parliamentary legislation in the form of Section 6A expressly prohibits the payment of royalty in excess of 20% of the Well Head Price and admittedly, as in this case, royalty has been paid by the respondent assessee by taking into consideration the international price and not the post-discount price, at which latter price, crude oil has been sold to the OMCs (Oil Marketing Companies), clearly, there is violation of Section 6A. Therefore, the explanation of the assessee should not be accepted.

8. Per contra, the learned counsel for the respondent assessee would contend that Section 6A of the Oilfield (Regulation and Development) Act, 1948 has not been breached. In this regard, reference is made to notification issued dated 16.12.2004. Therein, it is stated that from 01.04.2002, in respect of onland areas, the rate of royalty will be 20% of the Well Head Price. He still further draws our attention to the resolution which was issued by the Government of India in the Ministry of Petroleum and Natural Gas resolution dated 17.03.2003. Therein, it is stated as follows:

**“MINISTRY OF PETROLEUM AND NATURAL GAS
RESOLUTION
NEW DELHI, the 17th March, 2003**

No. O-22013/1/2001-ONG-III- The
Government vide its Resolution No. 224

dated 21-11-1997 decided the phased dismantling of Administered pricing Mechanism (APM). In the aforesaid resolution, it was envisaged that the prices payable to the indigenous crude oil producers will be linked to the increasing percentage of international prices Free on Board (FOB) in place of cost plus based prices prevalent till 31-03-1998.

2. The Government, constituted a Committee for evolution of a new scheme of royalty on crude oil w.e.f.1-4-1998, because, inter-alia, the State Governments had been requesting for revision in the methodology for fixation of the rates of royalty paid by National Oil Companies (NOCs) since 01-04-1998. The Committee consulted all stakeholders, especially the major oil and gas producing State Governments and the National oil companies. It also obtained expert opinion of National Institute of Public Finance & Policy (NIPFP), an eminent autonomous body supported by the Ministry of Finance. After considering the recommendations of the Committee and subsequent views of some of the State Governments, the Government has decided to introduce new Scheme of Royalty on crude oil w.e.f. 01-04-1998. The salient features of the new Scheme are as follows:-

- (i) The revised royalty dispensation will be applicable to the areas granted to National Oil Companies on nomination basis, the exploration blocks awarded to Private/Joint Venture (Pvt/JV) contractors prior to New Exploration Licensing Policy (NELP) and the onland discovered fields awarded to Pvt./JV contractors.
- (ii) Royalty will be fixed on *Ad valorem* basis.
- (iii) Royalty will be calculated in accordance with the existing

methodology, i.e. on “cum royalty” basis

- (iv) Royalty calculations will be made on a monthly basis.
- (v) A deduction of 7.5% and 10% of the crude oil price considered for onland and offshore production respectively will be made in order to determine the wellhead price.
- (vi) For the period 1-4-1998 to 31-3-2002:
 - (a) Royalty will be paid on the wellhead price derived as at sub para (v) above and calculated on the basis of notified percentages of weighted average FOB price of actual import of crude oil stipulated in the Government Resolution on dismantling of the APM.
 - (b) Royalty on crude oil production from onland and shallow water offshore areas (upto 400 mts water depth) will be paid @ 20% of the wellhead price as derived from the price determine as at sub para (a) above.
 - (c) Additional amount accrued during this period in the States as a result of these decisions may not be borne by NOCs and will be paid to the States under liabilities of the Oil Pool Account after adjusting the payments already made in terms of adhoc revisions since 1-4-1998.
 - (d) Additional amount accrued during this period to the Centre as a result of these decisions may not be paid by the NOCs and may be waived.
- (vii) With effect from 01-04-2002:
 - (a) The wellhead price of crude oil as derived from the market driven price obtained/obtainable by the producers based on “arm’s length

transactions” will be considered for royalty calculations.

- (b) For crude oil productions from onland areas, royalty will be paid @ 20% of the Wellhead price as derived from the price determined as at sub sub para (a) above till the year 2006-07. The convergence process may commence w.e.f. 2007-08 with tapering rates of royalty @ 1.5% each year so as to facilitate convergence with NELP rates of 12.5% within a period of 5 years i.e. by 2011-12 to be calculated accordingly. The matter may be reviewed for fine-tuning after 3 years, i.e. during 2005-06.”

9. He would also refer to Section 92 F (2) of the Act. He would, therefore, submit that there is nothing illegal in the respondent assessee being called upon to pay royalty on the basis of the transaction based on the international price. He would submit further that matters have been made very clear by the communication dated 30th October, 2003 issued by the Government of India to the Chairman & M.D. of the respondent assessee among others and, therein, it is stated in clause (vi) as follows:

“The revenue of State Governments in terms of royalty on crude oil will not be affected by the discount on ONGC’s crude oil.”

10. He would further submit that the expression “prohibited by law” must be understood in the context of the object which is sought to be achieved. In this regard, he drew our attention to the provisions relating to the explanation in question and it reads as follows:

“Disallowance of illegal expenses

It is proposed to insert an explanation after subsection (i) of section 37 to clarify that no allowance shall be made in respect of expenditure incurred by an assessee for any purpose which is an offence or which is prohibited by law. This proposed amendment will result in disallowance of the claim made by certain tax payers of payments on account of protection money, extortion, hafta, bribes etc. as business expenditure.

This amendment will take effect from 1st April, 1962 and will accordingly apply in relation to the assessment year 1962-1963 and subsequent years.”

11. Therefore, he would submit that it is inconceivable that the payment made by the respondent assessee, a Government of India undertaking, of the royalty to the State Government in terms of the Government of India's policy and directions could amount to protection money, extortion, hafta, bribes etc. He would submit that the object of the respondent assessee in making the payment was to comply with the directions of the Government of India and it could not, therefore, incur the wrath of the explanation to Section 37 of the Act. He would submit that the principle of the explanation may be alien when it comes to commercial transactions and in view of the fact that amounts are being paid in terms of the Government of India's decision and the payment is also made to the State Governments, it could not be said that there is any violation of the explanation. Lastly, he would submit that the Revenue has impugned the decision in respect of this matter in

regard to the year 2006-07 in these appeals, but he reminds us that in regard to the other assessment years, where similar question arose and the Appellate Authority took the similar view as was taken in this case, it has not been subjected to appeals and therefore, on principles analogous to res-judicata, the present appeals are barred. In this connection, he sought support from the decision of the Hon'ble Apex Court reported in **Berger Paints India Limited Vs. Commissioner of Income Tax** reported in **266 ITR Page 99** as also of that of the Delhi High Court in **Commissioner of Income Tax v. Mahalakshmi Sugar Mills Co. Ltd.** reported in **200 ITR page 275**.

12. In fact, in regard to *res judicata*, there is a case for the Revenue that it is not a case, where the assessment year is 2007-08. He would, in fact, refer to Section 11 of the C.P.C. and his attempt would appear to be that had it been for the previous year that the assessee had not challenged the order, there might have been some merit. On the other hand, the assessment year, where the assessment had become final at the hands of the appellate authority or at the higher level, relates to 2007-08 and therefore, we would not think that in the facts of this case, we should throw out the Revenue's case on the basis of *res judicata*.

13. The respondent assessee is an Oil Exploration Company. There is no dispute that in respect of oil exploration done on-shore, royalty is to be

paid to the State Government and in respect of off-shore exploration royalty is to be paid to the Central Government. Section 6A of the Oilfield (Regulation and Development) Act, 1948 Act reads as follows:

“6A. Royalties in respect of mineral oils.—

(1) The holder of a mining lease granted before the commencement of the Oilfields (Regulation and Development) Amendment Act, 1969, shall, notwithstanding anything contained in the instrument of lease or in any law in force at such commencement, pay royalty in respect of any mineral oil mined, quarried, excavated, or collected by him from the leased area after such commencement, at the rate for the time being specified in the Schedule in respect of the mineral oil.

(2) The holder of a mining lease granted on or after the commencement of the Oilfields (Regulation and Development) Amendment Act, 1969, shall pay royalty in respect of any mineral oil mined, quarried, excavated or collected by him from the leased area at the rate for the time being specified in the Schedule in respect of that minerals oil.

(3) Notwithstanding anything contained in sub-section (1) or sub-section (2) no royalty shall be Payable in respect of any crude oil, casing-head condensate or natural gas which is unavoidably lost or is returned to the reservoir or is used for drilling or other operations relating to the production of petroleum or natural gas, or both.

(4) The Central Government may, by notification in the official Gazette, amend the Schedule so as to enhance or reduce the rate at which royalty shall be payable in respect of any mineral oil with effect from such date as may be specified in the notification and different rates may be notified in respect of same mineral oil mined, quarried, excavated or collected from the areas covered by different classes of mining leases;

Provided that the Central Government shall not fix the rate of royalty in respect of any mineral oil so as to exceed twenty per cent of the sale

price of the mineral oil at the oilfields or the oil well-head, as the case may be.

(5) If the Central Government, with a view to encourage exploration in offshore areas, is satisfied that it is necessary in the public interest to do so, it may, by notification in the Official Gazette, exempt generally, either absolutely or subject to such conditions as may be specified in the notification, mineral oil produced from such areas from the whole or any part of the royalty leviable thereon.”

14. Undoubtedly, under Section 6A(4) of the Oilfield (Exploration and Development Act), 1948, the Government can issue a notification fixing the rate of royalty. The proviso is a limitation on the maximum rate of royalty that can be fixed. It expressly provides that royalty cannot be in excess of 20% of the Well Head Price. It is necessary at this juncture to notice the facts. The respondent assessee produces oil and is an internal producer of oil. Under the law, it is bound to pay royalty to the State Governments. Respondent sells crude oil to the Oil Marketing Companies. Thereafter, the oil is marketed by the Oil Marketing Companies and finally it reaches the consumers. The international crude oil price apparently has been on the rise for quite some time. Unless the OMCs get oil at a discount, necessarily the price at which oil and its products are finally sold in the market would be affected; that is to say, there will be rise in the price. Apparently, the Government of India had a policy, under which the price was to be controlled. The result was that the oil companies like the respondent assessee were asked to sell the oil, which they drilled at a discount to OMC's. This is what is the post-discount

price. If the amount of royalty, which the appellant paid to the State Government, is calculated with reference to the post-discount price, then there would be a violation of Section 6A, inasmuch as, the price, at which the respondent assessee was forced to sell, in a manner of speaking, under the Government of India's directions, to the OMCs was at a price, which was lesser than the international price. However, when it came to the payment of royalty to the State Governments, the Government of India also wished to persevere with the policy by which there would be no diminution in the royalty received by the State Governments. This aspect is very clear from the communication dated 30.12.2003, which we have already adverted to and extracted. In other words, the royalty to the State Governments is to be paid on the pre-discount price. Now the central issue, which we are called upon to resolve, is that arising from Section 37 of the Income Tax Act, inasmuch as, under the explanation that which is prohibited cannot be allowed as a revenue expenditure. At this juncture, we must notice the case of the respondent assessee with reference to Notification dated 16.12.2004, which we have already adverted to. It is the case of the respondent assessee that Well Head Price under Section 6A of the Act has not even been defined. It was on the basis of the discussion that it was decided that effective from 01.04.2002 and till 2006-07, the Well Head Price of crude oil as derived from the market driven price obtainable by producers based on arm's length transaction will be considered as royalty and it

is further made clear that royalty will be paid at the rate of 20% on the Well Head Price in terms of the aforesaid formula in Clause (a). The effect of a conjoint reading of Clauses (a) and (b) would be that the Government of India decided that for the purpose of calculation of royalty, the Well Head Price will be the market driven price on the basis of the arm's length transactions. Therefore, the contention is that the price, which is a controlled price or rather the post-discount price or in other words, the price at which the respondent assessee had to sell to the OMCs, which was a discounted price, could not be taken as the Well Head Price. Instead, the concept of transaction at arm's length was imported. He would explain it with reference to Section 92(F)(ii), which reads as under:

“[92F. Definitions of certain terms relevant to computation of arm's length price, etc.— In Sections 92, 92A, 92B, 92C, 92D and 92E, unless the context otherwise requires--

- (i) ...
- (ii) “arm's length price” means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions;”

15. No doubt, the said definition is actually meant for the sections, which are mentioned therein; but generally, as a concept, price at arm's length would appear to mean the description of an agreement made by two parties freely and independently of each other. In other words, Well Head Price for the purpose of calculating the royalty has been understood to mean by the Government of India, which is the Authority to

administer the central legislation namely The Oilfields (Regulation and Development) Act, 1948 that it should be the price at which it is sold or capable of being sold at arm's length. We do not find any acceptable response to contradict this understanding of the transaction at arm's length. We can safely proceed on the basis that the Well Head Price would be the price as provided for in the resolution and valid for the year in question. If that be so, the Well Head Price cannot be the price, at which the respondent assessee has sold the crude oil to the OMCs, which is the discounted price. If we were to look at the situation in the context of the notification read with the resolution read with the communication, which we have adverted to, the Government of India intended as we have already found, on the one hand, that the oil should be sold by the oil producers to the oil marketing companies at a discount, which is intended to pass on to the consumers and, at the same time, preserve the revenue of the State Governments by way of royalty. If this interpretation is accepted, we would come to inevitable conclusion that the argument of the learned counsel for the appellant that there is a breach of Section 6A may not hold good, as the royalty is reckoned with reference to the international price, at which, the crude oil could have been sold, but for the injunction from the Government of India, and it would not exceed 20%. Therefore, in the facts situation obtaining in this case, we are of the view that the case set up by the Revenue that it is a case, which involves violation of the mandate of Section 37 in its explanation may not hold

good. In this context, we would think that Section 6A may not be read in isolation; instead, we must also view it in the context of the notification read with resolution read with communication. Certainly, we cannot liken it to hafta or extortion money, which appears to have been the intention. It is very fairly conceded by the learned counsel for the Revenue, there is no question of any offence being committed. In fact, the respondents were only faithfully abiding by the decision of the Government of India.

16. In the circumstances of this case, we are therefore of the view that the amounts, which were paid, would not incur the opprobrium of being in violation of Section 37. There is no dispute that all the other ingredients required to sanction the expenditure as expenditure under Section 37 are present.

17. The upshot of the above discussion is that the appeals are found to be without merit in view of the fact that we answer the second question of law also against the Revenue. The appeals will stand dismissed. No order as to costs.

(V.K. Bist, J.) (K.M. Joseph, C.J.)

21.05.2015

Arpan