CMA Pradeep Kumar Chand
General Manager & Head of Internal Audit
Brahmaputra Cracker & Polymer Limited

A CRITICAL STUDY ON IMPACT ANALYSIS OF KEY INDIRECT TAX ISSUES - PRE & POST GOODS & SERVICE TAX (GST) REGIME ON BUSINESS OF OIL & GAS SECTOR

Preface

Introduction of GST on July 1st, 2017 was the biggest tax reform in India. GST is applicable on almost all goods and services. The Central Goods and Services Tax Act, 2017, Section 9(2) keeps above goods out of purview of GST regime and provides that, tax on the supply of the said goods shall be levied with effect from such date as may be notified by the Government with consultation of GST Council. Goods have been outside the purview of GST; Petroleum Crude; High Speed Diesel Oil; Motor Spirit; Natural gas; Aviation Turbine Fuel. Even though the major petroleum products (including crude oil, white petroleum (motor spirit, aviation turbine fuel), diesel and natural gas) have been kept out of GST cover, some other products such as LPG, fuel oil, kerosene, naphtha are included. The industry has to follow Hybrid System for both previous VAT as well as GST regime. The excluded petroleum products will continue to be taxed under the value added tax (VAT) and excise duty. There are some direct and indirect impacts of the GST on oil and gas sector.

Natural gas has emerged as the most benign fuel and it plays an important role in driving the economic growth of a country. Being cleanest of all fossil fuels, efficient, and relatively economical, it fulfils the requirements for fuel in today's industrial society. The sector has however, been facing enormous challenges over the last few years in India on the indirect tax fronts in terms of levy of multiple taxes, interpretation issues, unfavorable credit structure adding to the overall tax cost.

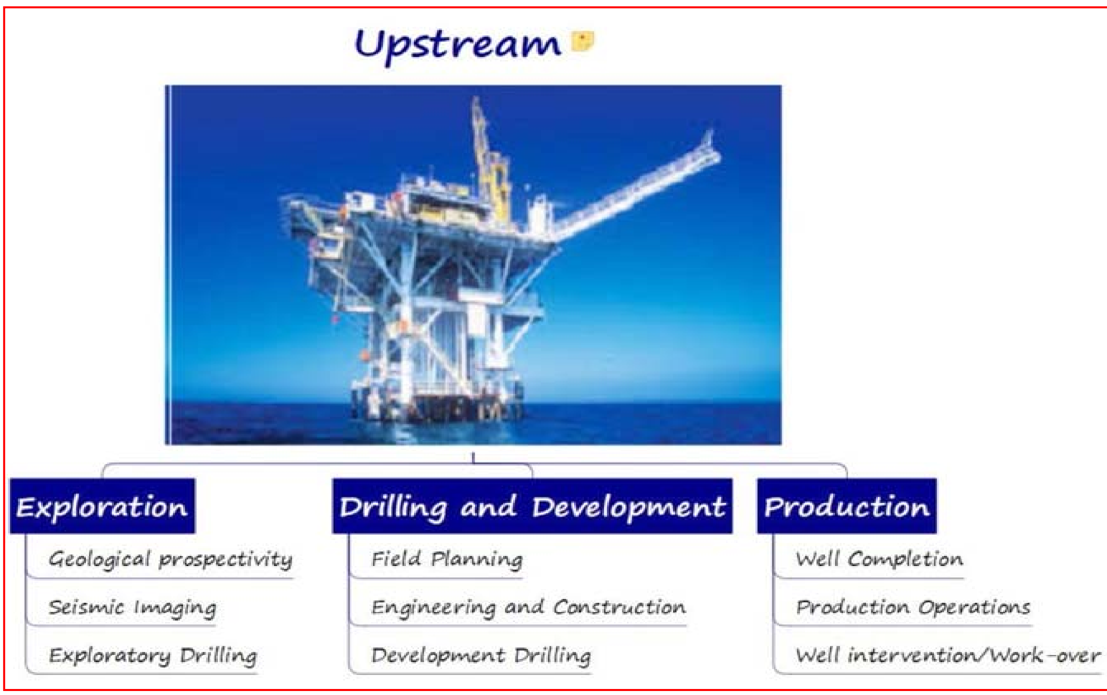
This analysis encapsulates the key indirect tax issues including the possible issues that are likely to arise under the proposed inclusion of certain petroleum products under GST regime.

Analysis of Oil & Gas sector:

Typical Structure of OIL& GAS companies:

VALUE CHAIN- a glimpse of the various activities starting from:-Identifying and assessing Oil & Gas reserves to extraction of hydrocarbons, and the eventual Selling of refined derivative products to consumers.

The three facets of the Value Chain are:-



Midstream Oil and Gas Sector

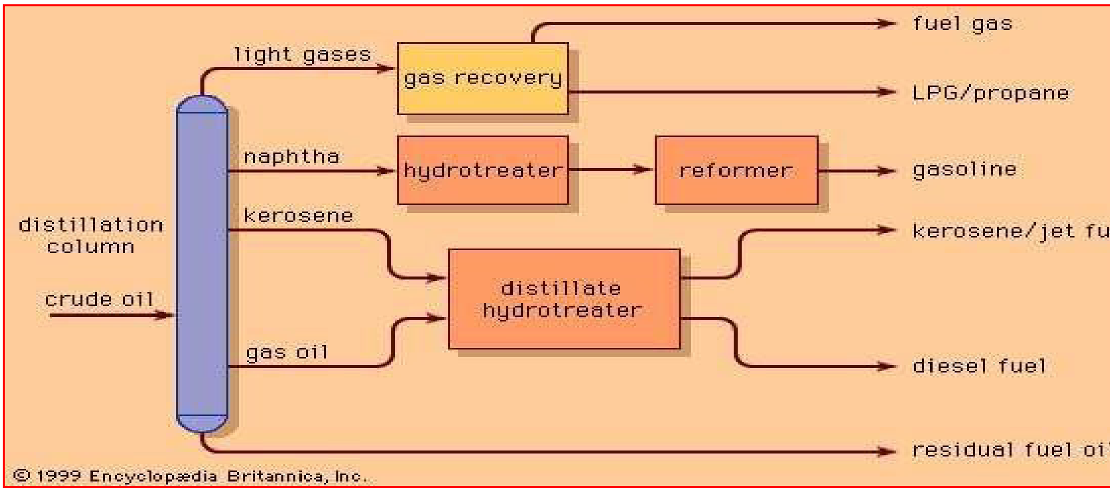
The midstream sector covers transportation, storage, and trading of crude oil, natural gas, and refined products. In its unrefined state, crude oil is transported by two primary modes: tankers, which travel interregional water routes, and pipelines, through which most of the oil moves through for at least part of the route. Once the oil has been extracted and separated from natural gas, pipelines transport the products to another carrier or directly to a refinery. Petroleum products then travel from the refinery to market by tanker, truck, railroad car, or more pipelines.

Downstream: Refining and Marketing

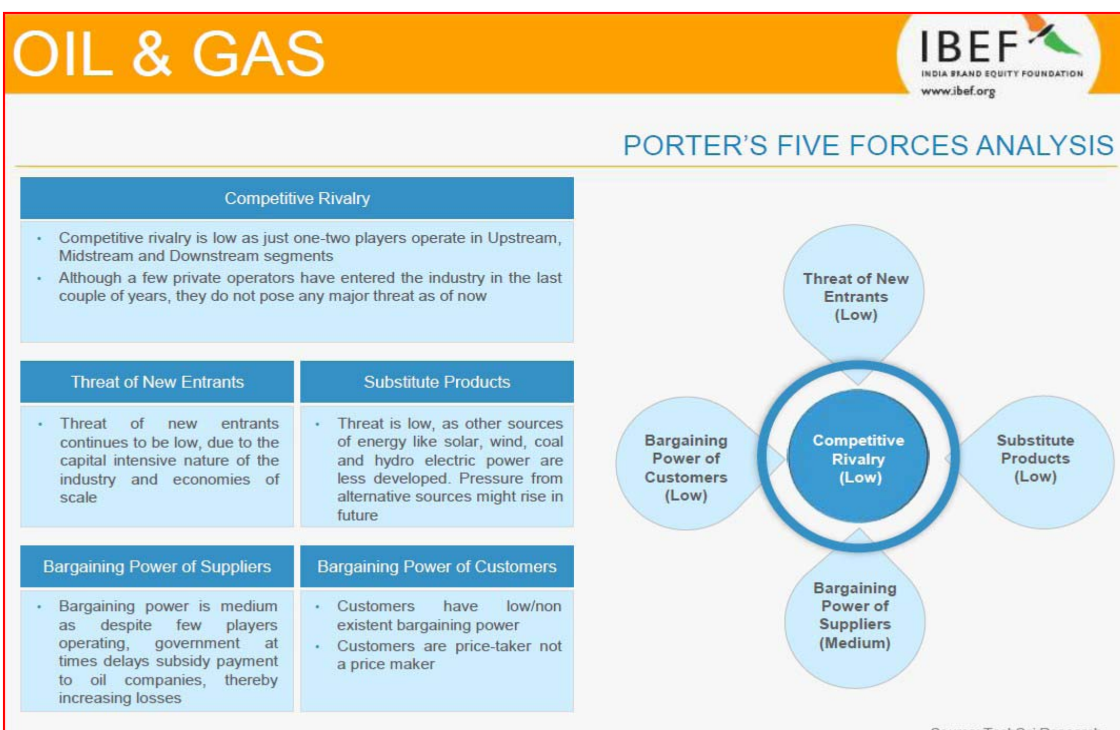
While refining is a complex process, the goal is straight forward: to take crude oil, which is virtually unusable in its natural state, and transform it into petroleum products used for a variety of purposes such as heating homes, fueling vehicles and making petrochemical plastics.

Marketing is the wholesale and retail distribution of refined petroleum products to business, industry, government, and public consumers. Generally crude oil and petroleum products flow to the markets that provide the highest value to the supplier, which usually means the nearest market first because of lower transportation cost and higher net revenue for the supplier.

Key downstream sectors include: Oil Refining, Supply and Trading, Product Marketing – Wholesale and Retail. The oil and gas industry has an enormous impact on all aspects of daily life. Individuals, corporations, and national governments make financial and policy decisions based on the cost, use, and availability of these two natural resources.



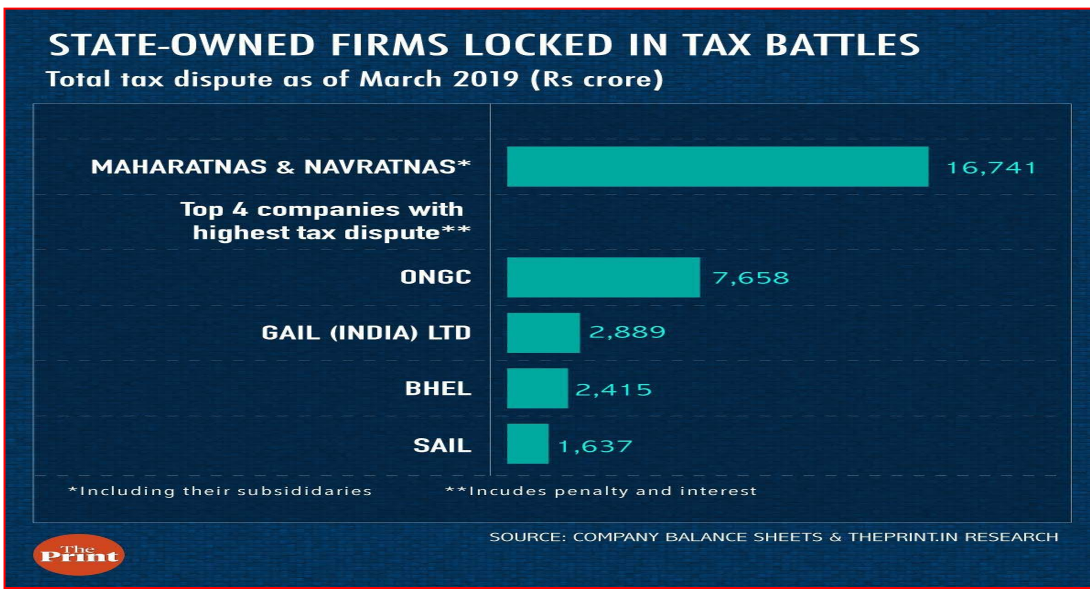
Industry Analysis for Taxation& Business Environment of OIL & Gas Sector by Porter Five Force



So Oil & Gas industry exists in Oligopolistic Market & No competition. So consumption tax plays a pivotal role in influencing the business decision. Oligopoly is created when there are few number of large firms in the industry that explore and Produce somewhat similar commodities of oil and gas and there are many buyers because entering the market is not easily because it is too costly for exploring and producing oil and gas. Oligopolistic Company could take advantage of economies of scale that reduce production costs by reducing average fixed costs and take advantage of high price that is determined by setter who has price power.

Crude oil price fluctuations have become an emerging topic for the entire world. Thus, the crude oil price fluctuation influences not only the oil importing and exporting countries but also the entire world economy in a significant way.

Maharatna & Navratna PSUs are involved in tax disputes worth nearly Rs 17,000 crore. Be it disputes over levy of service tax, or the more recent goods and services tax (GST), or over the levy of income tax, or entry tax imposed by states, the disputes have been dragging on for years in different courts and appellate bodies. GST regime will solve the litigation to a great extent & reduce cost of litigation.



There is a need to study involves a Comprehensive Study of Tax Structure of India with specific role of Oil & Gas Sector as Core Sector impacting the decision other Core & Non-Core Sector on :-

- The impact of taxation on Supply chain with eye on International Pricing for Oil and Gas & way forward on developing the tax strategy to improve Indian Economy by balancing Fiscal deficit of governments
- Harmonization -One Nation – One Tax i.e. it would become uniform across the country.
- Keeping these out of Input Credit Mechanize (Either partially or fully) would have high distortionary Effects.
- Taxing Petroleum Products as per Principle of Taxation and Organization for Economic Co-operation and Development (OECD) international Guidelines on VAT /GST.
- Entire GST law is based upon seamless input tax credit but in practice it is totally diverse scenario for Oil & Gas sector.
- How tax efficiency can be to ease high fuel prices, and how tax policy can be used to respond to disruptions in the Gas & Fuel oil supply chain, such as those caused by Risks arising out of several factors.
- Even if reduction in international prices of fuel does not provide any benefit to buyer yet.

- The tax on petroleum products and corresponding change in prices generates both direct and indirect effects across the sectors. Petroleum products directly enter as an input into a large number of economic activities on both Core (e.g., transportation, electricity generation, fertilizer production) and Non –Core Sector

Key Indirect Tax issues on Oil & Gas sector

A. Service tax on cash calls and reimbursements

Exploration & Production (E&P) activities are generally carried on by Unincorporated Joint Ventures (UJVs), on behalf of all members because of the high stakes involved.

Working of UJVs for E&P activities under the Production Sharing Contracts ('PSC') requires designation of one of the participants as operator. Such operator is responsible for carrying out the operations and incurring expenses based on the approved work plans. He shall then collect/ mobilize funds (referred to as cash calls) from the other members, according to their participating interest in the UJV. The amount so contributed by members towards cash calls is in the nature of financial/capital contribution.

The industry is of the view that Service tax should not be applicable on the aforesaid transactions, as each member including operator is providing service to oneself.

B. Blockage of Service tax paid on Services consumed in E&P Activities

In order to boost the natural gas sector in India, the Government of India has provided for exemptions from customs/ excise duty to specified goods, used for E&P activities, when imported or purchased from indigenous manufacturers. However, services consumed by such E&P entities are subjected to service tax. Production of natural gas is not liable to Excise duty under the Central Excise Act, 1944. Thus, service tax paid on services consumed by E&P entities is not allowed to be claimed as credit/ refund. Hence, tax so paid becomes a cost adding to the overall tax cost. Introduction of a refund mechanism in respect of such taxes can bring parity and make the E&P tax chain neutral.

C. Customs exemption on import of Liquefied Natural Gas (LNG)

NG is a clean fuel used in many sectors other than power such as fertilizer, city gas distribution (for transport and domestic use), petrochemical, LPG, steel industry etc. Recognizing the shortage of natural gas, the Government has encouraged the import of LNG.In terms of the notification no. 12/ 2012 dated 17th March 2012, customs duty on import of LNG is exempted if the same is supplied to power generating companies. Generally, at the time of importation of LNG, end use of the gas so imported is not known by the importers and thus, availing exemption under the aforesaid notification basis end use becomes a difficulty. Instead, an unconditional and a blanket exemption from customs duty on import of LNG would remove the anomaly in availing the exemption. Further, it would benefit various sectors including the fundamental ones such as fertilizer and steel.

D. Setting up of infrastructure – CENVAT Credit denial

Infrastructural set up i.e. construction of storage tanks, laying of pipelines, etc. is vital for the companies engaged in regasification or transportation of gas. Taxes paid on such construction activities form significant part of project costs. As per CENVAT Credit Rules, 2004 (rules prescribing the credit/ setoff of central taxes paid), credit of inputs and input services used for the construction or execution of works contract of a building or a civil structure; or laying of foundation for support of capital goods is not available.

Further, credit of taxes paid on construction expenses is not allowed to the service providers (e.g. those engaged in regasification/ transportation) contending that such storage tanks/ buildings/ pipelines qualify as civil structures/ immovable property. This leads to substantial increase in already exorbitant cost of operating such business. Further, in certain cases doubts have been raised on the pipe etc. contending the goods were used as an immovable property hence, no credit of taxes paid in relation to such goods should be allowed. The founding principle of CENVAT Credit laws is to provide set off of taxes paid by the manufacturers/ service providers on inputs and capital goods against the taxes payable on output reducing the cascading effect of taxes and taxing the value additions. As storage tanks, pipelines etc. are essentially required to provide services, the non- availability of set offs in respect of duty paid on goods and services used for construction of such structures renders such activities tax inefficient.

E. Value Added Tax and service tax on Sale and Transport of Gas

Transmission charges are collected separately for transmission of gas by the suppliers in addition to sale price of gas. Such suppliers selling and transmitting natural gas to the customers' premises consider the entire transaction as 'sale' transaction and pay sales tax/VAT[3] on the 'total price' including transmission charges. Service Tax was made applicable on the category of 'transportation of goods through pipeline' with effect from 16.06.2005. Thus, disputes by tax authorities have arisen on the applicability of service tax on such transmission charges recovered from the customer along with the sale price of gas.

Payment of VAT and service tax on transmission charges results in double taxation and thus, it has invited huge tax disputes.

F. Inter-state supplies to customers – Liable to VAT or CST

The Central Sales Tax Act, 1956 (CST Act) seeks to levy tax on sale of goods taking place 'inter-state'. As per section 3 of CST Act, 1956, sale or purchase of goods is deemed to be in the course of inter-state trade or commerce if the sale or purchase occasions the movement of goods from one state to another[5]. Here, movement of goods is understood as *physical movement* of goods. Where the supplies qualify as 'inter-state' supply (purchase from outside the state), goods can be purchased at 2% (by resellers and manufactures) as against VAT applicable on local purchases (purchase from within the state) at 5% to 26%.

To illustrate, where gas is supplied from Gujarat to a customer in Uttar Pradesh:

- The transaction qualifying as inter-state sale, would attract CST at the rate of 2% payable to the Gujarat tax authorities

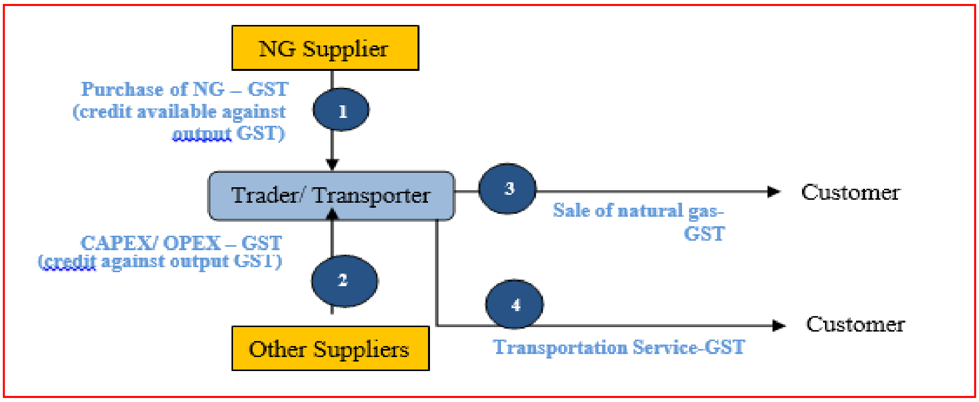
Where the gas is stock transferred (gas is transported in Uttar Pradesh) and then sold to customer in Uttar Pradesh, VAT at the rate of 26% would be applicable in the state of Uttar Pradesh

G. Concessional CST against Form C on goods required for laying of pipeline network

Under the CST Act, concessional rate of tax at 2% is applicable on inter-state sale of goods used for certain specified purposes (resale, use in manufacture/processing or for use in mining, generation of electricity or any other form of power) against issuance of Form C.As the goods required for use in natural gas pipeline network are not covered above, natural gas transmission companies are not able to issue Form C for purchase of goods for construction of pipeline network at concessional tax of 2%. Laying of cross country pipelines including connecting gas source to ultimate consumers is a priority for achieving the energy security of the country. Amendment of the existing CST provisions so as to make the pipeline transmission projects eligible for inter-state procurement of goods against Form C will reduce the project cost and will ultimately benefit the consumers.

Possible scenarios regarding the treatment of natural gas if included under the GST ambit:

There would be free flow of credits for suppliers of natural gas and other products under the proposed GST regime. A typical value chain for a supplier engaged in activities of trading and transmission of natural gas under the scenario is depicted below:



Under this scenario, input GST paid on goods and services (transaction 1 and 2) would be available as credit against the output GST liability on sale and transmission of natural gas (transaction 3 and 4). Thus, there will be no denial of GST paid in the chain resulting in efficiency across the chain. Currently, as excise duty (tax on manufacture of goods in India) is exempted and CST at 2% is applicable on inter-state supplies, assuming natural gas is taxed at standard rates (say at 20% to 22%) like any other product, it is likely to result in increase in tax cost for customers with no ability to claim credit (e.g. power plants). This would require levy of GST at concessional rate, for users who do not have ability to claim credit of GST paid on natural gas (such as power plants) to maintain parity of overall tax burden with current regime.

H. Way forward

Even after extensive discussions over the issue, no final consensus has been reached yet. The final decision regarding inclusion under the GST net is left on the GST Council. The importance of inclusion under the GST regime would need to be conveyed to the stakeholders on the following lines:

- Natural gas, unlike other petroleum products, is used primarily as an industrial input (and not as fuel in vehicles, etc. akin to HSD, Petrol in scale) by power/ fertilizer units, which are all thrust sectors for the economy. As natural gas is predominantly used in industrial sector and is an environmental friendly fuel, it should be considered for inclusion even without including other petroleum goods
- Natural gas does not generate any negative externalities and hence, should not be treated as a demerit product
- Share of contribution of natural gas to state revenue in comparison to contribution of other petroleum goods (such as diesel, petrol, ATF) is not substantial. Some states have already accorded a concessional VAT rate at least for certain users (e.g. domestic supplies). Thus, inclusion of natural gas in the ambit of GST may not have significant effect on the exchequer of the states.
- Internationally natural gas is generally accorded similar treatment as other goods under GST. For the treatment under key economies refer Annexure 1

Annexure 1

Illustrative treatment of natural gas in global economies

S. No.	Particulars	European Union	Australia	Malaysia	Canada
1	Applicability of GST/VAT	Yes	Yes	Yes	Yes
2	Standard/Concessional rate	Standard rate	Standard rate	Standard rate	Standard rate
3	Availability of credit/set off of GST paid by business consumers or traders of natural gas	Available	Available	Available	Available
4	Any other tax applicable	Not applicable	Not applicable	Not applicable	Not applicable

Conclusion:

Even if it is finally decided to exclude natural gas from GST, it should at least be zero-rated with time bound refund mechanism and not exempted which will pave way for achieving Tax Efficiency, Economic Performance, and improve Economy of India as a whole which will enable to become a global leader in Business.