Cristal 'total solutions'

Cristal Advocates

CAPITAL GAINS TAX

Taxation of Capital Gains

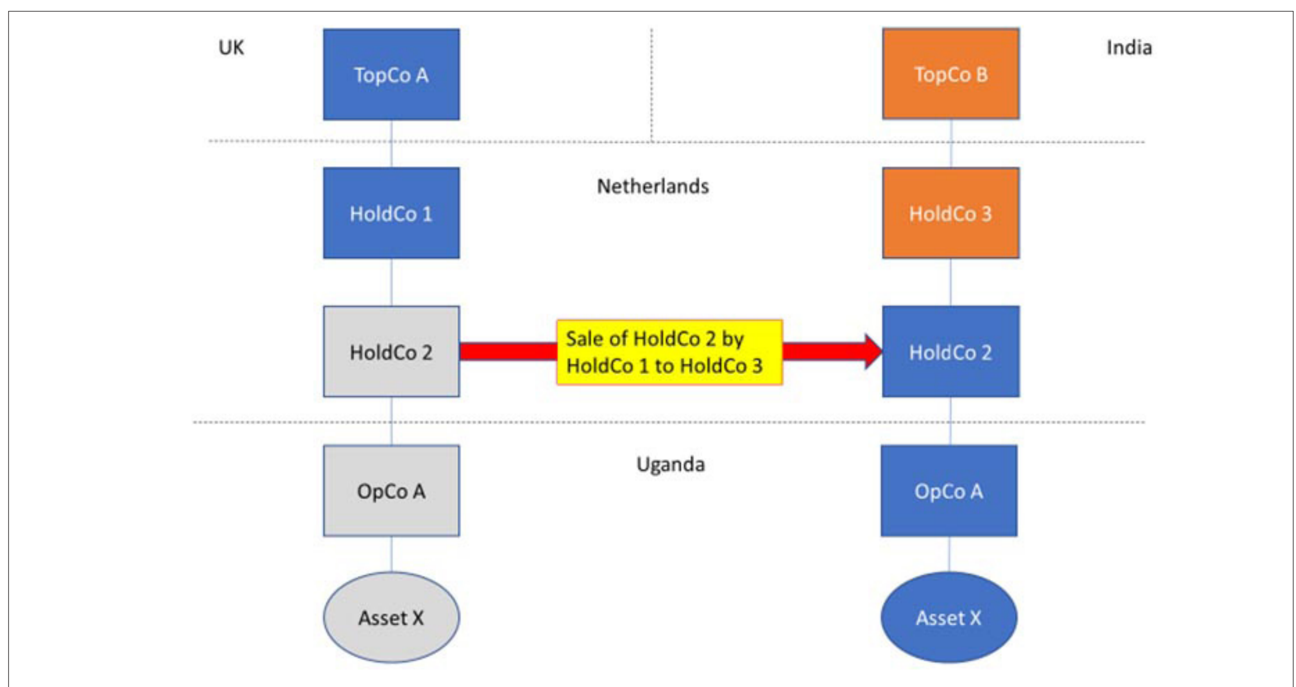
The Case of Indirect Disposals

1. Background

Over the last ten years an increasing amount of tax authorities' attention in many countries has focused on how capital gains should be taxed in the case of transactions involving multiple jurisdictions and indirect disposals of valuable assets with significant latent gains.

To understand the issue, it is helpful to consider the following structure where Asset X is a valuable asset located in Uganda, for example a mine, an interest in an oil field or a telecoms licence. Initially Asset X is controlled by TopCo A, which is a UK company, via a chain of subsidiaries: HoldCo 1 and 2, in the Netherlands, which have no other valuable assets, and OpCo A in Uganda.

In due course, TopCo A decides to refocus its business on different markets and Asset X is put up for sale. An Indian company, TopCo B makes an offer which is accepted. The parties determine that instead of Asset X itself being sold directly to the TopCo B group, a new intermediate holding company, HoldCo 3 will be established in the Netherlands to acquire the shares of HoldCo 2. Under this transaction structure there will be no disposal of Asset X itself, but instead HoldCo 2 will be sold. The direct ownership of Asset X and OpCo A will not change as a result of this transaction, but clearly the underlying ownership has shifted from TopCo A to TopCo B. Any gain arising from the transaction will crystallise in the hands of HoldCo 1 which is a Netherlands resident taxpayer.



Until recent changes in Uganda's tax laws, Uganda's ability to tax a gain arising on such a transaction was unclear. Other jurisdictions have faced similar issues in asserting their rights to tax gains which derive from assets in their territory even though the related sale transaction takes place in another jurisdiction. This issue has attracted the attention of the Platform for Collaboration on Tax (the Platform), which is a joint initiative of the UN, OECD, World Bank and IMF to assist developing countries in combatting aggressive tax planning (known as 'BEPS' – base erosion and profit shifting) by multinationals. The Platform has issued a toolkit, currently still in draft, providing guidance for fiscal policy makers on the issue (see www.oecd.org/tax/taxation-of-offshore-indirect-transfers.htm).

2. Two approaches

As a result of the attention focusing on the issue, two different approaches have been suggested by the Platform for countries wishing to strengthen their taxing rights. These can be characterised as the source approach and the deemed disposal approach. (It should be noted that the approaches are not mutually exclusive: some jurisdictions, including Uganda, have adopted elements of both.)

Under the source approach, the definition of domestic source income is expanded to include gains on disposals of shares which derive value from domestic assets. Kenya took this approach introducing legislation with effect from 1 January 2015 which extends the definition of Kenyan source income to include gains on shares deriving their value from immovable property situated in Kenya. For these purposes the definition of immovable property is confined to mining and petroleum exploration and exploitation rights. The source rule is not triggered unless at least 20% of the value of the shares derives from such property. Where a taxable gain arises on a share which derives more than 50% of its value from immovable property, the whole gain is taxed. In other cases, the taxable portion of a gain is determined by applying the following formula:

$$\text{Taxable amount} = \text{Total gain} \times \frac{\text{Value of Kenyan immovable property}}{\text{Value of all assets}}$$

In principle, a gain would be taxed in the case of a sale of a single share, but in practice only changes of 10% or more of the underlying ownership of the direct owner of immovable property in Kenya must be reported to the Kenya Revenue Authority. The direct owner of the immovable property is also responsible for payment of any tax due.

Applying the source approach to the example above and assuming that Asset X is immovable property, the gain realised by HoldCo 1 would be domestic source income and OpCo A would be liable to report the change in underlying ownership and pay the tax due.

Under the deemed disposal approach, the tax liability is triggered in the direct owner of the valuable asset by deeming it to sell the asset at market value, and immediately reacquire it at the same value, thus crystalizing the latent gain for domestic tax purposes. Tanzania took this approach in legislation introduced in 2012 which triggers such a deemed disposal when the underlying ownership of a company or branch changes by more than 50% in a 3-year period. As soon as the trigger applies an income tax accounting period ends and the taxpayer is treated as disposing of all its assets and liabilities at market value crystalizing latent gains and losses and must pay tax on any gains calculated under normal computation rules. Assets and liabilities are then deemed to be reacquired at those same values, so that there is a step-up (or down) in the tax basis.

Applying the deemed disposal approach to the above example, OpCo A would be deemed to realise all its assets and liabilities, including Asset X, at market value and pay the resulting tax to the tax authorities.

3. Some problems

There has been widespread criticism of tax-planning by multi-nationals in recent years: some justified, some less so. The legislative approaches outlined above are at best crude approaches to a problem that seems to require a more nuanced solution. For example, the source approach adopted by Kenya potentially taxes gains which don't relate to Kenyan assets, because all gains are subject to tax if more than half the value of the shares derives from Kenya; gains may also be subject to tax in the jurisdiction where the seller is tax resident, so there is potential double taxation. At the same time, Kenya's exclusive focus on mining, oil and gas assets excludes other valuable asset classes such as telecoms licences. The deemed disposal legislation adopted by Tanzania taxes 100% of latent gains on any type of asset (and liability), even if only 51% of the underlying ownership changes, and the actual asset owner itself realises no gains and therefore has no cash with which to settle a potentially significant tax liability. Both approaches potentially give rise to complex valuation issues: in the case of Kenya these arise in determining the proportion of Kenyan assets; in the Tanzanian case the disposal values themselves require evaluation. Both approaches potentially trigger tax in the case of stock exchange transactions such as mergers, which are not undertaken with the intention of avoiding tax.

4. Uganda's legislation

With a history of well-publicised cases involving the taxation of gains on both direct and indirect asset disposals, it is not surprising that Uganda has elected to take a 'belt and braces' approach incorporating both the source and deemed disposal rules into its legislation.

The source approach is set out in section 79(g) of the Income Tax Act which includes in the definition of Uganda source income gains derived from a disposal of immovable property located in Uganda or derived from the disposal of a share in a company the property of which consist directly or indirectly principally of an interest or interests in such immovable property, where the interest or share is a business asset. The definition of 'immovable property' adopted is much wider than that in Kenya's legislation including not only mining and petroleum rights but also intangible business assets or any part of a business. The word 'principally' has not been defined in the legislation, which gives rise to uncertainty.

A significant proportion of foreign direct investment in Uganda has been structured using intermediate holding companies resident in the Netherlands. The Netherlands tax treaty restricts Uganda's taxing rights in respect of share sales by a Netherlands resident, so Uganda introduced legislation in 2018 based closely on the deemed disposal approach as applied by Tanzania. A taxpayer which undergoes a change in underlying ownership of 50% or more in a 3-year period is required to treat all its assets and liabilities as disposed of (and immediately reacquired) at market value on the date of the change, crystallising gains (and losses) for tax purposes. There is no provision explicitly precluding both the source and deemed disposal approaches from applying to the same transaction, so double economic taxation is clearly a risk. There is also nothing to reduce the tax on a deemed disposal in case of a change in underlying ownership of less than 100% which makes the tax punitive in its effect.

5. Conclusion

Capital markets function best when tax is applied to real income and gains at realistic levels. Using tax to punish all multinationals for perceived 'bad behaviour' by a few is not a sensible long-term fiscal policy for any government which relies on the free market. Globally, a number of large and controversial transactions have focused fiscal policy-makers on the issue of taxing indirect disposals. The legislative solutions have taken a sweeping approach, risking double taxation of the same gains, taxing gains where none have arisen and applying disproportionate levels of taxation in the case of part disposals. Levels of taxation on certain transactions have become punitive and the impact on normal commercial operations could become a significant impediment to economic growth. It is to be hoped that a more nuanced approach will be adopted in the future.

On balance the source approach seems more logical as it taxes real, rather than deemed transactions, providing a basis for the seller to claim relief from double taxation where this is provided by a tax treaty or domestic tax laws where it is resident. It would seem reasonable, however, to tax only that proportion of the gain which relates to domestic assets, instead of the punitive approach of taxing all the gains where the value attributable to domestic assets exceeds 50%. There is also a case for exemption in the case of transactions which do not have a clear tax avoidance motive, such as transactions involving shares which are publicly listed and traded.

Cristal Advocates accepts no responsibility for any loss occasioned to any person acting or refraining from acting as a result of material contained in this publication. Further advice should be taken before relying on the contents of this publication.

Contacts for this Publication

Denis Yekoyasi Kakembo
dkakembo@cristaladvocates.com
+256 751 834 168

Denis is the Managing Partner at Cristal Advocates where he also leads the energy and tax practice. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates, he had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

He holds a Master of Laws degree in Petroleum Taxation and Finance from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

Bill Page
bpage@cristaladvocates.com
+44 7823 52 13 60

Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

Bill is a graduate of Oxford University and completed his inspectors' training with the UK Inland Revenue in 1989. ■

John Teira
jteira@cristaladvocates.com
+256 704 493 997

John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

He holds a Bachelor of Laws degree from Makerere University and a Post Graduate Diploma in Legal Practice from the Law Development Centre and various other qualifications. ■

Dickens Asiimwe Katta
dasiimwe@cristaladvocates.com
+256 772 370 021

Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

Francis Tumwesige Ateenyi
ftumwesige@cristaladvocates.com
+256 702 540 936

Francis leads the litigation and dispute resolution practice at the firm. He is an Advocate of the High Court of Uganda with expertise in oil and gas, infrastructure and dispute resolution. He has been part of teams advising on projects in Uganda, Tanzania, Mozambique and South Africa. He specializes in regulatory compliance, national content, health and safety and dispute resolution.

He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

He holds a Master of Laws degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom and various other qualifications. ■

- Energy & Infrastructure
- Business support
- Employment
- Banking & Finance
- School of Professional Excellence
- Tax
- Company Secretarial & Trustee Services
- Public Law & Policy Advocacy
- Dispute Resolution
- Corporate and Commercial

Contact us

Cristal Advocates
32 Lumumba Avenue
4th Floor, Padre Pio House
Lumumba Avenue

P.O. Box 1769 Kampala, Uganda
Tel: +256 (414) 671 274
Email; admin@cristaladvocates.com
www.cristaladvocates.com