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**Tax & Legal Alert**
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## Court of Appeal ruling on the deductibility of depreciation (capital) allowance at exploration stage in Petroleum industry

*Can depreciation allowances be claimed before a petroleum project begins commercial production?*

A recent Court of Appeal decision clarifies the deductibility of exploration and development expenditure during the pre-production stage.

This communication highlights the key issues arising from the decision and our analysis of the same.

## Overview of the case

On 23 September 2026, the Court of Appeal of Tanzania delivered its decision in **Commissioner General, Tanzania Revenue Authority v Beach Petroleum (Tanzania) Limited**, **Civil Appeal No. 08A of 2025, [2026] TZCA 1179.**

The case involved an appeal by the Commissioner General, Tanzania Revenue Authority ("**TRA**"), against the respondent, Beach Petroleum (Tanzania) Limited ("**Beach Petroleum**")

Beach Petroleum is a company engaged in petroleum and gas exploration under a Production Sharing Agreement ("**PSA**") entered into with the Government of Tanzania.

The dispute is centred on whether Beach Petroleum was entitled to claim depreciation allowances on exploration and development expenditure incurred while its petroleum project was still at the pre-production stage in accordance with section 17 read together with paragraph 1(3) of the third schedule of the Income Tax Act, 2004 ("ITA 2004").

## Facts

The TRA conducted a tax audit covering the years of income 2014 to 2016. Upon reviewing Beach Petroleum's tax return for the year of income 2015, the TRA noted that the Company had claimed depreciation allowances relating to exploration expenditure.

The TRA disallowed the depreciation allowance claimed on the basis that the project was still at the pre-production stage and the relevant assets had not yet been used in producing income as required under section 17 of the ITA.

Consequently, the TRA issued an assessment, and an agency notice for an adjusted amount of **TZS 6,403,621,783.90**, comprising principal tax of **TZS 5,249,775,600** and interest of **TZS 1,153,846,183.90**.

## TRA Arguments

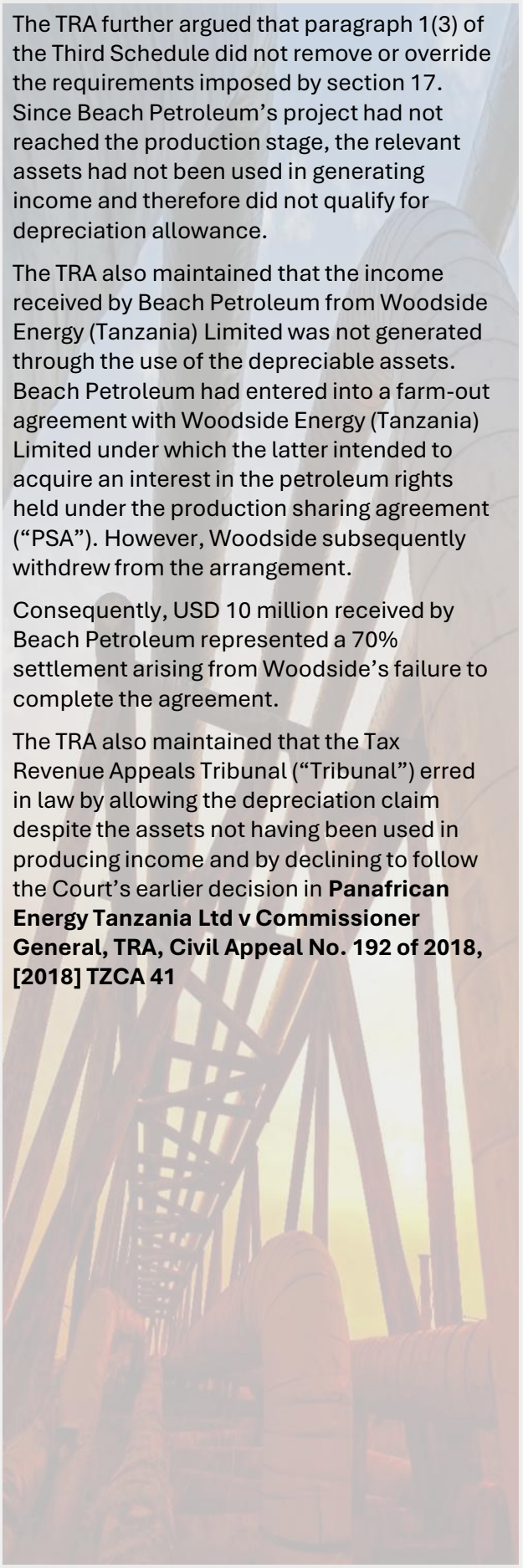
The TRA argued that a depreciation allowance is available only where the conditions under section 17 of the ITA are satisfied. In particular, the relevant asset must be ***owned*** by the taxpayer and ***used in producing income during the relevant year of income***.

The TRA further argued that paragraph 1(3) of the Third Schedule did not remove or override the requirements imposed by section 17. Since Beach Petroleum's project had not reached the production stage, the relevant assets had not been used in generating income and therefore did not qualify for depreciation allowance.

The TRA also maintained that the income received by Beach Petroleum from Woodside Energy (Tanzania) Limited was not generated through the use of the depreciable assets. Beach Petroleum had entered into a farm-out agreement with Woodside Energy (Tanzania) Limited under which the latter intended to acquire an interest in the petroleum rights held under the production sharing agreement ("PSA"). However, Woodside subsequently withdrew from the arrangement.

Consequently, USD 10 million received by Beach Petroleum represented a 70% settlement arising from Woodside's failure to complete the agreement.

The TRA also maintained that the Tax Revenue Appeals Tribunal ("Tribunal") erred in law by allowing the depreciation claim despite the assets not having been used in producing income and by declining to follow the Court's earlier decision in **Panafrican Energy Tanzania Ltd v Commissioner General, TRA, Civil Appeal No. 192 of 2018, [2018] TZCA 41**



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## Beach Petroleum's arguments

Beach Petroleum's argument was that the petroleum exploration and development activities require significant upfront investment before production commences.

The Company maintained that under paragraph 1(3) of the Third Schedule to the ITA, qualifying exploration and development expenditure was deemed to have been incurred in acquiring assets used in the production of income.

The Company further argued that section 17 of the ITA, which provides for the deduction of depreciation allowances, should not be interpreted in isolation. Rather, it should be read together with paragraph 1(3) of the Third Schedule.

Beach Petroleum's position was that despite the project being at the pre-production stage, the Company had earned taxable income, including an amount received from Woodside Energy (Tanzania) Limited under a farm-out arrangement.

On that basis, Beach Petroleum maintained that it was entitled to the depreciation allowances claimed.

## Court of Appeal's judgement

The Court made the following key findings:

1) Section 17 of the ITA imposes two principal requirements that must be satisfied before a depreciation allowance can be deducted. The relevant asset must be owned by the taxpayer and used in the production of income.
2) Paragraph 1(3) of the Third Schedule does not create an exception to the requirements under section 17. Instead, it treats qualifying exploration and development expenditure as expenditure incurred in acquiring an asset. This allows capital expenditure incurred in the extractive industry to fall within the depreciation regime.
3) The Tribunal erred in interpreting paragraph 1(3) as allowing depreciation even where the relevant asset had not been used in producing income
4) The Court relied on its earlier decision in Panafrican Energy Tanzania Ltd v Commissioner General, TRA, Civil Appeal No. 192 of 2018, [2018] TZCA 41, in which it held that depreciation allowance can be claimed only where the relevant asset is owned and used in producing income

## The Court of Appeal's decision

Based on the above findings, the Court allowed TRA's appeal and reversed the Tribunal's decision. The Court held that Beach Petroleum was not entitled to the depreciation allowances claimed because the relevant assets had not yet been used in the production of income. TRA was therefore justified in disallowing the depreciation claim

Consequently, TRA was entitled to recover the adjusted amount of **TZS 6,403,621,783.90**, including interest of **TZS 1,153,846,183.90**. The Court also ordered Beach Petroleum to bear the costs of the appeal



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## Analysis of the decision and implication to the taxpayers

### Position prior to the changes introduced by the Finance Act, 2016

For petroleum companies operating under the provisions applicable before 1 July 2016, the decision means that incurring qualifying exploration and development expenditure was not, by itself, sufficient to claim a depreciation allowance. Although paragraph 1(3) of the Third Schedule treated such expenditure as expenditure incurred in acquiring an asset, the requirements under section 17 still had to be satisfied. In particular, the relevant asset had to be owned by the taxpayer and used in producing income.

Accordingly, companies at the pre-production stage could not claim depreciation allowances despite incurring substantial exploration and development expenditure. The allowance remained unavailable for as long as the relevant assets had not been used in producing income.

The Court noted that the purpose of paragraph 1(3) was to facilitate the recovery of capital investment in the extractive industry through the immediate deduction of depreciation allowances. At the same time, the Court clarified that the paragraph did not dispense with the requirement under section 17 that the relevant asset must be used in producing income.

Considering that prior to 2016 there were not specific provisions for mining and petroleum, the decision would apply to the whole of the extractive industry. Thus, this position gives rise to practical questions regarding the operation of the former framework.

Exploration and development expenditure is ordinarily incurred before commercial production begins, when a mining or petroleum company may not yet be capable of generating production income from the relevant assets. It is therefore reasonable to consider when and how the intended recovery of that capital investment would occur where the depreciation allowance remained unavailable during the pre-production stage.

Further, an important practical question remains unanswered. The Court of Appeal's interpretation of section 17, particularly its linkage of the depreciation deduction to the actual production of income, may give rise to unintended consequences and potentially open a Pandora's box.

This concern arises because the general rule on the deductibility of expenditure under section 11 of the Income Tax Act (ITA) employs similar wording, requiring that an expense be incurred wholly and exclusively in the production of income. Indeed, section 17 is derived from the principles embodied in section 11. While section 11 sets out the general framework for deductible expenditures and excludes capital expenditure, section 17 operates as a specific provision that grants depreciation allowances in respect of capital expenditure.

If the Court of Appeal's interpretation is applied broadly, it raises a significant question: does it mean that a company which has not yet commenced income-generating operations would be denied deductions for expenses incurred during the relevant year of income? More fundamentally, what constitutes the "production of income" for purposes of the ITA? How should the provision apply during the initial stages of an investment, when a taxpayer may incur substantial operating and capital expenditures in preparation for future income generation?

In our view, this could not have been the intended interpretation of section 17. Extending such an interpretation beyond depreciation allowances could potentially lead to the denial of legitimate deductions merely because a taxpayer has not yet begun generating income. For context, income under ITA is defined under section 4 of the ITA to mean among other a total income of a person for the year of income.

Section 5 of the ITA further defines a total income of a person to mean a sum of the person’s chargeable income for the year of income from each employment, business and investment. Section 8(1) of the ITA provides that a person’s income from a business for a year of income is the person’s gains or profits from conducting the business for the year of income. Gains or profits are not defined under the ITA.

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> ***"Production of the person's income as used in section 17 of the ITA does not mean generation of revenue.***
>
> ***A person's income from a business for a year of income is the person's gains or profits from conducting the business"***

However, from the general definition, gains or profits are derived once expenses incurred in generating the gain has been deducted from the revenue.

Therefore, from the above the wording used under section 17 "production of the person's income" does not mean generation of revenue. The fact that an expense does not immediately generate revenue does not imply income is not being sought, incurring expense with intent to produce revenue should satisfy this test.

Consequently, denying these deductions would be inconsistent with the commercial realities of business start-up and investment phases, where expenditures are necessarily incurred in anticipation of future income (i.e. gains or profits) rather than in the course of producing income that already exists.

### Position following the changes introduced by the Finance Act, 2016

The Finance Act, 2016 introduced specific provisions applicable to mining and petroleum operations.

The amendments introduced Divisions 4 (for minerals) and 5 (for petroleum) under part V of the ITA and corresponding amendments to the Third Schedule.

The legislative amendments introduced a separate depreciation pool for qualifying expenditure incurred in respect of mineral and petroleum operations. Under the revised framework, depreciation allowances are granted at a rate of 20% per annum over five years, commencing in the year in which the qualifying expenditure is incurred. The computation of depreciation allowances for mining and petroleum operations, together with the definition of depreciation allowance expenditure, is set out in paragraph 5 of the Third Schedule to the Income Tax Act (ITA).

Notably, the definition of depreciation allowance expenditure under paragraph 5 differs slightly from the wording of section 17 of the ITA. Under the revised framework, depreciation allowances are granted in respect of qualifying expenditure incurred, without any express requirement that the underlying asset must be employed in the production of income. Instead, the expenditure qualifies for the allowance provided that the relevant asset is owned and employed wholly and exclusively in mineral or petroleum operations.

In the case of mining operations, section 70(2)(a) of the ITA expressly excludes the application of section 17 when calculating income from a separate mining operation. Consequently, the Court of Appeal's interpretation of section 17 would not apply to taxpayers engaged in mining activities. The position for petroleum operations is less straightforward. Unlike section 70, section 79 of the ITA, which governs deductions for petroleum operations, does not expressly exclude the application of section 17.

The amendments therefore provide greater clarity regarding the timing of depreciation allowances for mineral and petroleum expenditure. By linking the allowance to the year in which the qualifying expenditure is incurred, the revised framework better reflects the operational realities of the extractive industry, where substantial exploration and development expenditure is often incurred several years before commercial production commences. This approach recognises that significant capital investment is a necessary precursor to future income generation and avoids tying the availability of depreciation allowances solely to the commencement of production or the actual derivation of income.

> **"The Finance Act, 2016 introduced separate rules granting 20% annual depreciation over five years from qualifying expenditure incurrence.**

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## Conclusion and key takeaways

Although the post-2016 framework provides greater clarity on qualifying mineral and petroleum expenditure, this judgement raises a critical and broader question regarding the general deductibility of expenses including depreciation allowance incurred when a business fails to generate income in a given year.

This challenge is not unique to the extractive sector. The same may occur when businesses that ordinarily generate income face exceptional external disruptions. A prime post-2016 example is the impact of the COVID-19 pandemic on the tourism sector. During this period, operators faced significant challenges regarding deducting allowance on capital assets such as tour vehicles, which were forced to remain temporarily idle due to global travel restrictions. It is important to note that, even under such situation, these businesses continued to incur ongoing maintenance, insurance and regulatory expenses to ensure the vehicles remained in good working condition, ready to deploy the moment operations could resume.

The relevant question is whether the absence of income during the year should, by itself, prevent the deduction of expenditure necessarily incurred in connection with the business. Further, it should not be confused that the wording “income” as used in the ITA means revenue. We have analysed above the meaning of income and for business is gains or profits.

The requirement that expenditure must be incurred wholly and exclusively in the production of business income should not necessarily be interpreted as requiring the taxpayer to generate income (profit) in the same year in which the expenditure is incurred or rather revenue. This therefore calls for a broader discussion, and perhaps a legislative amendment to provide clarity and certainty for taxpayers.



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